Study H-820 November 21, 2001

Memorandum 2001-99

Mechanic's Liens: Double Payment Problem (Comments on Tentative Recommendation)

This memorandum reviews comments we have received on the Commission's Tentative Recommendation on *The Double Payment Problem in Home Improvement Contracts* (September 2001). (Another copy of the tentative recommendation is included for Commissioner reference.)

The following letters and other communications are attached:

(Items 1-26, Exhibit pp. 1-70, were forwarded to Commissioners upon receipt, as requested at the September meeting.)

Overview of Comments

Commentary has been almost uniformly negative, although the reasons vary. James Acret finds that the proposal would "needlessly complicate the mechanics lien statute and, on balance, would do more harm than good." (Exhibit p. 1.) Gordon Hunt concludes that the proposal is "unreasonable, unworkable, unfair and in short, 'a bad idea' that should not be adopted." (Exhibit p. 22.) Norm Widman of Dixieline Lumber gives the Commission credit for attempting to find an equitable solution for all parties, but concludes that the proposal would destroy the lien rights of subcontractors and suppliers. (Exhibit p. 59.) The Building Industry Credit Association opposes the proposal; "the cure is worse than the disease." (Exhibit p. 71.)

Several commentators expressed the concern that the proposal penalizes subcontractors and suppliers (as well as owner), who will suffer the burdens,

incur the costs, and risk nonpayment, when the "bad guys" — the unethical prime contractors — go unpunished and are free to manipulate the system with impunity. (See, e.g., Exhibit pp. 3, 5, 32, 61, 65-66, 70, 73.)

The "Problem"

Many commentators believe there is no problem or if there is a problem it is minor or that there is some other problem that isn't being addressed. (See, e.g., Exhibit pp. 3 ("trying to fix something that is not broken"), 6 ("It's not broken; it just needs a tune-up."), 33 ("not broke and adding bonding will not fix anything"), 42 ("we do not believe that the double payment problem is anywhere near as extensive as the CLRC has been led to believe"), 47 ("why change something that has worked well" — from a joint control company represented by Sam Abdulaziz). (See also Exhibit pp. 50, 52-53, 71, 77, 79, 106.)

Rod Den Ouden, a sand and gravel supplier, questions the degree of the problem and reports that his company has used the lien law "to force people to deal with us" but has never "taken away homes." (Exhibit p. 63.) It should be recognized that double payment generally would occur without anyone's home being sold on foreclosure, since the owner will normally choose to settle the subcontractor or supplier claim even if they have already paid all or part of the liability to the prime contractor. (For additional discussion of the problem, see the Contractors' State License Board materials at Exhibit pp. 85, 93-99.)

Availability of Bonds

Gordon Hunt writes that there is "no substantial evidence before the commission which indicates that the surety industry will, in fact, write the bonds being mandated by the statute." (Exhibit p. 22.) He argues that without such evidence, the proposal should not be adopted. (The staff is curious about Mr. Hunt's long-standing advocacy of mandatory full payment bonding by all contractors, dating at least from his 1968 law review article through materials submitted to the Commission this year.) Curiosity aside, this is a real concern and the staff has no way of assessing the capacity or soundness of the surety industry. James Acret voiced this same concern at an early meeting when mandatory bonding was first discussed. Lately, after the 50% bond proposal started to solidify, Ellen Gallagher (CSLB staff attorney) has also expressed concerns about the capacity and soundness of the surety industry. (For current CSLB material relating to this issue, see Exhibit p. 86; a new CSLB report on surety bonds will be distributed in a forthcoming supplement to this

memorandum.) Others also question the reliability of the surety companies. (Exhibit pp. 66, 72.)

Effect of Bonding Requirement on Contractor Pool

Several commentators believe the bonding requirement would have a damaging effect on the number of contractors available to do home improvement work. (See, e.g., Exhibit pp. 2, 31-32, 50, 72.) While the bond would remove some unworthy contractors, it would also remove worthy contractors who can't qualify for the bond. This will drive prices up by reducing competition. (Acret, Exhibit p. 2.) It will also inhibit trade contractors from bidding on owner-builder jobs (where they would be "prime contractors" subject to the bonding requirement). (*Id.*)

Burden of Obtaining Bond

Kenneth Regevig, president of a roofing company, believes the bond proposal is too cumbersome for a roofing contractor with jobs over $10,000. (Exhibit p. 34.) He writes that it would require a full-time employee to get bonds for a 5-15 job/week business and that they would run out of bonding capacity in a month or two. Mr. Regevig believes that the contractor is on the hook, particularly where the owner does not pay, and that requiring a bond "works in reverse" of its intended purpose. (*Id.*) Others share the view of the difficulty of getting bonds. (See, e.g., Exhibit p. 44.)

James Stiepan suggests that contractors and consumers will seek to avoid mandatory bonding by "segregating the project into two or more components." (Exhibit p. 44.) Under the proposal, dividing the job into contracts under $10,000 would mean that there is neither a bond nor a mechanic's lien right where the owner pays in good faith. From the owner's point of view, this should not be an undesirable result.

Dennis Highstreet, in the scaffolding business, reports that mandatory bonding is so cumbersome that his organization would be effectively eliminated from further participation in the residential construction market. (Exhibit p. 46.) We do not understand why a scaffolding company would be faced with any bonding issues. It is not clear why his company could not determine whether a bond exists on the job and make the necessary risk evaluations from that point. They could proceed without a bond based on the credit of the contractor or require whatever security they deem necessary through the application of sound business acumen expected in every other field of enterprise.

One way the tentative recommendation attempts to address the burden of obtaining bonds for each job is to encourage blanket bonds under regulations prescribed by the Contractors' State License Board. (See Section 3244.20.) George Peate of the Surety Company of the Pacific raises some technical questions about how this section should be interpreted. (Exhibit pp. 75-76.) In particular, he is concerned that the reference in Section 3244.20(c) to blanket bonds providing "equivalent" coverage as individual bonds would hamper the effective administration of bonds by CSLB. The staff thinks this is a good point and we would want to do further work on the appropriate language, with the surety companies and CSLB staff, if the proposal moves forward.

Cost

James Acret finds that instead of giving homeowners relief from mechanic's liens, the proposal transfers the risk of failed prime contractors to owners in the form of bond premiums. (Exhibit p. 1.) He believes that owners will be subject to further costs of litigation in order to assert the statutory protection for good-faith payments. The owner's property will be tied up while the dispute is pending. (*Id.*) Others have also identified the overall cost of the scheme as a problem. (See, e.g., Exhibit pp. 43, 44, 50; others, however, propose mandatory 100% bonds or lien recovery funds, which would cost two or more times as much.)

The Commission has recognized the cost of the 50% payment bond. However, this cost has been judged against a number of other proposals, and it appears overall to be the least expensive of the effective, "non-radical" approaches — which we mean to include owner reimbursement funds, lien guarantee funds, mandatory joint control, and mandatory bonding schemes.

Knowledge of Compliance with Bond Requirement

Some commentators fear that they won't know whether the prime contractor has obtained a bond. (See, e.g., Exhibit pp. 3, 4, 60, 63.) Harvey Foote, credit manager in the concrete industry, reports that they may get an order a few hours before making delivery, and there is insufficient time to do a bond check. (Exhibit pp. 3-4.) This is something that should be remedied by improving practices. When the order comes in, there should be paperwork, and if there is no paper, then the customer ordering delivery can provide a telephone number so the supplier can check on the bond.

Norm Widman, Dixieline Lumber, writes that contractors "rarely put home improvement contracts in a formal written Home Improvement contract form."

(Exhibit p. 60.) "To expect a contractor to write a contract, obtain a bond and then file it with the recorder's office in order to give the subs and suppliers security on the job, is just dreaming. It won't happen very often." Michael Learned, in the lumber business, also reports that "[m]ost home improvement jobs [start] before the ink is dry on the contract and way before a payment bond could be secured." (Exhibit p. 49.) These and other comments suggest that it is hopeless to do anything short of eliminating the direct lien, as proposed by James Acret. We are learning that subs and suppliers are incapable of or unwilling to protect their interests by determining whether a mandatory bond has been obtained. In appears that subs and suppliers will not do anything to protect themselves in their business relationships, preferring instead to rely on their rights against the owner and expecting that the owner will do what the sub or supplier is unwilling to do.

Mr. Widman also writes that many home improvement jobs are done on an emergency basis to make necessary repairs following fire, flood, or earthquake, when there is no time to determine whether the bond has bee provided. (Exhibit p. 61.)

Richard Charters, a roofing company credit manager, reports that getting information about whether a bond has been recorded in Los Angeles County is not practicable, since it can take months to locate the information. (Exhibit pp. 65-66.) The proposal does not rely on getting information only from recorders. In fact, the staff initially recommended against any recording requirement as a bothersome technicality that mostly results in transactional costs with no commensurate benefit, but the recording rule was included, on the recommendation of Gordon Hunt, for consistency with the existing procedure under Civil Code Section 3235. The proposal also requires that contact and identifying information be provided in the paperwork and that the information be available on request, so that subs and suppliers can contact the surety company and find out directly whether the required bond has been obtained. (Commentators are suggesting that the law will not be successful in requiring use of a contract form or providing information, unless severe penalties such as loss of enforcement rights are imposed on prime contractors. See, e.g., Exhibit p. 60.)

In connection with the recording requirement, Gordon Hunt suggests a technical change in Section 3244.10 to refer to the county where the real property is located, instead of the "subject" of the contract. (Exhibit pp. 23-24.) The staff would make this change. (Additional technical issues raised by Mr. Hunt have

not yet been analyzed, but will be reviewed if the proposal moves forward. See, e.g., service issues raised at Exhibit pp. 24-25.)

Good Faith

James Stiepan is apprehensive that the rule in Section 3244.40(a)(1) creates a "mine field for the homeowner by suggesting that double jeopardy protection is lost should an installment payment be made either early or late, regardless of any showing of actual prejudice to the lien claimant." (Exhibit p. 45.) He suggests that the presumption of good faith should apply if payment of outstanding claims are being made in a timely fashion. (For his draft language, see Exhibit p. 45.) The staff thinks this is a worthwhile suggestion and will work on the language if the Commission decides to pursue this recommendation.

Sam Abdulaziz and Kenneth Grossbart also raise some concerns about the interpretation of the good faith rule. (Exhibit p. 57.)

Michael Learned argues that good faith should require the owner to get a signed release from the supplier or issue a joint check. (Exhibit p. 49.) "It is not in 'good faith' to ignore the suppliers rights to be paid." Of course, the proposal does not ignore anyone's right to be paid. The contract between the owner and the prime contractor calls for payment to the prime. Current law doesn't require releases or joint checks, and the effect of either mechanism is subject to doubt. It would be a different brand of good faith to require by statute that the owner guarantee in some way that payments get to the end of the line. (If such a rule were desired, it would be provided directly, not as an element of "good faith.") But a good-faith payment under the proposal does not "ignore" the rights of subs and suppliers. They have their rights against the bond and they have the right to interrupt good faith with a direct payment notice or preliminary notice.

Notices

Gordon Hunt raises some concerns about the interplay between the existing preliminary 20-day notice and the "direct payment notice." (Exhibit pp. 9-13.)

With regard to the notice to owner revisions in Business and Professions Code Section 7018.5 (pp. 43-45 of the TR), Sam Abdulaziz and Kenneth Grossbart recommend using one notice instead of two. (Exhibit p. 57, item 3.) This is probably a good suggestion. They also suggest that the notice to owner be given to the owner at the time the contract is executed or as part of the contract. The provision for providing notice before the contract is existing law and we had not proposed changing it. They also raise a valid concern about the provision in

proposed revisions to Business and Professions Code Section 7159 (pp. 45-49 of the TR) requiring information on the surety to be on the contract. They point out that the contractor won't necessarily know this at the time the contract is executed. (Exhibit p. 57, item 4.) We will look for another mechanism for memorializing this information, with the intent being to be able to pass the necessary bond information and surety contact number along to subcontractors and suppliers who have an interest in verifying the information.

Complexity and the Direct Payment Notice

James Acret thinks the proposal introduces "significant new levels of complexity." (Exhibit p. 2.) He argues that the owner will be drawn into disputes between the prime contractor and subcontractors and will not know what to do when the prime is asking for payment and the sub has asked for payment by way of the direct payment notice. If the owner guesses wrong, the owner will be liable twice and if the owner pays no one, work will stop. (*Id.*)

But the direct payment notice should not operate this way. It permits discharging payments to the subcontractor *when payment is due as instructed by the prime contractor.* It redirects payment; it does not create an independent right to or authorization for payment. It also serves as the preferred method of "disrupting" the owner's ability to make good-faith payments to the prime contractor. Whether that system is more complex *to the owner* is doubtful. If the owner is not given unneeded preliminary notices, the owner's life should be simpler and more logical. If there are no issues, then payments are made to the prime contractor in due course, but without the foofaraw of the premature, confusing, and somewhat threatening preliminary 20-day notices that are routinely given under existing practice. If subs and suppliers are not paid, and the owner is given a direct payment notice, then there is a context and the work described or materials furnished should be evident when it is time to pay; the owner pays when authorized by the prime contractor. This is logical. There is no reason for the owner to pay or to have to agonize over whom to pay. If the prime contractor does not authorize payment, it doesn't happen. If the direct payment notice isn't given and no "preliminary" or other notice is given after labor, services, equipment, or materials have been furnished, there is no need for the owner to be confused and no reason not to continue to pay the prime contractor.

The proposal would result in more statutory options, because there are new special rules under the proposal. Home improvement contracts are distinguished

from other construction (as they are now under the Contractors' State License Law). Preliminary notices are not needed to preserve rights under home improvement contracts. The law becomes more "complex" to make this happen, but life in the home improvement industry should be simpler. Why? Because, as we have been told countless times, there is hardly any double payment problem worth mentioning. Ergo, since the vast majority of projects play out according to plan, in practical terms, owners will pay and contractors, subs, and suppliers will be paid or, if owners don't pay, contractors, subs, and suppliers will use their remedies to get paid.

Harvey Foote writes that there would not be sufficient time to get the information for a direct pay notice, such as in the concrete industry where an order may come in a few hours before delivery. (Exhibit p. 4.) But there would be no need to give the notice at that time. If the supplier decides to give the direct pay notice, it would be effective any time before the owner properly pays the prime contractor. There is no requirement that the notice be given before the materials or supplies are furnished.

