Study H-820 June 26, 2001

First Supplement to Memorandum 2001-52

Mechanic's Liens: Double Payment Issue (Commentary)

This supplement forwards some comments we have received on the staff draft tentative recommendation on *The Double Payment Problem in Home Improvement Contracts*, which is attached to Memorandum 2001-52. The following comments are attached:

Bonding

In a letter responding to earlier materials, George Peate of the Surety Company of the Pacific states that "it would be somewhat impractical for a surety company to be underwriting, issuing and tracking individual payment bonds for every homeowner project undertaken by all of its home improvement contractors." (See Exhibit p. 1.) He believes that annual blanket payment bonds would be feasible and would streamline paperwork and transactions.

Sam Abdulaziz reminds us that "a large surety company testified that they would issue such bonds," referring to the 50% payment bonds. (See Exhibit p. 4.) Several others have expressed the view that the surety industry will meet the demands of this type of scheme.

As noted in the main memorandum, it will be crucial to the draft proposal that surety companies can handle the demand for the 50% payment bonds that would be mandated for home improvement contracts over $5,000. (See Memorandum 2001-52, pp. 7-8.) We have gravitated to the 50% bond, based on the contract price in the particular home improvement project, because it is derived from the existing procedure in Civil Code Section 3235, and because it is easy to describe and to calculate. It would be more difficult to set up a mandatory blanket payment bond, because the correct amounts would have to be determined based on some factor such as past business (with a set base for new entrants) and would have to be reevaluated to make sure that the amount

provided an adequate level protection — both financially and constitutionally — for owners and for claimants.

The staff recommends including a provision in the draft giving the Contractors' State License Board regulatory authority to provide for blanket payment bonds that would be reasonably likely to provide the same degree of protection in each job as the default statutory provision for a 50% contract price payment bond. This dual approach would provide the greatest flexibility, affording small contractors a way to satisfy the statutory rule, while also offering the efficiency of a blanket payment bond described by Mr. Peate.

Post-Breach Notices

Sam Abdulaziz directs our attention to the federal Miller Act, governing federal public works projects, where "post breach notices have worked well." (See Exhibit p. 4.) The staff is researching this suggestion.

Recording

Sam Abdulaziz writes that "work should not start until a recorded bond is issued." (See Exhibit p. 4.) Draft Section 3244.10 provides that the bond is to be recorded "before work commences." (See p. 7 of draft attached to Memorandum 2001-52.) But the staff has some concerns, as discussed in the main memorandum, that this may raise technical issues. What if the bond is not recorded until a few days later? What difference does it make? What is the consequence if there is a technical violation of the statutory rule? In short, we have taken Mr. Abdulaziz's view in the draft statute, but have some concerns about technical issues it raises. The way the draft resolves the issue is by placing the burden on subcontractors and suppliers to determine if the appropriate bond is in place — but we do not require that they make sure the bond was recorded before work commenced. Under the draft, the bond protects claimants regardless of when it was recorded and, contrariwise, claimants work at their potential peril if no bond is ever executed. But they do not lose their protection just because the bond is filed late (or work commences earlier than expected).

Payment in Good Faith

Gordon Hunt has constitutional objections to the draft provision protecting owners to the extent of good faith payments made to the prime contractor. (See Exhibit p. 5.) He also argues that subcontractors and suppliers will automatically file mechanic's lien claims and stop notices as soon as they finish work so they

can defeat the "good faith" claim of the homeowner. He proposes instead that the bonding requirement be enforced by sanctions, such as the automatic suspension of the prime contractor's license by operation of law, for failure to obtain the required bond. (See Exhibit p. 6.) We are not sure what role good faith payment would have in this scheme, since it would not provide any protection from liability for double payment. As we understand Mr. Hunt's argument, mechanic's liens cannot be limited in any way, except where a bond liability is substituted. So if a bond is not in place, regardless of the amount or nature of the contract or the property, the mechanic's lien right must still exist, to avoid offending the constitution. Furthermore, while the Legislature may impose strict filing and notice deadlines on the exercise of the mechanic's lien right, this position holds that the Legislature is powerless to adopt a scheme that substitutes a duty to determine whether a bond is in place for the duty to file notices and that makes the subcontractor's or supplier's mechanic's lien right dependent on the existence of the prime contractor's right.