The Lumber Association of California and Nevada describes the proposal as dispensing with lien rights if the contractor doesn't get a bond. (Exhibit p. 41.) This is not accurate, since the lien right is not eliminated but only limited to the extent of good-faith payments. This is recognized implicitly later in the LACN letter where they discuss the direct payment notice. The direct payment notice prevents payments in good faith and is appropriately used where the subcontractor or supplier does not trust the creditworthiness of contractors up the line.

Similarly, Paul Byrne discusses the direct payment notice option as if it were a failing in the proposal. (Exhibit p. 43.) "If you enact such a fault procedure, we would merely send out a 'direct payment notice' when we delivered the material (if we were selling someone who was not worthy of the credit)." That is fine. It is not a failing, it is exactly what the supplier should do. But contrary to Mr. Byrne's idea of a mere letter, the official direct payment notice would be just as impressive as the preliminary 20-day notice, and better yet, would make sense. It would tell the owner what to do and the consequences. The preliminary notice is full of fury but ends with a whimper, and the owner won't know what to do with it. This is not to say that all owners will understand or respond correctly to a direct payment notice either, but it is clearly a better option (except from the prime contractor's perspective).

Preliminary 20-Day Notice

James Acret objects that elimination of the preliminary 20-day notice means that "homeowners will be subject to stop notices and liens that will 'come out of nowhere.'" (Exhibit p. 1.)

But the existing preliminary 20-day notice can "come out of nowhere" because it reaches back 20 days. And while it is labeled "preliminary," it is preliminary only to recording a claim of lien, and can be given then, with the same 20-day reachback. The preliminary notice is supposedly "required" to be given, but there is no mechanism to enforce the requirement other than at the claim of lien stage, and the vast majority of home improvement contracts, as we are informed, never reach that stage. This is not a system that is well-designed to inform owners or anyone else of who is working on a job in a timely fashion.

Gordon Hunt and H. Richard Nash ask whether the mechanic's lien statute will be unconstitutional if the preliminary notice requirement is removed, since the notice was one factor cited by the court in *Connolly*, which upheld the mechanic's lien statute. (Exhibit pp. 19, 72.) The preliminary notice is not needed under the proposal because there is no lien if the owner pays in good faith. In addition, it is intended that enforcement would be against the bond as the first preference. If, on further analysis, it appears that a generally pointless preliminary notice is crucial to the constitutionality of the mechanic's lien statute, it could be retained without any harm to the scheme by revising Section 3244.50 to eliminate the provision excusing compliance with other preliminary notice provisions. It should be noted, however, that the preliminary notice scheme in existing law is two-faces, masquerading as a "preliminary" notice requirement, but in fact providing a 20-day reachback and permissibly given at the very end of the job as a technical precondition to recording a claim of lien. (These issues are discussed in some detail in the staff notes to the general revision draft accompanying Memorandum 2001-92, on the agenda for the last meeting.)

$10,000 Floor

James Stiepan considers that the "bright line threshold imposed for mandatory bonding is entirely superficial and does not necessarily correlate with the need for a bond." (Exhibit p. 44.) The floor is admittedly arbitrary (not "superficial"), as all such amounts are, from jurisdictional limits in small claims court to contractor's license bond amounts.

Robert Brown, president of a plastering company, argues that the $10,000 floor will make collection too expensive. (Exhibit p. 48.) This suggests that the problem of nonpayment from prime contractors and the consequent double payment exposure of owners is more prevalent than generally acknowledged. It also ignores the force of the direct pay notice that under the proposal would protect the subcontractor and preserve lien rights as they exist now.

Richard Charters asks what would prevent the prime contractor from dividing the job into multiple contracts under the floor amount, in order to avoid the bond requirement. (Exhibit p. 66.)

Angela White asks whether change orders are included; if not, the job would be bid under $10,000 to avoid the bond and then change orders added. (Exhibit p. 73.) This is covered by Section 3244.10(c) in the proposal, which requires a bond when the amount goes over $10,000.

Collusion by Owner and Prime Contractor

Rod Den Ouden suggests that the owner and prime contractor could work together to squeeze out the supplier. (Exhibit p. 63; see also Exhibit p. 70.) He argues that the job would be done for a cheaper price and the supplier would find it very difficult to prove that payments were not made to the prime contractor in good faith. If the contract is over $10,000, this is not how the proposal would work. The bond would still protect the subs and suppliers regardless of payments by the owner. In addition, good faith can be disrupted by timely preliminary notices or by the direct payment notice, without the need to prove lack of good faith.

Alternative "Mini-Proposal" Eliminating Liens on Small Contracts

James Stiepan, in opposing the mandatory bonding proposal, concludes that

> the Commission would be better served to adopt the alternative of simply providing for a good faith payment defense for a limited class of home improvement contracts.... When this new regimen has been tested judicially, then the Commission can, if it so desires, broaden its horizon to deal with the remaining set of home improvement contracts. If and when that occurs, my view is that the Commission would be much better served in looking to direct payment protection, rather than mandatory bonding, as a palliative for the restriction on lien rights.

(Exhibit p. 45.)

Frank Collard, credit manager for a concrete company, finds the alternative proposal workable, and concludes that the "recommendation should stop there!" (Exhibit p. 50.) Norm Widman thinks this is proposal is unworkable, but since it is limited home improvement contracts under $10,000, it could be effective to provide protection on the small jobs where typically the work is over before the preliminary notice is received. (Exhibit p. 61.)

Sam Abdulaziz and Kenneth Grossbart prefer the alternate proposal because it is "less of a taking" though still unconstitutional, in their view. (Exhibit p. 51.)

The Building Industry Credit Association finds this proposal to be the lesser of two evils, but questions whether there is enough information to determine whether the floor amount would address the problem identified. (Exhibit p. 72.)

Other Alternatives

A number of commentators propose alternatives to the tentative recommendation, outlined below. Edward Levitch writes that contractor licenses are too easy to get, that the owner should have a certificate of deposit for the cost of the project up front, and that contracts should be standardized and clearly state the responsibility of owner to contractor and contractor to owner. (Exhibit p. 7.) Norm Widman suggests that owners should not have to pay prime contractors if they don't provide the required notices on required home improvement contract forms, but that subcontractor and supplier rights would continue as under existing law. (Exhibit p. 61.)

Privity. James Acret again suggests a simpler alternative (Exhibit p. 2):

> The best way to address the double payment problem would be to enact that mechanics lien and stop notice rights are held only by contractors, subcontractors, laborers, and suppliers who have a direct contractual relationship with the homeowner. The statute would be simplified. Homeowners would be protected. Justice would be done to claimants. And the need for the preliminary 20-day notice would be eliminated.

Education. Several commentators suggest that the best approach is to educate owners. (See Exhibit pp. 3, 6, 7, 8, 31, 43, 46, 62, 67, 69, 70, 73.) Harvey Foote proposes to send a Home Improvement Educational Notice with the homeowner's tax bill or on refinancing or sale. (Exhibit p. 3.) Norm Widman suggests that information be provided to the owner when the building permit is issued and that the owner be required to sign an acknowledgment that the information was received. (Exhibit p. 62; see also Exhibit p. 70.)

Beefed-up Enforcement. Implicit in some remarks is the need for significantly more enforcement of rules governing licensed contractors by the Contractors' State License Board. (See, e.g., Exhibit pp. 3, 6, 61, 67.) Bob Tuck suggests adding a 20-30% penalty and expedited enforcement against the contractor's license bond in cases involving double payment liability. (Exhibit p. 6.) We have assumed that CSLB enforcement is not likely to be an effective solution, that the amount of the license bond (generally $7,500, and $10,000 for swimming pool contractors) is insufficient to provide a meaningful remedy, and that penalizing a contractor in these circumstances is probably ineffective because the contractor is insolvent.

Notice of Subcontracts. Bob Tuck suggests requiring the prime contractor to give the owner a Notification of Subcontracts form listing all subcontracts and their dollar amounts before work commences. The prime contractor would then break out the relevant subcontracts in invoices to the owner. (Exhibit p. 6.) This option has been touched on in Commission meetings, although not considered as a subject for further exploration.

Shorten Preliminary Notice Reachback. Paul Byrne, a roofing material supplier, suggests that instead of the Commission's "faulty procedure" that would "completely absolve the homeowner from all responsibility," the time for "posting" a preliminary notice should be shortened to two or three days. (Exhibit p. 43.) If we understand the idea, it would eliminate the 20-day reachback feature and make the notice more realistic. The owner would get a notice related in a more timely way to work being done, and would be in a better position to determine whether to pay or not. But Mr. Byrne apparently thinks that the owner should be responsible for making some kind of pre-determination of the prime contractor's reliability under any preliminary notice scheme. That is a fundamental issue here: who is best positioned to judge the creditworthiness of the prime contractor? The owner, who makes one or two major contracts in a lifetime? Or a subcontractor or supplier who makes thousands in the course of a business's lifetime?

Increased License Bond. Rod Den Ouden argues that the license bond is too low and should be increased. (Exhibit p. 63; see also Exhibit pp. 66, 67.) The Commission has discussed this option several times, generally coming to the conclusion that while it might be useful, it isn't much of a remedy when a contractor fails on a number of jobs, leaving many subs and suppliers unpaid

and the owner on the hook. The Contractors' State License Board is looking into step-bonding schemes that would scale the license bond on home improvement contracts to the amount of business done by the contractor in a year. (The CSLB report will be forwarded in a later supplement to this memorandum.)

Recovery Fund. Gordon Hunt suggests reconsideration of the recovery fund proposal like that submitted by Professor Kelso — a homeowner's lien recovery fund financed by a building permit fee add-on — as a preferable alternative. (Exhibit pp. 27-28.) William Calahan, Associated Roofing Contractors, also recommends a lien recovery fund. (Exhibit pp. 77-78.)

Design Professionals

Mary Ann Egan is concerned that the proposal would require design professionals to obtain bonds. (Exhibit p. 74.) If the proposal moves forward, the staff recommends making clear that the mandatory bond requirement applies to prime contractors subject to licensing under the Contractors' State License Law, which would exclude design professionals.

Operative Date

Sam Abdulaziz and Kenneth Grossbart suggest a longer delayed operative date period so that CSLB would be able to complete adoption of necessary forms and regulations. (Exhibit p. 57.) They suggest an additional six months' delay, to July 1, 2004. This issue can be addressed later, if the proposal moves forward. CSLB shouldn't need more than a year, and if they do, maybe they would need an additional year instead of an six months. We also tend to disfavor mid-year operative date because it makes the codes harder to use; the publishers print both versions of the statute, adding to the bulk and creating confusion.

Constitutional Issues

Confusion persists as to the meaning of the mechanic's lien provision in the constitution, the relevance of the statutes and case law before 1911 (when the direct lien was enacted), and the *Roystone* decision. (See, e.g., Exhibit p. 39, stating that there is an "attempt to take away rights that have been in place for over 150 years.") Gordon Hunt reviews some of the early history, apparently inspired by the discussion of the statutory and constitutional history in the tentative recommendation. (Exhibit pp. 13-21.) A number of other commentators write that the proposal would be unconstitutional, but without any analysis.

There is no dispute that the law before 1911 provided what it did — whether before or after the 1879 Constitution — and we need not spend time discussing it further. But a number of commentators, Mr. Hunt among them, continue to confuse the Legislature's authority and the history of enactments with the constitutional limits on permissible legislation. We all clearly recognize that the direct lien dates from 1911, and yet *no one has suggested that the protection for good-faith payments under the law before 1911 was unconstitutional*. Sam Abdulaziz and Kenneth Grossbart write that "what had happened in the 1880's is not persuasive." (Exhibit p. 52; see also Exhibit p. 81.) This is puzzling, because the legislative enactments and court decisions following the 1879 Constitutional Convention would seem highly relevant to our understanding of the mechanic's lien article, upon which all constitutional arguments ultimately rest.

The fact that the Legislature adopted the direct lien rule in 1911 is not a "constitutional ruling" — it was, like its scores of predecessors and successors, a statutory enactment. Like the good-faith rule in existence for most of the time between 1879 and 1911, the direct lien rule is a legislative implementation of the constitutional mandate, one of countless alternatives that could be enacted. Both the 1911 and the pre-1911 approaches are constitutional. The Legislature, as shown by the history of this statute, has great latitude in implementing the constitutional direction. Mr. Hunt's conclusion that the "current proposal would therefore be unconstitutional" (Exhibit p. 17) does not follow from his discussion, unless he is prepared to argue that the statute before 1911 was always unconstitutional and that the direct lien is constitutionally mandated.

This would be a tremendous surprise to the delegates to the Constitutional Convention of 1878-79, as amply demonstrated in the record of the convention debates. It would also be contrary to the views of the judiciary, which had ruled to the contrary before *Roystone*, i.e., holding that it would be *unconstitutional* to make the owner pay more than the contract amount. As Mr. Hunt well knows, since he was probably the first to suggest this approach, the tentative recommendation adopts a version of the existing 50% payment bond in Civil Code Section 3235, which no one has claimed is unconstitutional (*pace* Justice Henshaw, dissenting in *Roystone*). Mr. Hunt's constitutionally-based objections can only be relevant to the proposed rule applicable under the $10,000 floor, notwithstanding the breadth of his language.

There are a number of other puzzling statements in Mr. Hunt's essay. For example, he writes:

> When the Constitution was adopted, the Legislature was given the mandate to provide for the speedy and efficient enforcement of that constitutionally guaranteed lien right. It has always been acknowledged that the Legislature provides for this "direct lien" that must be speedily and efficiently enforced regardless of the status of the account between the owner and the contractor.

(Exhibit p. 18.) And yet we know, and Mr. Hunt acknowledges, that good-faith payment was a discharge of liability before 1911. How can it be said that it has "always been acknowledged" that the "Legislature provides for this 'direct lien'"? The fundamental point that must be understood is that the direct lien has existed in California only since 1911, when it was adopted by the Legislature, not mandated by the constitution. Before that time, good-faith payment to the prime contractor discharged the owner's debt, even though subcontractors and suppliers were not paid.

Mr. Hunt's discussion of *Connolly* recognizes that this case involved the constitutionality of the mechanic's lien statute itself, not the issues relevant to good-faith payment. (Exhibit pp. 19-20.) His conclusion, however, attempts once again to misapply *Connolly*:

> [T]he comments of the California Supreme Court make it amply clear that the lien right enshrined in the organic law of this state serves a public policy that should not and cannot be defeated by payment from the owner to the contractor contrary to the express intent of the California Legislature.

(Exhibit p. 20.) This conclusion cannot fairly be drawn from *Connolly*. Nor is it germane to speak of the proposal being "contrary" to the intent of the Legislature since it is plain that if the Legislature were to adopt the proposal, the Legislature would have refined and revised its intent. If the direct lien had been enshrined in the constitution in 1879, we would not be having this discussion. But it was not, and it was specifically discussed and rejected in the Constitutional Convention. It should not be necessary to explain that the enactment of the direct lien amendments by the 1911 Legislature does not forever bind all future Legislatures. But apparently that is what is being argued.

Mr. Hunt recognizes in his discussion of the *Wm. R. Clark* decision that it is a *legislative* policy that underlies the holding invalidating pay-if-paid clauses. (Exhibit pp. 20-21.) And yet, the confusion of legislative and constitutional authorities continues: "The current proposal violates that policy and would be unconstitutional." (Exhibit p. 21.) The *public policy* against waivers was

established by legislative enactment. *Wm. R. Clark* does not cite the constitution as the source of this policy. The case does not hold that the Legislature is constitutionally barred from permitting pay-if-paid clauses in contracts between contractors. This case thus has no bearing on whether a good-faith payment rule would be constitutional. Attempts to expand the legislative public policy into an immutable constitutional rule must be rejected.

On a more practical front, James Stiepan expresses concern about the constitutionality of the proposal, and suggests that if the proposal were held unconstitutional, it would have the effect of requiring bonds without the coordinate protection for the owner against double payment liability. (Exhibit pp. 44-45.) If the Commission thinks this is a valid concern, we could include an uncodified provision to the effect that the scheme is to be considered as a whole and not severed for the purposes of judicial review. The normal approach is to legislate severability, although that may not be necessary in modern times.

Sam Abdulaziz and Kenneth Grossbart write:

> A major concern in this area is that if the Legislature agrees with your logic, it could easily leap to the conclusion that any curtailment of lien and stop notice rights, even on commercial and industrial projects, would be constitutional. It would take years for the courts to correct this misconception.

(Exhibit p. 52.) The logic of the constitutional analysis does not place us on this slippery slope. One "curtailment" of mechanic's liens does not open the door to all possibilities, including outright elimination of the lien. The staff does believe that a privity rule would be constitutional, and that protection of owners for good faith payments generally would be constitutional. The latter scheme, as we all know, was in place for most of the first three decades following adoption of the constitutional provision. We leave it to the Commission to evaluate the suggestion that it should not make a recommendation with the bonded protection of subs and suppliers combined with protection for owners' good faith payments in home improvement contracts because the Legislature might be encouraged to do the same thing for all private construction jobs, with or without a bond.

Political Issues

Some may find a comment by Gordon Hunt concerning the political nature of the double payment issue to be confusing. He writes, "When this process first began, this consultant, in my initial report, commented upon Assemblyman

Honda's legislation. I was told that it was 'political' and that I shouldn't comment upon it." (Exhibit p. 28.) For the record, the original background study received from Mr. Hunt in late 1999 logically broke into two parts. One concerned 15 technical and minor substantive reforms he was proposing; the other was a lengthy critique of Assembly Member Honda's pending bills. As has been explained on several occasions in the course of this study, it is not the Commission's practice to get involved in the merits of pending legislation. The Commission undertakes an independent study of any matter assigned to it and then communicates to the Legislature through its formally adopted recommendation, or it makes no recommendation. The Commission historically has not taken sides on bills alive in the Legislature.

As we all know, however, as this study developed, the Commission found itself in the position of having to consider the merits of pending mechanic's lien bills at the request of the Assembly Judiciary Committee. In 1999, however, this was not the situation. (Concerning pending bills, see, e.g., Memorandum 99-85, p. 2; Minutes, November 1999 Meeting, p. 7.) In addition, staff analysis of Mr. Hunt's background study showed that the major part of what was issued as Part 2 was identical to a letter he wrote on behalf of the Building Industry Credit Association in opposition to Assembly Member Honda's bills. The staff did not think is was appropriate to receive that material as a background study for the Commission when it was an obvious part of a lobbying effort against a legislator's pending bill. Accordingly, in a letter dated December 17, 1999, the staff asked Mr. Hunt to reconsider Part 2 of his report. He did so, making a few minor changes to eliminate references to the Honda bills, and resubmitted the material. Upon receipt, the staff, with some misgivings, prepared the report in Commission form and distributed it without further comment. This is not to say that Mr. Hunt's views were not important, but in the context of a Commission study, partisan commentary on pending legislation was not what we were looking for. Mr. Hunt has always been free to make whatever written or oral comments he wants, as a Commission consultant or otherwise, and we trust that no one will think he intends to suggest that the staff was attempting to censor his comments.

We are confident that the Commission's record shows, in this project and every other one, that all views are welcome, whether supportive or critical, or anywhere in between.

Conclusion

There is hardly any support for a mandatory bond, even the 50% payment bond inspired by the *existing* option under Section 3235. (However, more than one writer urges a mandatory 100% bond. Exhibit pp. 69, 106.) The overwhelmingly negative reaction is surprising to the staff, because almost all, if not all, of the participants in the discussion at the San Diego meeting in May seemed to support the proposal in outline form — perhaps most significantly, Mr. Hunt and Mr. Abdulaziz. (Mr. Acret was not present at that meeting.) We doubt the Commission would have proceeded with this approach if it had been denounced by all of the participants at that meeting.

A number of commentators seem unwilling or unable to understand the dynamics of the proposal. We recognize that the proposal needs some improvement and we appreciate the detailed analysis and commentary received from some writers, even though they oppose the overall initiative. But many of the attached letters are replete with inaccurate characterizations of the proposal. No doubt some commentators only received biased summaries and were asked to write to the Commission expressing their opposition. We don't fault them for reacting negatively to inaccurate or incomplete information. From the start, the politics have been unavoidable, and in this environment it has been quite challenging to proceed in the tried and true Law Revision Commission way of dispassionately analyzing the issues, considering alternative solutions, and rationally arriving at the best recommendation for reform. Perhaps less optimistically, the process seeks proximate solutions to insoluble problems.

The tentative recommendation's implementation of the basic idea through the provision of statutory details may have soured the stakeholders. Mr. Hunt's main objections, when all is said and done, seem to hinge on placing the risk on subs and suppliers in cases where the prime does not get the mandatory bond. He would place the risk back on the owner, leaving the possibility of double payment where it is most likely to occur — in the case of an irresponsible or scofflaw prime contractor who doesn't get the bond. Mr. Hunt also has been consistent in maintaining that there can constitutionally be no defense against double payment liability where the owner has paid amounts due in good faith. So, perhaps if the proposal eliminated the $10,000 floor and reallocated risk, Mr. Hunt would embrace it once again, as he did last spring. So, too, with Mr. Abdulaziz, and the interest groups that depend on their counsel and advice. It

also appears that the Lumber Association of California and Nevada would accept this modification.

But we don't find much hope for support even with these modifications from most other writers. As noted, a large percentage of them — subcontractors and suppliers, as well as a few prime contractors — advocate education of the owner. Education is an admirable undertaking, but in the staff's view, it is unresponsive to the problems inherent in the direct lien statute. We don't see that these commentators would favor mandatory bonding under any circumstances, although if it were a practical option (mandatory in statutory language, but ignored in practice) — as really suggested by Mr. Hunt — maybe they could live with it. But the staff would not suggest that the Commission make this recommendation to the Legislature.

Some of the other ideas might work — make payments accountable so that subs and suppliers who have contributed get paid in a timely fashion, beef up the CSLB so that licensed contractors are made to toe the line, bar recovery for subs and suppliers who deal with unlicensed contractors, restrict enforcement rights to those in privity with the owner. But how many of these ideas would be viewed favorably by the commentators the Commission has heard from, not to mention all of those who have not commented?

Lack of commentary from homeowners, individually or through political groups, may be taken as evidence of the insignificance of the double-payment problem. But anyone with experience in legislative matters knows that industry groups are vastly more represented than consumer interests on any issue. Furthermore, the significance of the double payment problem is not measured only by its frequency. It can be devastating to a homeowner, and there is no analogous and complementary situation for subcontractors or suppliers with scores or hundreds or thousands of jobs and transactions each year. The problem is systemic. The real possibility of having to pay twice demonstrates a troubling irrationality in this statute. It stands as a striking exception to normal business practices depending on privity of contract and credit assessment. It is a state of affairs that cannot be explained or justified by special pleading about the unique nature of the construction business. That argument is nullified by the fact that states following the New York rule do not have a direct lien, and that public works contracts do not have it. In California, we are led to believe that subcontractors and suppliers cannot take any responsibility to determine

whether their customer is licensed or has a bond. (See, e.g., Exhibit pp. 41, 61.) In this atmosphere, it is difficult to imagine where progress can be made.

What Next

As the Commission knows, we are committed to reporting the Commission's conclusions to the Assembly Judiciary Committee early next year. There is no time, even if there were a purpose, to starting over on a new proposal. Although the Commission has a general rule against the staff speculating on political prospects in formulating Commission recommendations, in this case we feel the obvious can be stated. Based on the commentary we have received, the prospects for enactment of the proposal in the tentative recommendation, or any bonding proposal, are faint. (For remarks from Ellen Gallagher on this point, see Exhibit p. 102.)

The Commission may still wish to approve a final recommendation to see where it leads, and the staff will seek an author. Or the Commission may wish to focus the constitutional issue by approving the "mini-recommendation" to provide protection only for owners under home improvement contracts below $10,000, without any bonding requirement (or, alternatively, for any furnisher of labor, services, equipment, or materials in the amount of $5,000 or other appropriate amount, regardless of the contract amount; or a combination of contract amount of, say, $25,000, as to any sub or supplier amount of, say, $5,000, or other appropriate amount).

The final decision need not be made until the January 2002 meeting. If the Commission wants to approve any different approach, the staff can circulate a "discussion draft" (instead of an official tentative recommendation) for final review in January.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

JAMES ACRET
2 Coco Place
Pacific Palisades, California 90272
310.573.9164 · Fax 310.573.7558 · jacret@gte.net

October 9, 2001

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

I cannot support the tentative recommendation to address the double payment problem. It would needlessly complicate the mechanics lien statute and, on balance, would do more harm than good.

Homeowners need relief from the mechanics lien, which transfers to them unpaid debts incurred by prime contractors. The risk of such default should properly be borne by the party who perhaps unwisely extended credit, and not by homeowners. The mandatory payment bond scheme, instead of relieving them of that risk, transfers it to them in the form of bond premiums that will be included in the price of home of improvements

Mandatory bonding distributes among responsible contractors the risk of credit advanced to a very few irresponsible contractors. Since the cost of the bond premium will be included in the contract price for every home improvement most of the risk is then passed on to homeowners who employ financially responsible contractors.

Even though the cost of the mandatory payment bond will be paid by homeowners, they will still be subjected to mechanics lien claims until they can prove in court that they have paid the prime contractor in full. The cost of mechanics lien litigation is ruinous. The existence of the lien against the homeowner's title during litigation will usually prevent the homeowner from selling or refinancing the property.

Since the preliminary 20-day notice is eliminated, homeowners will be subject to stop notices and liens that will "come out of nowhere."

Since the proposed legislation would not affect stop notice rights homeowners will still have their money tied up and sequestered by claimants. Exercise of stop notice rights is just as damaging to homeowners as the exercise of mechanics lien rights: usually more damaging.

By introducing mandatory payment bonds and optional Direct Pay Notices, the tentative recommendation will add significant new levels of complexity to the mechanics lien statute.

The proposed Direct Pay Notice would put the homeowner in an untenable position. Suppose there is a dispute between prime contractor and subcontractor. The subcontractor gives the owner a Direct Pay Notice. Prime contractor then instructs the owner to ignore the Direct Pay Notice since the prime contractor believes the subcontractor is not entitled to be paid. The owner must now referee the dispute. If the owner's guess is wrong the owner will be liable to the subcontractor for ignoring the Direct Pay Notice or to the prime contractor for honoring it. If the owner simply withholds the money from both, either may, with justice, pull off the job.

The scheme will reduce competition by removing from the home improvement market a significant number of prime contractors who will not be able to establish bonding capacity.

Many trade contractors who do not customarily deal directly with homeowners cannot arrange bonding capacity and therefore would not be available to compete for "owner builder" jobs.

Under proposed §3244.3 "the liability of an owner under a home improvement contract is limited to the contract price." This approach does not eliminate the double payment problem because there is no assurance that the owner will receive a completed project in exchange for the contract price. If a prime contractor underbids a job, or is inefficient, the contract price may be exhausted by legitimate mechanics liens, stop notices, and Direct Pay Notices while the job remains incomplete. To obtain a finished project, the owner will have to make "double payments."

The best way to address the double payment problem would be to enact that mechanics lien and stop notice rights are held only by contractors, subcontractors, laborers, and suppliers who have a direct contractual relationship with the homeowner. The statute would be simplified. Homeowners would be protected. Justice would be done to claimants. And the need for the preliminary 20-day notice would be eliminated.