One might also conclude that once the construction industry became dependent on routinely-filed preliminary 20-day notices, the law was rendered powerless to save them from this largely pointless and wasteful exercise. We had a similar discussion when the optional direct pay proposal was reviewed last year. Maybe service of a premature or unnecessary paper should be grounds for automatic suspension of a subcontractor's license. But that sanction, like the one proposed by Mr. Hunt, would probably be ineffective. The Contractors' State License Law is full of penalties, and yet there are constant complaints, as indicated by bills in the legislature, correspondence to the Commission, newspaper articles, CSLB newsletters and their Sunset Review Report, and no doubt many other sources, all illustrating the failure of sanctions to reform the home improvement marketplace. Failure to pay subcontractors is a license violation now.

In the staff's analysis, the draft statute does not offend the constitution. We don't intend to review that issue here. (See Memorandum 2000-36 on "Mechanic's Liens: Constitutional Issues" (June 2, 2000), and supplements.) But note that the payment in good faith rule was the governing, constitutional system before the "direct lien" was enacted in 1911. The draft does not eliminate liens of parties not in privity with the owner. Their lien and stop notice rights are continued and enforceable. But they are balanced against the right of a homeowner who has already paid in good faith. As coupled with the payment

bond and the easy ability to determine whether the bond is in place, we cannot see a constitutional defect.

Homeowner Commentary

We are beginning to receive some feedback from individual homeowners, as illustrated by Robin and Eileen Taylor's attached email. (See Exhibit p. 3.) This communication reflects the view that subcontractors and suppliers should be expected to take some minimal steps in extending credit. Members of the League of California Homeowners are also expressing support for legislation to protect homeowners and to deal with bad-faith contractors.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

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GEORGE PEATE
VICE PRESIDENT - UNDERWRITING
EXTENSION 270

February 28, 2001

California Law Revision Commission
Attention: Stan Ulrich, Assistant Executive Secretary
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

RE: PROPOSALS CONCERNING MECHANIC'S LIEN REFORM IN THE HOME IMPROVEMENT CONTRACT AREA (STUDY H-820, MEMORANDUM 2001-18)

Dear Mr. Ulrich:

The current study by the California Law Revision Commission of Mechanic's Liens and Home Improvement Contracts has come to our attention. As a bonding company in California specializing in bonds for small to mid-sized contractors, and as the largest writer of California contractor license bonds for two decades, Surety Company of the Pacific would like to comment briefly on the portion of your recent memorandum (2001-18) dealing with payment bonds (pages 15-19). Our comments are offered here not for the purposes of advocating one position or another, but for practical, informational purposes, providing a surety company perspective.

Generally speaking, it would be somewhat impractical for a surety company to be underwriting, issuing and tracking individual payment bonds for every homeowner project undertaken by all of its home improvement contractors. Considerable time and effort could be required in all of these various steps and it is conceivable that forcing such a requirement upon the contractor might even discourage the contractor from undertaking smaller home improvement-type projects. On the other hand, the underwriting and issuance of one blanket-type annual payment bond offers a very practical approach to the matter at hand. The surety would simply underwrite the contractor and issue one bond to cover all of his projects for homeowners. The blanket payment bond would streamline underwriting paperwork and transactions, thereby simplifying the business relationship between the surety and the home improvement contractor.

Admittedly, in those instances where a home improvement contractor might experience financial difficulties, the rather uncomplicated business relationship with the surety can suddenly become very complicated indeed in the event that numerous potential claimants might begin suffering financial damage and contacting the surety in question. But for all those contractors who do not experience disputes or financial problems on their home improvement contracts, the blanket payment bond seems to offer a straightforward solution to the stated concerns of the California Law Revision Commission and others.

Also, it would seem that one blanket payment bond issued on an annual basis would be less costly than numerous individual bonds issued over the course of a year on multiple home improvement projects.

Finally, the concept of having several different levels of bond sizes tied to the contractor's annual sales in past years seems like a reasonable and practical approach. (Perhaps such a blanket payment bond amount could be determined by the Contractors State License Board every two years at license renewal time.)