JAMES ACRET

JA:ll

Holliday Companies

2193 W. Foothill Blvd.
Upland, Ca. 91786

Telephone 909-982-1553
Fax 909-949-6315

10-22-01

Re; H-820

Calif. Law Revision Commission
Fax 650/494-1827

Gentlemen

I have been in the construction industry for about 30 years as a credit manager and have seen just about all the abuses that are that are committed by general contractors– subs, and even homeowners. I am wondering if we are trying to fix something that is not broken. We keep trying to re-write the law to protect the homeowner from paying twice by making more regulations. While the heart of the problem lies with education. Currently the dept. of motor vehicles sends out with all vehicle registration renewals a notice of new laws and DUI warning information. Why are we unable to notify all homeowners of the pitfalls of doing home improvement work and how to protect themself? It seems to be matter of placing said notice in all the tax bills sent to every homeowner by the county taxing authority. A notice could be also a part of every escrow document provided at the time of sale of a residential property. Also every time a deed is recorded a Home Improvement Educational notice could be sent by the county recorder as a part of the deed they send to the owner. We will never be able to cure fraud on the part of an intentional scam by bad contractors, but relying on the contractors to be the ones to provide a bond does not seem to cure the basic problem, we need to educate the homeowner.
In your proposed changes to the law what happens if said homeowner hires a unlicensed contractor to do his work. Are the subs and suppliers able to record a lien, is the owner still not liable. How does the homeowner know his contractor is not licensed if we have not educated him first that they must be? And how do we do that. I will be the first one to say that I have collected from a homeowner, sometimes even after they are advised there is a problem with their contractor and suggest they pay with joint check or withhold funds, they still pay the contractor thus creating the lien that we must proceed against. I do not like the fact that any owner should pay twice but since the contractors license law does not have sufficient teeth in its enforcement efforts and the penalty for non-compliance is small compared to the possible reward it does little to prevent fraud. Should an unlicensed contractor be hired by the homeowner the license law has little or no enforcement and the owner has no license bond to go after (education again)
We in the Concrete Industry have a unique problem in that our product is often ordered for delivery only hours prior to being needed, so it would be impossible for us to verify the existence of a bond or provide a direct payment notice to an owner on such a short time span. I am sure there are other suppliers that have the same issue ie: landscapers, roof repairs etc.
We in the industry are not the bad guys here nor is the homeowner (except for lack of education)

EX 3

Holliday Companies

2193 W. Foothill Blvd.
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Telephone 909-982-1553
Fax 909-949-6315

10-22-01

Re: H820 cont. page 2

There is some point in life that we must be responsible for our actions, the fact that homeowners don't do home improvement very often is an easy scapegoat for lack of education. We don't protect them from paying too much for the home they bought or the car they purchase. Yet we fine them if they commit a vehicle code violation or fail to pay income tax due. So why don't we educate them on the largest single investment a consumer makes their home?
The domino affect of this proposed legislation will end up hurting the homeowners as a whole and protecting the few. As an example many of our homeowner jobs are small contractors placing concrete for patios, driveways, & pool decks etc. Since we are not privy to the contract of the parties associated with the job at time of delivery (because the order is placed by a worker not a principal of the Co.) there is not sufficient time to do a bond check or get the information for a direct payment notice. I am sure you are aware that a good number of home improvement contractors are small sole proprietors without a lot of capitol. Without the extension of credit a good number of these hard working people could not survive. As a supplier to some of these people the additional monitoring required by your proposed legislation would make homeowner work unacceptable and we would only take cash in advance as payment for any home improvement work.
Each segment of the construction industry has its own problems with respect to homeowner work some have the luxury of time to build custom items, others like us do not and serve at a moments notice. This is a difficult issue and one which your commission has given considerable thought, please continue your efforts and look more toward education of homeowners rather than more regulation and changes to existing law.

Sincerely,

Harvey Foote, Credit Manager

ATLAS
HEATING AND AIR CONDITIONING COMPANY

October 17, 2001

Law Revision Commission
RECEIVED
OCT 22 2001
File:

California Law Revision Commission
4000 Middlefield Road Room D-1
Palo Alto, Ca. 94303-4739

Re: Mechanics Lien Law Revision

Dear Commissioners;

Having studied the proposed revisions at www.clrc.ca.gov., on behalf of myself as an HVAC contractor and on behalf of our SMACNA residential contractors in California in my capacity as a Bay Area and national SMACNA board member, I would like to make the following comments on the proposed mechanics lien law revisions:

A residential HVAC contractor is at greatest risk of nonpayment when he or she works as a sub versus working directly with the homeowner, but subcontract work is a big part of the industry. My experience as a contractor and as chair of the SMACNA National Residential Steering Council tells me that this is true throughout the country. Prime contractors use us as interest free savings and loans and justify slow or non-payment by disputing our percentage of completion billed or by saying they haven't been paid. They often impose usurious retentions, that are held until well past the completion of work, awaiting final inspection or architect sign-off. It is not uncommon for the prime to have moved on to other jobs, whose start-up costs are funded by previous jobs' retentions.

The Mechanics Lien Law as it now stands is one of only three ways that we can enforce payment for services rendered. The only other two are Small Claims Court with its $5000.00 cap, or by suing in Superior Court and getting a judgement, which is not an option except in cases of very large subcontracts. The mechanics lien process is very effective in moving a payment stalemate along without ever encumbering the homeowner. The preliminary notice informs the prime that we're thinking about him and his ability to pay and it informs the homeowner that this could be an issue down the line. It is simple and effective. In our experience (we've completed over 2,000 jobs as a sub in the last ten years), ninety-nine percent of the non-payment problems are solved simply by recording the lien. It takes no more than that to motivate the homeowner and as a result, the prime contractor, to settle any disputes and get us paid. What I have just described is very common to the industry, and though it might result in some angst for the homeowner, it very rarely results in double payment.

The effect of this proposed legislation will be to vastly reduce the pool of good subcontractors available to primes and therefore to homeowners, especially in the large market that is the

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small residential remodel, ($50,000 to $150,000). The quality subs will stop bidding this work and move their market focus elsewhere, to add-on, replacement and repair and away from remodeling work. This will leave the small, less experienced, less skilled and largely unlicensed subs to fill the void, and they will. Legal disputes over poor quality installations will ensue and this segment of the market will become increasingly repugnant to any subcontractor worth his or her salt. The consumer will be the biggest loser, and the prime contractor will be in second place.

Perhaps a better approach would be to add a requirement that the prime contractor complete a simple "Notification of Sub Contracts Form" to the homeowner before work commences. This would list all of the subcontracts with their accompanying dollar amounts. It could have a column for noting the payments by the homeowner related to each subcontract. The prime would be required to break out any subcontract amounts in his invoices to the homeowner, who could then post these on their form, like a worksheet. This one-page form would educate and empower the homeowner and help keep the prime on track.

Couple this with a "Homeowners Double Payment Relief Act" that would enable a homeowner who is faced with double payment to quickly and simply attach the contractors state license bond for the amount of the double payment plus penalty. Make the penalty stiff, like twenty or thirty percent. Even our under-funded and under-staffed CSLB could handle a few hundred of these a year, fairly and effectively.

Leave our Mechanics Lien Law as it is, with just a few simple additions, as mentioned. It's not broken; it just needs a tune-up.

Sincerely,

Bob Tuck

Bob Tuck
President
Atlas Heating and Air Conditioning Co.

CC: Cal SMACNA
Law Offices of Abdulazziz and Grossbart

L E V I T C H

October 23, 2001

California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739
650-494-1335 FAX: 650-494-1827

To Whom It May Concern:

The staff memorandum regarding the lien laws does not surprise me. I have been in business since 1960. My original contractors license was number 191905 so please hear me out.

The fundamental reasons for problems are on two levels. One, contractors licenses are too easy to get. I recommend at least a 2-year degree from a junior college with a major in accounting and a 4-year apprenticeship from a certified school.

Two, if a property owner wants to build, he/she better have the money. "Show me the money" should be mandatory with a certificate of deposit with funds allocated for the project. Payment bonds & filing of contracts is great but the billing of clients should be standardized. Mandatory...weekly billings on percentage of completion similar to, for example, AIA billing.

Last but not least, clarify the responsibility of client to contractor and contractor to client. They should be standardized. "Read my lips" clause for each contract regarding this issue is a must.

Good luck,

Edward J. Levitch, AIA
President, Levitch Assoicates, Inc.

J&W Redwood Lumber Co., Inc.

1179 W. Washington Ave., Escondido, CA 92025-1675 PH: (760) 741-8776 FAX: (760) 741-9437

October 23, 2001

CA Law Revision Commission
4000 Middlefield Road, Room D1
Palo Alto, CA 94303-4739

Gentlemen:

Your recent letter regarding the proposed changes for the California Lien Law effect our business directly and I do not agree with either Proposal 1 or 2.

In our business, because we are a material supplier, we deal with many different types of customers. A majority of our customers are the small contractors who do decks, patio covers and fences. Most of these licensed contractors have very few employees and a low overhead. This enables them to provide quality work for homeowners at "very affordable prices". They are in competition with the larger contractor companies and do not always have the buying power or room to store large amounts of material in a warehouse somewhere. They purchase the merchandise, which is needed on a job-by-job basis. We can extend credit to these smaller contractors because we have the guarantee of the California Lien Law. We issue the 20 Day Preliminary Notices on any invoice over $300. This notifies the homeowner that the materials came from us. I propose that we emphasize the need to educate each and every property owner on the ins and outs of the California Lien Law. Combine this with teaching them about paying only a minimum deposit, getting three bids and NOT paying in full up front. They should always use a licensed and bonded contractor. Before payments are issued – get the appropriate release! This is what will protect the homeowner regardless of the dollar amount of the project. Property owners can obtain this information by visiting the web site of the CA Contractors State License Board. The website could contain more detailed information relating to releases. If we make this information more available the California Lien Law will prevail.

The California Lien Law is a good collection tool! Having more small contractors in business means more people bidding on jobs and less expensive prices for homeowners. The only change we should make is to educate homeowners on using the California Lien Law to their advantage.

Sincerely,

Jill Saunders
Credit Manager

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Report to
Law Revision Commission

Comments By Consultant

Gordon Hunt

Double Payment Problem in Home Improvement Contracts

October 2001

California Law Revision Commission
4000 Middlefield Road, room D-1
Palo Alto, CA 94303-4739
650-494-1335 FAX: 650-494-1827

1. THE "DIRECT PAYMENT NOTICE" REFERRED TO IN SECTION 3244.40(a)(2) SHOULD BE ALLOWED TO BE GIVEN BY SUBCONTRACTORS OR SUPPLIERS AT ANY TIME IN ORDER TO REDIRECT PAYMENTS WHEN THEY ARE DUE

In reading through the "Tentative Recommendation" of September 2001, No. H-820, it is not entirely clear as to when subcontractors and material suppliers could give the "Direct Payment Notice" to the owner. In reading through the Tentative Recommendation in Item 7 on Page 3, Lines 18-22, the summary appears to say that a stop notice or claim of lien served upon the owner could not be served until payment to the claimant was overdue. It goes on to say, "A direct payment notice could be served at any time in order to redirect payments when they are due." That led this consultant to believe that a subcontractor or material supplier could give a Direct Payment Notice at any time during the progress of the job, even though payment was not "overdue".

On Page 9 of the Tentative Recommendation, Lines 30-32, the first sentence states that stop notices and claims of lien that would put the homeowner on notice so as to prevent further good faith payments to the prime contractor could not be given until payment was "overdue" to the subcontractor or supplier. This appears to be consistent with the first sentence of Item 7 on Page 3 of the Tentative Recommendation and would not, in any way, contradict the second sentence of Item 7 on Page 3 of the Tentative Recommendation.

On Page 10 of the Tentative Recommendation, in Lines 15-22, the following was stated:

> "(3) Where subcontractors and suppliers anticipate that they may not be paid by the prime contractor, they would have the alternative of giving the owner and prime contractor a direct pay notice that would call for the owner to pay the subcontractor or supplier directly instead of through the prime contractor when the prime contractor bills for their work or supplies. The direct pay notice could be served for any work or supplies that had been furnished and would not have to wait for payment to become overdue."

That appears to be consistent with the second sentence of Item 7 on Page 3 of the Tentative Recommendation.

The proposed statute to implement the foregoing is on Page 40, Line 25 through Page 41, Line 14. Under Section 3244.40(a)(2), it appears that the "Direct Payment Notice" can be given to the owner to prevent the owner from making a "good faith" payment to the contractor.

Section 3244.40(b) provides that a claim of lien or stop notice is not timely within the meaning of Subdivision (a) unless it is given by the claimant after "payment is in default under applicable law". That is not at all clear. What applicable law is referenced there? Contract law or the law of mechanic's liens?

Under the Comment Sections, Page 40, Lines 39-41, it is stated that Section 3244.40 makes it clear that the owner cannot make a good faith payment that would reduce the unpaid contract amount below the amount needed to pay claimants who have "given proper notice". I assume what that means is that either notice of a claim of lien, notice of a stop notice, or a "Direct Payment Notice". As you know, a claim of lien is recorded in the County Recorder's office. The stop notice is filed directly with the owner or the construction lender, depending upon where the funds are coming from for the project. In most home improvement contracts, it will be the owner's own funds and there will not be a construction loan. It seems redundant for a claimant to have to give a notice of a stop notice that they have filed with the owner.

The next paragraph under the Comment Sections on Page 40, beginning at Line 42 and continuing over through Line 5 on Page 41, provides that Subdivision (b) delineates the meaning of a "timely communication" to the owner that can defeat a good faith payment. It goes on to state that lien claims and stop notices do not affect the rights of the owner unless given "after" payments to a claimant have become due and remain unpaid under "governing statutes and contract rules". It is assumed that this reference merely relates to the claim of lien or stop notice and does not relate to a "Direct Payment Notice". It is also unclear as to what is meant by "governing statute" and "contract rules". As far as governing statute is concerned, it is assumed that your reference is to Civil Code §§3115 and 3116. It is also assumed that "contract rules" means the terms of the contract between the subcontractor and its customer or the material supplier and its customer. As you

know, subcontractors are paid progress payments and generally speaking, their payment is not due until ten days after the contractor has been paid by the owner. As pointed out in my prior correspondence (see letter dated September 18, 2001, Page 4), the courts have clearly held that a subcontractor or material supplier may record a lien or serve a stop notice even though from a contract standpoint, the money is not "due". It should also be noted that the terms of payment for material suppliers are generally thirty days from date of invoice, but occasionally, are due "upon presentation of invoice".

In the "Note" on Page 41, Lines 6-14, it is stated that additional detail will be needed to flush out the "Direct Payment Notice" listed in Subdivision (b). I assume that the note meant to say under Subdivision (a)(2). The note goes on to state that the purpose of the Direct Payment Notice is to permit a subcontractor or supplier to give notice to the owner so that debt discharging payments cannot be made in good faith. It goes on to state the owner would be able to pay the subcontractor or supplier directly as soon as the prime contractor informs the owner that progress payments for the work done or material or equipment is supplied. Finally, it is stated that unlike mechanic's lien claims and stop notices, the Direct Payment Notice does not involve other consequences such as tying up financing or starting the clock running on enforcement procedures.

In reading all of the foregoing together, this consultant concludes that a subcontractor or a material supplier could serve upon the owner a "Direct Payment Notice" as soon as it has furnished, labor, service, equipment or material to the jobsite. This consultant arrives at that conclusion by reason of the statement on Page 3, Lines 21-22 that, "A Direct Payment Notice could be served at any time in order to redirect payments when they are due". That conclusion is also consistent with the statement made under Item "(3)", Lines 15-21 on Page 10 of the Tentative Recommendation quoted above.

That conclusion likewise seems to be consistent with Civil Code §3244.40 and the comments related thereto. If, in fact, that is the intent of Civil Code §3244.40, then it appears to be consistent with the comments made by this consultant in my letter dated September 18, 2001. It is submitted, however, that there should be more clarity set forth in the statute, which would make it clear that the "Direct Payment Notice" (as noted on Page 3, Lines 21-22) could be served at any time in order to redirect payments when they are due.

Finally, I would like comment that the "Direct Payment Notice" should either be directly set forth in the statute itself or in the alternative, if it is to be determined by the Contractors' State License Board, then you should at least set forth, in the statute, the elements that the notice should contain so that the Contractors' License Board will have appropriate direction in the preparation of the notice.

2. COMMENTS REGARDING THE ALLEGED "DOUBLE PAYMENT PROBLEM" IN HOME IMPROVEMENT CONTRACTS.

As noted since the inception of this study, the alleged problem is not a significant one. In fact, as noted on Page 2, Lines 21-22 of the Tentative Recommendation, there is no good measure of the magnitude of the double payment problem. It is correct that it has been the recommendation of this consultant, and is still the recommendation of this consultant, that this radical change to the lien law is unnecessary and may create more problems than it will solve.

The Tentative Recommendation also states that the Commission is soliciting comments on the desirability of an alternative scheme that would simply protect good faith payments on home improvement contracts below $10,000, without providing for a mandatory bond in all home improvement contracts. Without acknowledging the desirability of such a scheme or the constitutionality of such a scheme, this consultant feels that it would a better approach to this alleged "double payment problem" than the current proposal. It would limit lien rights in a very limited area and as some have suggested, is the area where most of the alleged problems occur. As noted above, there would be serious constitutional issues with regard to such a proposal. This consultant believes, however, that it would be a better approach than the current proposal. These comments are made based upon the condition that all statutory remedies would remain on home improvement contracts in excess of $10,000.00.

As has been noted by this consultant, and staff, the Mechanic's Lien Law was a mere creature of statute from 1850 until 1879 when the Constitution provided for the lien right. At that point in time, the mechanic's lien became not merely a creature of statute, but a right granted by the organic law of this state. As has been previously noted, no other creditor remedy enjoys this constitutionally enshrined status. Also, as previously noted, the constitutional grant of the mechanic's lien right mandates that the Legislature shall provide for its "speedy and efficient"

enforcement. Prior to 1911, the Legislature struggled with trying to adopt a statutory scheme pursuant to the conflicting concepts of the private right of contract (that is, regulating the contract between the owner and the contractor) and the lien right as granted by the Constitution.

The case of Knowles v. Joost discussed on Page 13 of the Tentative Recommendation was decided in 1859. The opinion states that before the notice of lien was filed, or notice was given to the owner of the building, the owner had fully paid the contractor all that was due the contractor under the contract. The opinion then points out that under the statute of 1856, it was intended that the liens of subcontractors and materialmen should be satisfied by the owner of the building out of monies "due from him from the contractor", and the third section of that statute authorizes the owner, upon being served with proper notice, to withhold from the contractor a sufficient sum to cover the lien claimed by the subcontractor. The opinion points out that it was not the design of the Legislature to make the owner responsible except upon notice, and only to the extent of the sum due to the contractor at the date of the notice. The opinion concluded that the statute provides materialmen and subcontractors a cheap, easy and expeditious means of attaching in the hands of the owner any money due from the owner to the contractor, but does not prevent the owner from agreeing to pay for the work as soon as it completed. Thus, all that Supreme Court decision did was to interpret the statute as it existed at that time, to-wit, it was a statute that was consistent with the theory that the lien rights of the subs and depended upon there being an amount due from the owner to the contractor when the subs and suppliers sent notice to the owner.

McAlpin v. Duncan, discussed on Page 14 of the Tentative Recommendation, was a case decided in 1860. Again, the court was construing the 1858 statute, but the 1858 statute was essentially the same as the statute construed in the Knowles v. Joost case. Specifically, as noted on Page 14, Lines 14-22 of the Tentative Recommendation, the Supreme Court held that what they gathered from the act is that materialmen and subcontractors have a lien "to the extent of the contract price of the principal contractor", and that those persons must give notice of their claims to the owner and if they do not, it will not prevent the owner from paying the contractor, thereby discharging the debt. Finally, that by giving notice, the owner becomes liable to pay the subcontractor or material supplier. Again, what the court was interpreting was essentially the same statute, which limited liens to the amount of the contract price.

The case of Renton v. Conley, discussed on Page 15 of the Tentative Recommendation, was construing the Mechanic's Lien Act of 1858. At this point in time, California had not changed from a "contract analysis" to a "direct lien" scheme for the enforcement of mechanic's liens. In the Renton case (which was a pleading case), the claimant was as supplier of lumber to the contractor. The Complaint alleged that they had furnished the lumber, had not been paid and recorded a lien. There was no allegation in the Complaint as to whether or not the lumber company had given notice of the lien to the owner before the owner paid the contractor and there was no allegation that there was any amount remaining unpaid from the owner to the contractor. The Supreme Court was consistent with its prior decisions wherein it concluded that they had, on several occasions, construed the lien law, and notwithstanding the broad language of the statute, they had consistently held that where the owner had made payments to the contractor in good faith, under and in pursuance of the contract, before receiving notice of the liens, the materialmen could not charge the building with the liens exceeding the balance of the contract price remaining unpaid when the notice of lien was given, citing the McAlpin case. The court concluded that, "The act of 1859 certainly lends as much support to the views advanced by the appellants as the Act of 1868; and, as we have seen, that act has been construed as limiting the lien as above indicated."

Mechanic's Lien Law becomes a direct lien in 1911. The world of mechanic's liens changed dramatically in 1911. In the Report dated September 11, 2001, 1911 Cal.Stat.Ch. 678 is referenced, but not quoted. In the letter of this consultant dated September 18, 2001, the full text of 1911 Cal.Stat.Ch. 678 was set forth. The intent of the Legislature was clearly set forth at that time. At that point in time, the Legislature clearly indicated that the world of mechanic's liens had changed from a "contract" basis to a "direct lien" basis. The revision of 1911 bears repeating:

> "Section 14 of Chapter 681, Stats. 1911, enacting the sections relating to the Mechanics' Lien Law, provides: The provisions of this act shall be liberally construed with a view to effect its purpose. They are not intended as a re-enactment of the provisions of former statutes, with the policy heretofore impressed upon the same by the courts of this state, but are intended to reverse that policy to the extent of making the liens provides for, direct and independent of any account of

> indebtedness between the owner and the contractor, thereby making the policy of this state conform to that of Nevada and the other Pacific Coast states."

As noted on Page 16 of the Tentative Recommendation, at that point in time, California became a "direct lien" state. That was provided for in former Code of Civil Procedure §1183 and is currently provided for in Civil Code §3123. The Legislature made it clear in 1911 that the lien rights, as conferred by the Constitution, were directly against the owner's realty regardless of the status of the account between the owner and the contractor. Specifically, Civil Code §3123(a) provides as follows:

> "The liens provided for in this chapter shall be direct liens, and shall be for the reasonable value of the labor, services, equipment, or materials furnished, or for the price agreed upon by the claimant and the person with whom he or she contracted, whichever is less. The lien shall not be limited in amount by the price stated in the contract as defined in Section 3088, except as provided in Sections 3235 and 3236 and in subdivision (c) of this section."

As a result, since 1911, the Legislature has clearly carried out the constitutional mandate directing the Legislature to provide for the speedy and efficient enforcement of the lien right created by California's organic law. The liens are "direct liens" and are not "limited in amount by the price stated in the contract". Civil Code §3088 defines the contract that is mentioned in Civil Code §3123 as follows:

> "'Contract' means an agreement between an owner and any original contractor providing for the work of improvement or any part thereof."

As acknowledged in the Tentative Recommendation, the owner was given the right to limit its liability to the contract price by obtaining a payment bond in the amount of 50% of the contract price. This consultant discussed the "leading case" of Roystone Co. v. Darling in my report on the constitutionality of the full payment defense proposal, and that is again repeated on Pages 16, 17 and 18 of the Tentative

Recommendation. The net effect of the statement of intent of the Legislature, as set forth in 1911 and as reflected in Civil Code §3123, and as acknowledged in the Roystone case, is that lien claimants have a direct lien on the owner's real estate for the reasonable value of the labor, service, equipment and material they have furnished regardless of the status of the account between the owner and the contractor. The current proposal turns that concept on its head and now makes the status of the account between the owner and the contractor the determinative factor of the lien rights of the subcontractors and suppliers. If the owner has paid the contractor in full before a claim of lien is recorded or a stop notice is served, or a "Direct Payment Notice" is served on the owner, or if the project is under $10,000, or if the project exceeds $10,000 and is not bonded, then if the owner has paid the contractor in full, the subs and suppliers have no rights. It is respectfully submitted that the current proposal would therefore be unconstitutional as previously indicated.

This consultant has tried hundreds of Mechanic's Lien foreclosure cases. This consultant has successfully objected to the introduction of any evidence of payment by the owner to the contractor when I have represented subcontractors and suppliers. Said objection is, of course, based on Stats 1911 and the Roystone case and CCP §1183 and Civil Code §3123.

The case of Pacific Portland Cement Co. v. Hopkins is discussed on Page 19 of the Tentative Recommendation. As noted on Page 252 of the Supreme Court's opinion, "The transaction involved took place in 1909 and our discussion has referenced the Mechanic's Lien Law as it read prior to the Amendments of 1911 to Sections 1183 et. seq. of the Code of Civil Procedure." In other words, this case was governed by the law as it existed prior to 1911. The trial court had found that the owner had paid the contractor in full before the claimant had given notice of its lien right. The Supreme Court noted on Page 254 that where there was a valid contract for the construction of a building, the liens of those claiming under the contractor were measured by the contract price or so much thereof as had not been duly paid to the contractor. The Supreme Court then discussed the Roystone case as noted on Page 19 of the Tentative Recommendation. Since the lien in question arose under the law as it existed prior to 1911, the contract rule was in effect and by reason of the fact that the owner had paid the contractor, the claimant was held not to have a mechanic's lien right. This case is not relevant to the radical change in the lien law made in 1911.

The Mechanic's Lien law has never been "self-executing". Before the constitutional provision,, it was a matter of statute. When the Constitution was adopted, the Legislature was given the mandate to provide for the speedy and efficient enforcement of that constitutionally guaranteed lien right. It has always been acknowledged that the Legislature provides for this "direct lien" that must be speedily and efficiently enforced regardless of the status of the account between the owner and the contractor.

The case of Frank Curran Lumber Co. v. Eleven Co. is discussed on Page 20 of the Tentative Recommendation. That case is cited for the general proposition that the lien right is implemented by the Legislature through its power to "reasonably" regulate and provide for the "exercise of the right". It is obvious that the Legislature has, over the years, heard from all segments of the construction industry concerning their particular interests under the lien law and has sought to balance those interests. As had been noted by this consultant on numerous occasions, the current law now balances the "direct lien" right of the claimants by giving the owner the right to bond the project. The Frank Curran Lumber Co. case involved an issue as to what the effect of a release bond would have on a mechanic's lien. It has absolutely nothing to do with whether or not a statute eliminating the lien right, under the circumstances described above, and under the current proposal, would be constitutional or not. At the bottom of Page 183 and the top of Page 184, the court made the following statement:

> "Under article XX, section 15, the Legislature is empowered, in balancing the interests of the lien claimant and the property owner, to adopt legislation which will relieve the property owner of the burden of the lien and at the same time afford the lien claimant reasonable assurances that his claim, if valid, will be paid in full. Section 1193.2 of the Code of Civil Procedure provides such relief to the property owner and also provides ample guarantee to the lien claimant of the payment of his claim. The language of the Constitution granting the right to a mechanics or materialman's lien does not compel a construction which would deprive the property owner of his right to dispose of his property free of such lien until the dispute is finally determined in a court of law. Such a construction would not balance the interests of the

> respective parties but in fact would favor the lienholder to the detriment of the owner of the property. Section 1193.2 of the Code of Civil Procedure does not deprive the appellant of its constitutional right to a lien. On the contrary, it provides for the speedy and efficient enforcement of such lien in a manner that is just and equitable both to the appellant, as a holder of the lien, and to the respondents, as owners of the property."

Thus, the Frank Curran Lumber Company case clearly acknowledges that you can't destroy the lien right and you must provide for its speedy and efficient enforcement. Specifically, the court noted that the claimant has a claim against the surety company and therefore, the release bond section of the code does not deprive the lien claimant of its constitutional right to a lien and, in fact, provides for its speedy and efficient enforcement in a manner that is just and equitable to both parties. As noted above, the current proposal does not provide for the speedy and efficient enforcement of the lien right in the circumstances outlined above.

On Pages 21 and 22 of the Tentative Recommendation, the debates and proceedings of the California Constitutional Convention of 1878-79 are discussed. As noted in the Memorandum on Page 22, Lines 25-30, a contrary interpretation of the debates is possible since the Legislature in 1880 amended the Code of Civil Procedure §1183 to provide that the lien "shall not be affected by the fact that no money is due or to become due on any contract made by the owner with any other party". It was a standoff and the extent of the lien was left to legislative determination, but certainly the Legislature was not authorized in providing for the "speedy and efficient" enforcement of the lien to enact a statute that would eliminate the lien. This is particularly true since the Legislature has consistently indicated, since 1911, that the lien right is a "direct lien" regardless of the status of the account between the owner and the contractor. It is clearly the intent of the Legislature to provide for a direct lien.