We hope that the foregoing comments and observations might prove useful to the California Law Revision Commission during the course of its deliberations with respect to this difficult subject. Should you wish to further discuss any of the points raised in this letter, please feel free to contact us.

Sincerely,

George Peate
Senior Vice President-Underwriting

GP/tg

From: "Robin Taylor" <rbtaylor3@hotmail.com>
To: sulrich@clrc.ca.gov
Cc: Lchome@homeowners.org
Subject: Mechanic's Liens
Date: Thu, 21 Jun 2001 08:37:38 -0700

Dear Mr. Ulrich,

I have heard the Calif Law Review Commission is holding a meeting in Sept. to discuss amending the "Mechanic's Lien", at least to the extent that homeowners who pay their bills in good faith to the prime contractor are no longer held responsible for the "bad faith" of that contractor who fail(s) to pay their bills.

I have heard the greatest abuse is roofing contractors who fail to pay their suppliers. This abuse has caused me to put off re-roofing my house for years. I recently joined the League of Calif Homeowners in an attempt to counter this abuse.

Even though subcontractors and material dealers are not interested in performing serious background credit checks before extending credit that are done in other industries, I feel they should have to join the 21st century business community. Good credit should be a requirement in the contruction industry just as it is in all other industries.

Robin Taylor
Eileen Taylor
2201 N Forest
Santa Ana, CA 92706-2428

Date: Wed, 20 Jun 2001 15:16:23 -0700
From: "Abdulaziz & Grossbart" <aglaw@earthlink.net>
To: "Stan Ulrich" <sulrich@clrc.ca.gov>
Cc: goff@hobpr.com

June 20, 2001 SENT VIA E-MAIL ONLY

Stan Ulrich
LAW REVISION COMMISSION

RE: MEMORANDUM 2001-52

Dear Mr. Ulrich:

Thank you for getting the memorandum out so quickly. I commend you for your work. I have not had a chance to review it in any detail, nor have I discussed it with any of my clients. However, I did want to get some preliminary thoughts out to you and the commissioners.

Although I do not believe there is any real problem with the present system, if the gist of your memorandum is used, I suggest that you look at the Federal Miller Act which would indicate that post breach notices have worked well in the federal system.

I truly believe that work should not start until a recorded bond is issued. It is for that reason that I suggest a recorded conformed copy be given to the owner prior to start of work. The contract could state words to the effect that "To protect yourself from mechanic's liens, make sure you have a conformed copy of the mandatory recorded bond."

With respect to the availability of the bond, you will recall that a large surety company testified that they would issue such bonds. I will attempt to have a confirmation of that to you by e-mail.

Thank you for allowing us the opportunity to comment.

Very truly yours,
ABDULAZIZ & GROSSBART

SAM K. ABDULAZIZ
SKA:dak

cc: Gordon Hunt (via e-mail only goff@hobpr.com)

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From: Susan Goff <goff@hobpr.com>
To: "'sulrich@clrc.ca.gov'" <sulrich@clrc.ca.gov>
Subject: Letter from Gordon Hunt
Date: Mon, 25 Jun 2001 09:28:37 -0700

VIA E-MAIL

June 25, 2001

Stan Ulrich
California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

Re: Law Revision Commission
Memorandum 2001-52

Dear Stan:

The following will constitute my comments upon your draft proposal.

AN OWNER WHO PAYS THE PRIME CONTRACTOR IN GOOD FAITH WOULD NOT BE SUBJECT TO FURTHER LIABILITY

The above concept is embodied in your proposed Section 3244.30(a), which states, in effect, that even where a home improvement contract is not bonded, the liability of the owner is limited to the contract price and that payments made to the original contractor, in good faith, discharge the owner's liability to all claimants to the extent of the payments. The net effect of this section is to eliminate lien rights even though the job is not bonded as required under Section 3244.10(a). One the one hand, the proposed statute mandates that home improvement contracts in excess of $5,000.00 must be bonded, but in Section 3244.30(a), even if the job is not bonded, the owner still maintains the full payment defense. The net effect of this is to eliminate lien rights where the owner has paid the contractor in full before the lien claimant has an opportunity to serve a stop notice or record a mechanic's lien. It is my opinion that the foregoing provision will render the statute unconstitutional. If you are going to provide the full payment defense, and require mandatory bonding, then the statute must have a provision that states that where the job is not bonded (circumstances where the owner and contractor either negligently or intentionally failed to comply with Section 3244.10), lien and stop notice rights must not be eliminated even though the contractor has been paid in full.