The Connolly case is discussed on Page 23 of the Tentative Recommendation. It is, of course, a case that this consultant is very familiar with as I served as Amicus Curiae (among others) on behalf of the lien claimants in that particular case. It is true that the issue in that particular case was whether or not the stop notice and the mechanic's lien constituted a taking without due process of law. The California Supreme Court, in a four to three decision, upheld both the lien and the stop notice

law. Numerous statements of the Supreme Court in the Connolly case were highlighted by this consultant in prior reports. It should also be noted that on Page 808 of the opinion, the California Supreme Court acknowledges that the California mechanic's lien derives from the Constitution. The Supreme Court also notes that, "Once recorded, the mechanic's lien constitutes a direct lien (§ 3123) on the improvement and the real property to the extent of the interest of the owner or the person who caused the improvement to be constructed (§§ 3128, 3129)". As previously noted by this consultant, on Pages 809 and 810 of the opinion the Supreme Court clearly set forth that the owner and lender can protect themselves against stop notices by securing and recording a payment bond from the general contractor and may, likewise, obtain the release of a stop notice by filing a release bond. As previously noted, the Supreme Courted noted on Pages 822 and 823 of the opinion that if an owner contended that a claimant was not entitled to a lien, that upon receipt of a preliminary notice, the owner could immediately file suit to enjoin the claimant from asserting the lien. Further, by use of a temporary restraining order, the plaintiff could secure a hearing before the lien was imposed. Even after the lien was recorded or a stop notice filed, the owner could seek a mandatory injunction ordering the claimant to release the lien. As noted by the Supreme Court, the owner need not wait until the claimant sues to enforce the lien as the imposition of the lien and the owner's denial of it validity, would comprise a controversy sufficient to permit an immediate suit for declaratory relief, which would have priority on the calendar. Although the question of payment by the owner obliterating the lien right was not before the court, the comments of the California Supreme Court make it amply clear that the lien right enshrined in the organic law of this state serves a public policy that should not and cannot be defeated by payment from the owner to the contractor contrary to the express intent of the California Legislature.

The Wm. R. Clark Corp. case is likewise discussed on Page 23 of the Tentative Memorandum. There, the California Supreme Court did hold that a "pay if paid" clause in a subcontract would not waive the unpaid subcontractor's lien right. The California Supreme Court specifically stated on Page 890 of the opinion that even though a "pay if paid" provision is in a subcontract, and therefore is not precisely a waiver of a mechanic's lien right, the court could conclude that such a provision is "...void because it violates the public policy that under lies the anti-waiver provisions of the mechanic's lien laws". The Supreme Court further stated on Pages 891 and 892of the opinion that the Legislature has determined that there are policy considerations that override the value of freedom of contract. The

Supreme Court indicated that they were merely recognizing and enforcing that legislative policy determination. The Legislature has made a policy determination that since the lien right is constitutional in origin and the Legislature is given the mandate to provide for its speedy and efficient enforcement, that the lien right should be a direct lien against the owner's property regardless of the status of the account between the owner and the contractor, The current proposal violates that policy and would be unconstitutional.

The "Tentative Recommendation" then comments on the cases referenced by this consultant starting on Page 24. The Roystone case has been discussed extensively. Suffice it to say that the Supreme Court clearly recognized that the "contract era" was gone and by virtue of the 1911 act, we were now in the "direct lien" era where the status of the account between the owner and contractor was now "immaterial". The Legislature balanced the interests of the lien claimants and the owner. The Legislature now allowed liens to be directly asserted against the owner's real estate "regardless of the status of the account between the owner and contractor". The interests of the owner were protected by the bond provisions pursuant to which the owner could limit its liability to the contract price by bonding the jobs.

It should be noted that the English v. Olympic Auditorium case discussed on Pages 24 and 25 also states on Page 642, "If the Legislature attempted to limit this lien by the non-responsibility statute, such statute would necessarily be unconstitutional as an unauthorized limitation of the right granted by the Constitution."

The balance of the material in the "Tentative Recommendation" has been previously addressed in prior reports.

3. THE TENTATIVE RECOMMENDATION IS UNWORKABLE, UNREASONABLE, UNFAIR AND SHOULD NOT BE ADOPTED

This consultant recognizes that the Commissioners have decided to adopt the "good faith payment defense" in home improvement contracts. For the reasons hereinafter set forth, this consultant would respectfully request that the Commissioners carefully consider the comments referenced above and the following comments before making a final decision to move forward with the Tentative Recommendation. It is respectfully submitted that the Tentative Recommendation

is unreasonable, unworkable, unfair and in short, "a bad idea" that should not be adopted. In addition to the reasons set forth above and for the following reasons, it is respectfully suggested that the Tentative Recommendation should not be adopted. The reasons it should not be adopted include, but are not limited to, the following:

A. There is no evidence that the alleged double payment problem is a significant problem that requires this radical reform to the Mechanic's Lien Law. Lobbyists consistently advise people seeking to enact legislation in Sacramento to bring to the Legislature "war stories" which show a legitimate need for reform. Legislators are not inclined to enact legislation unless there is a strong factual showing that there is a need for such legislation. The need for the tentative recommendation has never been demonstrated and, in fact, it has been acknowledged by all participants in discussing the alleged double payment issue that there is no evidence that this is a major problem. For reasons which will hereinafter be discussed, this radical reform is like dropping a million dollar missile on a one-man tent in the middle of Afghanistan. The replacement is overkill for the alleged crime.

B. There is no substantial evidence before the Commission which indicates that the surety industry will, in fact, write the bonds being mandated by the statute. What we have is one letter from one surety company indicating that that surety company would write the bonds. What is missing is what the underwriting criteria will be before that surety company or any surety company would write these bonds. The real facts in the construction industry are that surety companies only write bonds upon the theory that they will never suffer a loss pursuant to the bonds which they issue. They go through an underwriting process whereby they carefully assess the business capacity and financial condition of their principal (in this case, the prime contractor). They will only issue a bond for a contractor if they determine that the risk is either adequately collateralized or the principal has adequate financial resources to justify the extension of credit. There is no evidence before the Commission as to how many home improvement contractors or home improvement subcontractors will qualify for bonding on home improvement projects. In fact, it has been surmised by several commentators during this process that legitimate home improvement contractors who are honest, hard working and capable will be put out of business by reason of not being able to qualify for the bonds. Absent satisfactory evidence that the plan as envisioned by the Tentative Recommendation can be implemented in the marketplace, it should not be adopted.

C. There is no evidence before the Commission as to what the economic impact on the home improvement business will be in the event that the tentative recommendation is adopted. We don't know, for example, what the total number of dollars are spent by homeowners on home improvement contracts per annum. Is it one-half billion dollars, or is it one billion dollars? Assuming it is somewhere in the billion dollar range, we then have to determine what the premium on the surety bonds will be. It is assumed that home improvement contractors are considered a "shaky risk" and therefore, the premium will be somewhere between one and five percent. Assuming that the average premium will be three percent, then one must multiply three percent times one billion dollars to determine the ultimate costs to homeowners in the State of California to implement this plan. In light of the fact that there is no evidence that double payment in a major issue in the home improvement business, it seems imprudent to saddle the homeowners of this state to such a substantial economic impact for what is evidently a minor problem. The analogy to the million dollar missile being used to destroy a one-man tent in the desert of Afghanistan again seems to be appropriate.

D. The tentative recommendation is in clear violation of the existing law of this state which makes mechanic's liens a direct lien against the owner's real estate regardless of the status of the account between the owner and the contractor. See the comments referenced above.

E. The economic impact, as referenced above, may be substantially increased if the Tentative Recommendation is adopted by reason of the fact that many contractors who are required to bond their projects pass the same requirement on to the subcontractors. Thus, the subcontractor bids will go up to cover the cost of bonding. It is quite common to see a requirement for performance and payment bonds in public works. This occurs by reason of the fact that the prime contractors who are required to furnish both performance and payment bonds to the public body routinely pass this requirement on to their subcontractors. This is especially true when they are using low bidding subcontractors that they have not had prior dealings with. One can just add that additional burden to the burden mentioned above.

F. The Tentative Recommendation has many shortcomings and some have been mentioned above. In addition to those mentioned above, some additional problems should be addressed. Section 3244.10 provides that the contract shall be filed and the bond recorded with the county recorder of the county "where the subject of the contract is situated". This consultant, of course, interprets the quoted

language to mean the county where the real property is located. Why not say it just that way? Civil Code §3235 so provides. Civil Code §3235 provides that the original contract is filed in the office of the county recorder of the county where the property is situated and the bond is recorded in such office, i.e., the office of the county recorder where the real property is located. Why not just state that the contract shall be filed and the bond shall be recorded in the county where the real property is situated? Mechanic's lien foreclosure actions are in rem actions. A mechanic's lien must be recorded in the county where the real property is located. The courts have consistently held that only the county in which the real property is situated has jurisdiction over a mechanic's lien foreclosure action. That language should be clarified. Section 3244.40, regarding what is or is not a good faith payment, has been previously commented upon. It is not clear, in that section, as to when the "Direct Payment Notice" can be given by the subcontractors and material suppliers. It should be clarified to state that the "Direct Payment Notice" can be given at any time by subcontractors and material suppliers. Further, there is no discussion as to how the Direct Payment Notice is to be served. For example, the Preliminary Notice Law allows personal service, certified mail or registered mail. As a practical matter, the way the industry operates, is that nobody uses personal service and nobody uses registered mail. Most claimants send their Preliminary Notices by certified mail and many of them send it by certified mail, return receipt requested. When is the notice to the owner deemed to have been received? Is it deemed to have been received upon receipt? How does that account for delay by the post office, and the fact that in many homes today, both the husband and the wife work, and nobody is home to accept the certified mail when the post person shows up at the door. The post person then leaves a note in the mail box and makes an attempt to deliver later on if no one comes in to pick up the notice. Thus, days and, in fact, weeks can to by before the notice is actually received by the addressee of the notice (the homeowner). By then, the cat will probably be out of the bag and the homeowner will have already paid the contractor. The method of service and when service is deemed complete should be set forth in the statute. That is the precise reason for Civil Code §3097(f)(3), which provides:

> "When service is made by first class certified or registered mail, service is complete at the time of the deposit of that registered or certified mail."

That same language should be set forth in the Tentative Recommendation if it is adopted. Service should be deemed to be complete when the certified or

registered mail is deposited. Time is of the essence on these small home improvement contracts where the contractor can be in and out in a matter of days, such as in the case of a patio, a driveway, a block wall, or a re-roof project.

G. As has been previously noted, the punishment for non-compliance with the statue doesn't fit the crime. The only punishment for the home improvement contractor who doesn't comply with the law is disciplinary action. As has been noted by persons other than this consultant, during these proceedings, the threat of disciplinary action does not have a significant deterrent effect on home improvement contractors. As previously noted by the undersigned, that provision should be changed to provide that the effect of non-compliance with the mandatory provisions of proposed Civil Code §3244.10 should be immediate suspension of the contractor's license and, most importantly, where the home improvement contract is not bonded, there shall be no limitation of mechanic's lien and stop notice rights and they shall remain in full force and effect.

H. Proposed Section 3244.20, relating to the bond requirements, is ambiguous and inadequate under Subdivision (c). Subdivision (c) allows a prime contractor's blanket payment bond satisfying the regulations of the Contractor's State License Board. These are the regulations that Ellen Gallagher, from the Contractors' State License Board, has indicated that the Board does not like to advertise. There is an ambiguous statement that the blanket payment bond means coverage of "potential claims", aggregating not less than 50% of the total value of a prime contractor's home improvement contracts on a "quarterly or semi-annual basis or some other appropriate measure determined by regulation". That is a hole in the statute big enough to drive a sixteen wheeler through. I would respectfully urge that if this Tentative Recommendation is adopted, that Subdivision (c) be eliminated.

I. There has been a lot of discussion about the balancing of the interests of the various stakeholders in the construction industry. Lenders have been given priority over mechanic's liens as long as their deed of trust is recorded before work commences. This is necessary in order to induce lenders to make construction financing available. When it became apparent that mechanic's liens were being wiped out by foreclosure of the prior deeds of trust of the lender, the Legislature wisely enacted the stop notice remedy so that the unpaid contractor, subcontractor or material supplier could file a bonded stop notice with the construction lender or an unbonded stop notice with the owner where the project was being financed out

of the owner's own funds. Thus, a fair and reasonable balance was achieved between lien claimants on the one hand, and the lenders on the other. With regard to tenant improvements, the lien law provides that the owner can post and record a Notice of Non-Responsibility and if that occurs, then the courts have held that the lien claimant merely has a lien on the leasehold interest of the tenant and on the structure down to the surface of the ground. The courts have likewise held, however, that if the owner is a participating owner, (that is the owner has made the erection of the improvements mandatory under the lease agreement), then the Notice of Non-Responsibility will be invalid, and the lien claimants will have a lien not only upon the structure, but also upon the underlying fee interest of the owner. Again, a balancing of the interest between the non-contracting owner and the lien claimants. On public works, the Legislature determined that it did not make a great deal of sense to have lien claimants foreclosing on the courthouse, the city hall, or the school house. As a result, in balancing the interest between the unpaid subcontractors and suppliers, and the tax payers of the State of California, the Legislature wisely required that all public works projects be bonded and has given to the subcontractors and suppliers both a stop notice remedy and a bond remedy against the surety on the payment bond. The payment bond must be 100% of the contract price. The Tentative Recommendation clearly protects the interests of the homeowner. It provides that where the owner has paid the contractor in full, in good faith, there are no lien or stop notice rights, and the material suppliers and subcontractors are entitled to seek recovery on the "mandatory" payment bond. What happens if the payment bond doesn't exist? The subcontractors and material suppliers are out of luck. This is clearly not a fair balancing of the interests. To be truly fair, the statute would have to provide that if the project is not bonded, as required by the Tentative Recommendation, then lien and stop notice rights shall remain in full force and effect.

J. As a practical matter, the prime contractor and the subcontractors, of course, will have knowledge of the fact that it is a home improvement contract that they are involved in. The material suppliers will not. Lack of information and misinformation has plagued the construction industry for years. It is very difficult for material suppliers to obtain accurate information from their subcontractor customers at the inception of the job when they are making the decision as to whether or not extend credit. The Tentative Recommendation exacerbates the problem. First of all, it would be very difficult for the material suppliers to find out whether or not they are, in fact, involved in a home improvement contract. In addition, it is often very difficult to get the accurate name of the owner on a home

improvement project. Once the material supplier gets the information, the material supplier will then send out the "Direct Payment Notice" probably by certified mail, and there will be further delay at that level. This makes compliance with this Tentative Recommendation very difficult for material suppliers in the industry. In addition, it will be even more difficult for either the subcontractors or the material suppliers to verify whether or not the job is, in fact, bonded. Credit decisions must be made promptly in the construction industry. Neither subcontractors nor material suppliers are equipped to send people to the county recorder's office to determine whether or not there is a bond recorded. Have any of the Commissioners ever gone to the county recorder's office to try to find out whether or not a payment bond has been recorded? Until you have had that experience, you are unable to appreciate the difficulty of that endeavor. That is the reason for Recommendation No. 13, discussed on Pages 16 an 17 of Memorandum 2001-71 "Mechanic's Liens: General Revision" dated September 17, 2001. Under that section, this consultant recommended that the owner and the contractor provide a copy of the payment bond to the persons who have served them with Preliminary Notices. The staff does not support that recommendation. They think it creates too much paperwork. On the contrary, it is a communication device and it makes all the sense in the world. If the job has been bonded, the bond protects the owner and protects the claimants, and the claimants should have notice and knowledge of that fact rather than require them to go through a difficult and almost unmanageable problem of trying to ascertain whether or not the job is bonded, and whether or not it is a home improvement contract.

K. If the Commissioners still feel that they want to adopt the Tentative Recommendation, then again it is respectfully suggested that the Commissioners also adopt Professor Kelso's owner's recovery fund as previously commented upon. In fact, the manner in which this entire study began was a result of Assemblyman Honda's proposed Constitutional Amendment coupled with a default recovery fund. Assemblyman Honda recognized that if you are going to eliminate the lien rights of the claimants on home improvement contracts, it would only be fair in balancing the interests of the owner versus the interests of the subcontractors and material suppliers to give them a source of recovery, to-wit, the default recovery fund. Professor Kelso modified that proposal by making it an owner's recovery fund financed by a permit fee. As noted by this consultant in prior written material, this consultant believes that if you are going to adopt the Tentative Recommendation, and allow the full payment defense, and no lien or stop notice rights for the subcontractors and material suppliers where the job is not, in fact, bonded, then

there should be a recovery fund. It should be a homeowner's recovery fund funded by a permit fee. As previously noted, the way it would work would be that the permit fee would be charged at the time the permit was taken out to create the fund. If a subcontractor or material supplier didn't get paid and recorded a mechanic's lien or served a stop notice, and brought an action to enforce the mechanic's lien and/or stop notice, the owner could raise, as an affirmative defense, that it had paid the contractor in full. It should be noted that this will always be an issue in these cases where the job is not bonded. There will have to be discovery on the issue in these cases thereby increasing the cost of litigation to owners and claimants alike. When the matter went to trial, the court would make a finding as to whether or not the owner had paid the contractor in full. If, in fact, the court made a finding that the owner had paid the contractor in full, the judgment would be entered allowing foreclosure of the lien or enforcement of the stop notice, but with a specific finding that the owner had paid the contractor in full. When that judgment became final, and upon proof by the homeowner that they, in fact, "paid twice", the homeowner could then make a claim against the fund.

L. The Tentative Recommendation proposes eliminating the Preliminary Notice. As previously noted by this consultant, that likewise is a bad idea. If the Commissioners will carefully read the Connolly case, one will find that one of the primary pegs upon which the California Supreme Court hung its hat was that the lien law required the Preliminary Notice. Thus, the owner was put on notice early in the job of who the potential lien and stop notice claimants were so that they could take steps to see to it that they are paid during the progress of the job or bring appropriate action to prevent them from recording a lien or serving a stop notice if the owner believed that they did not have the right to a lien or a stop notice. If the Preliminary Notice is eliminated in home improvement contracts, this will give another reason for the court to hold that portion of the statute unconstitutional.

M. When this process first began, this consultant, in my initial report, commented upon Assemblyman Honda's legislation. I was told that it was "political" and that I shouldn't comment upon it. As has been noted, the entire focus of the Commission, since the very first meeting, has been this "political" issue. In fact, staff in commenting upon the constitutional issue has stated that this full payment defense issue is not a constitutional issue, but in fact, a "political" issue. As consumer legislation, it certainly would appear to be politically popular as there are a lot more consumers than there are business entities in California. However, the construction industry is a very large part of the overall economy of California

employing millions of Californians who depend upon the businesses that employ them to receive their paychecks. As noted above, the Tentative Recommendation does not, in fact, adequately protect the interests of the business entities that contribute so much to California's economy and employee so many millions of people. It is respectfully submitted that more protection should be given to the persons who create the very work of improvement that the owner receives.

This consultant recognizes that the Commissioners have probably already made up their minds on this issue. I would respectfully urge the Commissioners to carefully reconsider that decision in light of the comments made herein. I would respectfully request that the Tentative Recommendation not be adopted. If it is adopted, then better protection needs to be provided to the subcontractors and material suppliers as hereinabove set forth.

4. CONCLUSION

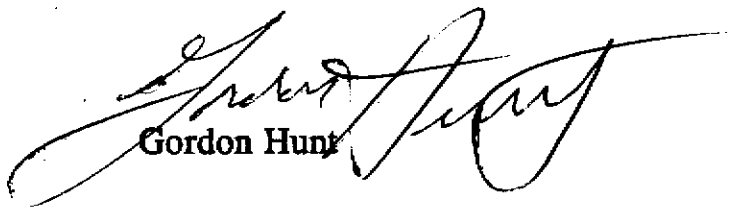
It is apparent that the Commissioners have already opted to adopt the "full payment defense". If the interpretation of this consultant is correct that subcontractors and suppliers may serve a direct payment notice "at any time", then this addition to the proposed statute is an improvement as suggested by this consultant in prior comments. It is still the recommendation that this proposed new statute not be adopted as it will create more problems than it solves for home improvement projects and will substantially increase the cost of home improvement projects for all homeowners when only a very few, if any, are ever subjected to double payment. Evidently, Mr. James Stiepan agrees when he states it is "ill advised", "will tend to raise costs across the board", "may make the smaller contractor non-competitive", and "there will be a spate of creative attempts to circumvent the requirement", and finally, "we are probably better off with the disease than the cure". (See First Supplement to Memorandum 2001-70, bottom of Page 1 and top of Page 2.)

This consultant respectfully requests that the Commissioners carefully reconsider this substantial change to the lien law in light of the State Constitution and the legislative intent referenced above.

On a personal note, I would like to commend Mr. Ulrich for the very fine work that he has done in connection with this study. I would like to thank the Commissioners for the careful consideration they have given this consultant and the

extensive time and effort they have devoted to this study. Little did we all know it would take this long and require this much effort. It has been my privilege and pleasure to have been of service to the California Law Revision Commission.

Respectfully submitted,



Gordon Hunt

GH:slg

slg:\\Second\company\Hunt\GH\Law Revision Comm\Report - October 2001.wpd

From: "Mike Wu@aec88" <Mike_Wu@aec88.com>
To: <commission@clrc.ca.gov>
Subject: bond for contract over $10,000
Date: Mon, 29 Oct 2001 10:15:41 -0800

To whom it may concern,

It has been extremely different to complete w/ non-licensed handyman type contractors who have barely been controlled or monitored:

1. Don't pay workers' compensation.
2. Don't pay payroll taxes (pay in cash), while allowing their employees to draw unemployment or welfare.
3. No fringe benefits to employees.
4. No liability insurance.

These activities shall be abated thoroughly to avoid further deteroiation.

Add the bond requirements will kill mostly non-union contractors which are providing works at reasonable quality and price and keep the inflation down. Keep adding assurances to everything which make less things accomplished and more cheating. Educate home owners, business owners about lien rights is more important than sacrificing the rights. Crooks are still around and they will keep taking advantages until owners can make right decisions; not until new legistation passed.

Bonds should really be option to customers, not mandatory. Customers should have options to take risks by saving costs. Adding more and more regulations and nonsnese and make the rules so different to understand and eventually be neglected. Just like someone don't border to file taxes anymore or wait until the last minute.

Again, educating owners and customers is the only hope.

Pls solve the problem at the root.

Mike Wu
Associated Engineering & Construction

From: "Mike Wu@aec88" <Mike_Wu@aec88.com>
To: <commission@clrc.ca.gov>
Subject: More comments
Date: Mon, 29 Oct 2001 15:06:59 -0800
X-IMAPbase: 1004396982 1
Status: O
X-Status:
X-Keywords:
X-UID: 1

Stan,

More comments:

Contracting is already a low profit and high risk business.

It is not fair to have less protection for contractors that provide small home improvements in a smaller price range (<$10,000), they will become more vulnerable and less stable.

To distinguish between home improvements, residential development and commercial projects will be another confusion. Why create additional burden on contractors and legistration which possibly don't understand contractors? This is not a progressive, small scale and prototype trial-and-error project.

Double payments mostly are due to bad business practice, foul play or ignorant owners. Why create something for those players who pay no respect to law? We shall not punish innocent contractors who perform. It is the owners that are ignorant who don't understand the process have mishandled their own liabilities. No one in this society understand all law provisions, shall ignorant be protected or exempted? This is a more fundamental prospect of how shall we look at legistrations modifications, especially when we try to add protection to a group of people in the expense of others.

Mike

Canoga Rebar Inc. *"first in service"*

10049 Canoga Ave., Chatsworth, Ca 91311 *www.canogarebar.com*
Phone: (818) 998-7848 Fax: (818) 998-1363
License No. 421500

October 29, 2001

California Law Revision Commission
4000 Middlefield Road Room D-1
Palo Alto, Ca 94303-4739
(650) 494-1335 FAX (650) 494-1827

RE: Proposed Lien Statute amendments
(Insurance bonding revenue act)

Gentlemen:

My company is a rebar subcontractor in the San Fernando Valley area of Los Angeles for the last 25 years. I am also a homeowner who has had homes remodeled and repaired and also those occasional seismic adjustments we seem to have in California. I think it happens when Mother Nature forgets to take her "Earth Control Pills".

I've been involved in almost a hundred lawsuits involving the issues that are now under study by your commission. Often the homeowner will bring a prelim to the General contractor and ask him what it means only to be told that's the GC's job to worry and take care of those things for the owner. On the other hand, any building is complex sequence of permits, building codes, and legal documents and of course problems.

I feel very strongly that the owner, who controls the money, must make sure when he sees a prelim sent to him that that person is paid. The system is not nearly as complicated as the work on the project. I feel the present system works very well and is not in serious need of repair. I have worked with bonding companies and they are terrible to deal with.

The system not broke and adding bonding will not fix anything, but add additional complications and costs. The system is much better left alone. Please!

Sincerley,
CANOGA REBAR, INC.

Robert E. Main
Vice President

KAYAR Corporation dba

K. REGEVIG ROOFING

License No. 367890
TAR AND GRAVEL SPECIALISTS

2600 McCone Ave.
Hayward, California 94545
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FAX (510) 782-1320

October 29, 2001

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

Re: Mechanic's Lien Matters

Dear Sirs:

I am opposed to changing the present California lien laws in any way. There is already adequate protection for the customer in that anyone desiring to protect their lien rights will send a preliminary lien notice.

The payment bond proposal is also too cumbersome for a roofing contractor in that most of our jobs are over $10,000. We do 5 to 15 projects per week and it would take a full time employee just to secure the performance bonds. The other problem is that it would only take a month or two to run out of bonding capacity. Also, this would virtually eliminate any new contracting businesses getting started as it takes a few years to obtain any sort of bonding capacity. At the present time, we only have to issue bonds once or twice yearly.

Getting performance bonds on a daily basis would be a monumental task. It is really the contractor who is at risk for the money he has advanced to complete a project. Asking him to provide a payment bond works in reverse if its intended purpose.

If the owner does not pay, now the contractor is on the hook to his subcontractors and suppliers with no recourse to the owner of the property.

Sincerely,

Kenneth A. Regevig

Kenneth A. Regevig
President

KAR/tlr

1977 - 2001

24

YEARS OF SERVICE

K. REGEVIG ROOFING

LAW OFFICES OF FRANK L. ROWLEY
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email: FLR@Attorneys.Com

Of Counsel:

Gerald J. Brantnall, Jr.

October 31, 2001

California Law Revision Commission
4000 Middlefield
Room D-1
Palo Alto, Ca 94303

Attention: Mr. Stan Ulrich, Esq.

Re: Proposed Mechanics' Lien Law Revision

Dear Mr. Ulrich:

In response to a request from one of my clients, I have rendered an opinion on a survey (see copy enclosed) being taken by the Lumber Association of California and Nevada (LACN). I am providing you with a copy of my response to the client.

Would you please provide this opinion to the commission for its consideration. Should you or the commission have any questions, please feel free to contact me.

Very truly yours,

Frank L. Rowley

Enclosures

LAW OFFICES OF FRANK L. ROWLEY
Attorney at Law

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Jerome D. Artz

John P. Garcia

Raphael L. Rosingana

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email: FLR@Attorneys.Com

Of Counsel:

Gerald J. Brentnall, Jr.

October 31, 2001

Big Creek Lumber Company
1400 West Beach Street
Watsonville, CA 95076

Attention: Linda Stith

Dear Linda:

You have asked for comments on the LACN proposal regarding the CLRC proposed changes to the Mechanics' Lien Laws. I'm going to offer my opinion and also send it to the CLRC. If you would like it to go to the LACN, you may do so.

The various proposals by the Law Review Committee are merely misinformed attempts to implement an idea that was put forth by Assemblyman Mike Honda some time ago. The basic problem with their attempts to "fix"the problem is that they have no idea what the problem is and the result of what will happen if their proposals are signed into law.

To understand the perceived problem, you must first go back to the beginning. In the case of Mechanics' Lien Law, you must go back to 1850 when the first legislature implemented the procedure. The simple fact appears to be that the first lawmakers understood the need to build the infrastructure of the State of California. To insure that artisans, material suppliers and laborers of every class would be willing to invest in this State, a scheme was needed to insure that they would be compensated for their labor and material. The legislature felt so strongly about this that they didn't simply codify it into law but made it a part of the State Constitution as Article 20, Section 15 (renumbered 1976) and codified in Sections 3082 to 3065 of the Civil Code.

The Mechanics' Lien Laws have continued to serve this State since that time. In the 1960's - 1970's there was a growing trend throughout the United States to strike down laws that were unconstitutional because they didn't meet the requirements of "due process." Because the State Mechanics' Lien Law has very short limitation periods and the Courts have strictly construed the statutory requirements to bind a persons real property, the Mechanics' Lien Law has met the requirements of providing due process to an owner of real property. In short, this law is the only constitutionally protected creditor right in the State of California.

The fact that the constitution of the State gives this right in and of itself raises serious questions as to whether any legislative attempt to deny those rights will pass constitutional muster. The recording of a Mechanics' Lien is a privileged act (FRANK PISANO & ASSOCIATES vs ROBERT TAGGART 29 Cal.App.3d 1 1972) Much of the input dwells on the issue of constitutionality and, while that discussion continues, the legislators and committees overlook the primary problem with their proposed fixes.