MECHANIC'S LIENS WOULD APPLY ONLY TO THE EXTENT THAT THE OWNER HAS NOT PAID THE PRIME CONTRACTOR IN GOOD FAITH

The above concept finds it genesis in Section 3244.30(b). Said section provides, in effect, that a payment is not made in "good faith" by the owner to the original contractor, if the owner has received "notice of a claim" from a claimant "by way of a claim of lien or a stop notice". The effect of the foregoing section is that as long as the owner pays the original contractor before the owner receives notice from a claimant that it has recorded a lien or filed a stop notice, the owner will have no liability on account of Mechanic's liens or stop notices. This section, I believe, is likewise unconstitutional for the reasons stated above and in prior memorandums. As a practical matter, if Section 3244.30(b) is enacted you will force the subcontractors and material suppliers to immediately record a mechanic's lien and serve a stop notice when they have completed the furnishing of labor or material on the project. You will create a "rush to judgment" scenario in that the original contractor will be pressing the owner to pay immediately upon completion of the job and the unpaid subs and suppliers will be rushing down to the County Recorder's office to record the liens and serving their stop notices immediately upon the completion of their work. This will create more problems in the industry than it will solve. It will likewise reward the very person who allegedly creates the alleged double payment problem, to-wit, the unscrupulous contractor. The

contractor who decides not to pay the subcontractors and suppliers will encourage the owner to pay the retention immediately upon completion of the job before the subs and suppliers can file their liens and stop notices. It will likewise encourage subs and suppliers to assert their liens and stop notices before money is due pursuant to their contractual arrangement. Subs are not required to be paid until ten (10) days after the owner pays the contractor. The terms of payment of most suppliers is thirty (30) days from the date of their invoice. Please note my comments made above to the effect that where the job is not bonded, lien and stop notice rights must continue.

THE PENALTIES FOR NON-COMPLIANCE WITH THE MANDATORY BONDING REQUIREMENT AS SET FORTH IN THE PROPOSAL ARE INADEQUATE

The only penalty set forth in the statute for failure to bond the job is Section 3244.50. is disciplinary action against the contractor. That is an insufficient penalty. As noted above, if the project is not bonded as mandated by Section 3244.10, then lien and stop notice remedies should remain in tact. In that connection, see my e-mail to you which I forwarded to you on June 15, 2001, and Page 3 which states the following:

"EFFECT OF FAILING TO BOND THE JOB

No matter what we say or do in the Legislation, there will be jobs where the bond is not obtained, either because or ignorance or intentional failure to get the bond either by the owner or the prime contractor. There has to be a penalty in the statute to cover that circumstance. Obviously, the basic penalty in the statute is the fact that where the bond is not obtained, the Legislation should provide that mechanic's lien and stop notice rights will not be impaired in any fashion. It could also be made a grounds for disciplinary action for any original contractor who fails to either notify the owner of the requirement of the bond or fails to obtain the bond on a home improvement contract. The Legislation could be similar to Business & Professions Code §7125.2(a). Said section states that the failure of a licensee to obtain workers compensation insurance required pursuant to the license law shall result in the "automatic suspension of the license by operation of law". Similar statutory provisions could be put into the bonding sections, to-wit, a section that states that the failure of the prime contractor to obtain the bond on a home improvement contract shall result in the automatic suspension of a license by operation of law. This would really put some substantial teeth in the statute."

I hope that the foregoing comments will be helpful to you and the Commissioners when the proposal is discussed on June 29, 2001.

Very truly yours,

HUNT, ORTMANN, BLASCO,
PALFFY & ROSSELL, INC.

Gordon Hunt

GH:slg