In a nutshell, the problem is that a few misguided people are acting, in good faith, on complaints that it is somehow unfair to require the owners of property to know and use the protection of the State's Mechanics' Lien Laws to protect both themselves and the laborers and suppliers that improve their property, and therefore, are attempting to fix something that isn't broken. Further, the fix will do more harm to the very citizens that they are attempting to protect than it will do to the construction industry. Even if they can pass legislation that would somehow withstand a challenge on constitutional grounds, what the legislators do not appreciate is that they can't legislate a requirement that a supplier, contractor or laborer provide their goods or services on a "credit basis." The fact that virtually all construction in this State is done on a "credit basis" suggests that, if the person giving credit cannot be assured that he will be paid, he simply will not give the credit. Applying this to Mr. Mike Honda's constituent in San Jose who wanted a new roof, but became upset when she received a notice that told her who the supplier was and the legislative notice regarding the Mechanics' Lien Laws, the supplier under the proposed scheme would simply require full payment up front or, at best, COD.

The question becomes, is it an improvement for the citizens to pass legislation that will virtually stop construction because of a lack of willingness to grant credit? The norm is that most builders, even institutional lenders, only pay after the work is performed. This may change to "pay first, receive goods and services second." This was the most basic motivation for the institution of the Mechanics' Lien Law in the first place, which was to assure payment to any person willing to provide goods and services on credit, thereby allowing the State to grow and flourish. Would it help Mike Honda's little old lady, if she couldn't get the money to pay for the roof up front? Unfortunately, what the legislators overlook is that there are people who buy and use goods that have no means to pay for them other than on the credit provided by the persons supplying the goods and services.

Now that you understand the background, lets look at the specifics of the LACN questionnaire. LACN is correct in its statement that the perceived idea that there is a substantial problem with double payments is incorrect. Even if the law required an owner to pay twice, the Courts have for years used its equitable powers to do justice and fairness. Simply stated, the Courts have held that where you have two innocent parties, one of which must suffer a loss, it should be the owner who had the ability to protect both himself and the claimant and failed to do so, but received the value of the goods or services. What the proponents of these changes fail to point out is that the provider of goods and/or services must meet strict legal requirements before they are allowed to collect from an owner and, if they miss any requirement, they lose their security in the owner's property. As often as not, this provides a windfall to an owner, in that they obtain the materials and services free.

As to point number one, requiring a 50% surety bond of contractors in excess of $10,000, this requirement again will hurt the home owner in the long run. Any requirement for a bond will require the homeowner to either directly or indirectly fund the bond. It will also remove otherwise competent contractors from the competitive bidding process and could result in higher prices being paid by the homeowner. It should also be noted that the right to have the contractor post a bond for a project is already written into the law. It is one of the safeguards provided for by the Mechanics' Lien Law. Because it is optional to the owner and is seldom used in home improvements, would suggest that the owners do not want to use it.

Point two, requires the general contractor to record the bond and contract. This is currently in the law as an option for the owner to protect himself against liens that would exceed the amount of payment required by the contract. This adds nothing new it simply shifts the responsibility to the contractor, thereby raising the costs to the contractor, which will eventually be passed onto the owner.

Point three, allows an owner who pays his contractor in "good faith" to prevent a claimant from filing a mechanics' lien. This would in effect deprive a claimant of his/her constitutional rights. It would be highly unlikely that such a scheme would withstand a constitutional challenge. It also allows the owner to disregard any of his obligations as it would allow him the ultimate decision on who to pay with impunity. Not a good idea.

Point four is essentially the same as three and is one of the existing three major remedies provided to suppliers and contractors, i.e. Liens, bonds and stop notices. As of this time, it is the owner's responsibility to require and pay for the bond.

Point five, allows stop notices and mechanics' lien rights only where the owner hasn't paid the general contractor. This stays with the theme of shifting all responsibility from an owner to the claimants. It would be next to impossible to determine if the general contractor was in fact paid for any particular portion of work. The burden would be on a claimant to prove that the owner hasn't paid. It also attempts to take away the claimant's constitutional rights.

Point six suggests that bonds will not be required for home improvement contracts under $10,000, and mechanics' lien rights and stop notice rights exist as to amounts not yet paid by the owner. This recommendation is so vague and unintelligible that it is useless. What happens to contracts under $10,000? How can a supplier or contractor know what amounts haven't been paid on a contract between an owner and his contractor? This type of thinking merely takes a system that works and has worked for over 150 years and makes it so complex and convoluted as to be unworkable.

Point seven holds that preliminary notices will no longer be necessary or required for home improvement contracts. This removes the final link between an owner the rest of the world. If the claimant does not tell the owner that the claimant is out there, then the owner can completely ignore all claimants and sleep peaceably at night. The fact that the preliminary notice is the cornerstone of the Mechanics' Lien Laws and is strictly construed by the

Courts to protect the owners makes it the first line of protection for both the owner and potential claimants. How can an owner protect against paying twice if he isn't aware of who may be claiming money for materials and services used and consumed in his property?

LACN is correct in their opinion that, under proposed revisions, contractors and suppliers are going to lose their lien rights. It seems clear that the object of the entire process is to shift the entire risk of collection away from the consumer to those who are providing the product and servies. LACN is incorrect in its belief that a statutory provision for a direct-pay system will solve the problem. The direct-pay system has no penalty to the owner and it does what the Stop Notice currently does, except that the Stop Notice provides that, if the owner makes a payment without holding back the claimed amount, he is personally liable for those funds.

The proposal by the LACN that all home improvement projects under $10,000 are subject to a "good faith" payment defense is nothing more then a surrender of well established rights in an attempt to appease well-meaning but misinformed interests and to save large suppliers and contractors at the expense of all small contractors, suppliers, laborers and owners that are the most vulnerable and least able to afford such a loss.

In summary, the net gain by any owner would be lost in the industries adjustment to such law. These proposals have the potential of creating chaos within the construction industry and history has shown that American business isn't going to lose money, at least, if they want to stay in business. Losses are traditionally passed on to the consumer which is what will occur in this instance if the State shifts the risk of credit collection solely onto the backs of business. Rather than giving in to such demands and hoping that the "hit" will be a small one, the construction industry should actively resist any attempt to take away rights that have been in place for over 150 years.

Very truly yours,

Frank L. Rowley
Attorney at Law

Lumber Association of California & Nevada

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Fax: (916) 369-8271
www.lumberassoc.com

October 15, 2001

TO: LACN MEMBERS

FROM: JAN HANSEN
EXECUTIVE DIRECTOR

RE: PROPOSED REVISIONS TO CALIFORNIA MECHANIC'S LIEN LAW - ACTION REQUIRED

Dear Members:

Nearly two years ago, the Legislature issued a directive asking the California Law Revision Commission (CLRC) to study possible revisions to the mechanic's lien laws in California. After numerous hearings, proposals and comments from the affected industries and associations, the Commission has prepared a Tentative Recommendation which is being circulated for public comments before the next hearing on November 16, 2001. Following the meeting, they plan to make a final recommendation that may be introduced as a legislative proposal in 2002.

The Commission believes there is a substantial "double payment" problem in California. The problem, as framed by several Legislators and legislative proposals, is that homeowners have been required to pay twice for work and/or materials, and were later required to pay subcontractors of material suppliers because of mechanic's liens recorded by the unpaid subcontractors or material suppliers. LACN has been present at all of the CLRC meetings throughout the state, and LACN has advised the Commission at several hearings that the "problem" is being greatly exaggerated and that the actual number of homeowners who are forced to pay twice for work or material is very small. However, the Commission perceives that there is a consumer protection issue here which must be addressed, and some special interests are aggressively fostering that perception.

The CLRC is looking to make recommendations to the Legislature regarding mechanic's lien laws and the following is a summary of the major points which the CLRC is seeking public comment on before issuing their final report.

1. A 50% surety bond will be required of all contractors for any home improvement contracts in excess of $10,000.00;

2. The prime contractor must record the bond with the county recorder, and file the home improvement contract with the county recorder;

3. An owner who pays his contractor in good faith will not be subject to additional liability for mechanic's lien claims (to the extent of his payment);

4. Subcontractors and material suppliers may make a claim against the surety bond instead of a mechanic's lien claim when the owner has paid the prime contractor;

5. Stop notice and mechanic lien rights will continue to exist, but only where the owner has not paid the prime contractor;

6. Bonds will not be required for home improvement contracts under $10,000, and mechanic's lien rights and stop notice rights exist as to amounts not yet paid by the owner; and

7. Preliminary notices will no longer be necessary or required for home improvement contracts.

The proposal uses many existing laws which pertain to the rights of an owner to limit his liability by obtaining and recording a bond for 50% of the amount of the contract, but make the bond a requirement for home improvement contracts in excess of $10,000.

LACN believes there are problems with the proposal as it now stands: First, although mechanic's lien and stop notice rights are lost when the owner has paid the prime contractor because of the requirement of the surety bond, there is no satisfactory remedy if the prime contractor fails to obtain and record the mandatory bond. That is, your lien rights would be lost despite the fact that there is no bond, and because there is no bond, the only remedy available is to sue the contractor for the money he received from the owner and owes to you. The CLRC believes that with this mechanism, you as a subcontractor or supplier will take all necessary steps to insure that your customer, the contractor, has recorded the required bond before you sell material or provide labor.

If a subcontractor or supplier fails to ensure there is a bond, you may have no lien rights at all. We believe this is unacceptable and unfair. We suggest that the recommendation be amended to provide that lien and stop notice rights are lost upon good faith payment by the owner only when the contractor has recorded the bond as required by law, and that any contractor who fails to obtain and record a bond as required be subject to automatic license suspension by the Contractors' State License Board.

LACN also believes that discussion regarding direct pay should be incorporated into the proposal. Specifically, the proposal, which allows a subcontractor or material supplier to service a "direct pay" notice on the homeowner, should be a part of the recommended law changes. Under the "direct pay" notice, a subcontractor or material supplier could serve a direct pay notice to the owner, which would prevent the owner from making a "good faith" payment to the prime contractor that extinguishes your lien rights. Where you believe that the prime contractor is not a good credit risk, or where there have been problems with payments in the past, you should be

4

able to notify the owner that they may pay you directly, and if they choose to pay the prime instead, they should not benefit from the protection afforded to a good faith payment.

While we do not believe that the double payment problem is anywhere near as extensive as the CLRC has been led to believe, it is relatively certain that the CLRC will be recommending a change in the laws based upon this "problem". Many other proposals that were considered by the CLRC were much less acceptable, and would have resulted in the total loss of lien rights without the benefit of a bond in lieu of the lien. One proposal was simply for a "full payment defense", which provided that if the owner proved that he paid the prime contractor, he was not liable for any amounts that remained due from the prime to the subs or material suppliers. That proposal has potentially catastrophic results for subcontractors and material suppliers, and suggests that we must be prepared to support a change, which impacts our businesses to the least degree possible. Because the pending proposal affects only Home Improvement Contracts, as defined by Business and Professions Code Section 7151.2, there are a substantial number of projects to which this law will not apply, and the existing lien laws will remain in place as to such projects.

Finally, the CLRC has also asked for comment on a simpler concept, i.e., that only home improvement contracts under $10,000 are subject to a good faith payment defense by the owner, and no bond would be required for such projects. LACN believes this simpler concept may be a more acceptable approach for our members rather than revising the existing structure of the mechanic's lien laws. We acknowledge that although there will be some risks for suppliers in these smaller contracts, you will continue to be served by the protections of existing law on larger projects and contracts.

We are soliciting your comments on the proposed changes which we will provide to the CLRC before its hearing in Los Angeles in November. This is your opportunity to be heard on this matter which may dramatically affect your business. Please generate a letter on your company's stationery addressed to Joyce Cook, Chair, California Law Revision Commission, and **send, fax or e-mail it to me by November 1, 2001 along with the attached cover letter designating your choice so I can share it with the Legislative Committee.**

We will assemble all responses in a single package and, to the extent possible, prepare a cover letter summarizing the common points raised by the responses as an industry response. We encourage you to review and consider this request, and to respond as soon as possible to this proposal. If you delay, you will lose the opportunity to have your opinion on this important matter aired before the CLRC.

7025 EAST SLAUSON AVENUE
COMMERCE, CALIFORNIA 90040-3620

TEL (323) 728-7115
FAX (323) 721-5041

November 2, 2001

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

Re: THE IMAGINED "Double Payment Problem in Home Improvement Contracts"

Gentlemen:

I do have some suggestions as to how you can protect the homeowner even further than as under the current lien laws. We sell roofing materials, and are involved in many small home improvement projects.

If it is your intention to completely absolve the homeowner from all responsibility when he signs a contract, then your approach is a very good one. If you do that, most suppliers will just demand payment up front from any contractor who can't prove himself credit worthy.

A much better approach would be to shorten the time allowed for the posting of a Preliminary Notice to two or three days, so that the homeowner would receive the Notice before he made his payment to the contractor, and could protect himself. Preliminary Notices have the advantage of a look of legality, and the homeowner should be put on his guard when he sees such a document. The current lien law really protects the homeowner to a very great extent, and unless he pays his contractor before he receives the Preliminary Notice, he should be able to protect himself one hundred per cent.

If you enact such a faulty procedure, we would merely send out the "direct payment notice" when we delivered the material (if we were selling someone who was not worthy of the credit). I guess that this would be only a letter without the force of the Preliminary Notice, and could very well not catch the homeowner's attention. But it would cancel his right to pay "in good faith".

Let's look at the bonding requirements in your proposition. These would add probably more than two per cent to the cost of a contract. No homeowner wants that much protection. And this part of your proposal gives us the hint of who is pushing this action. It would be a bonanza for the insurance companies, and I'm sure that they would be heavy contributors to anyone who backs this bad legislation.

Please notify us when you are having your hearings on this proposal.

Very truly yours,

Paul C. Byrne, Jr.
President

THE IRVINE COMPANY

James L. Stiepan
Vice President and
General Counsel
Office Properties

November 1, 2001

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

Re: Double Payment in Home Improvements Contracts

Dear Mr. Ulrich:

This is in response to the solicitation for comments on the Tentative Recommendation issued by the Commission in September 2001 regarding the above matter.

I do not wish to unduly belabor previous objections I have provided to the mandatory bonding proposal. Let me therefore just capsulize those quickly:

1. The cost of mandatory bonding will be passed on to consumers, thereby increasing the cost of home improvement work. It is better left to the consumer to make the appropriate risk / reward determination.

2. Bonding will be both expensive and problematical for small contractors. The immediate effect will be to make them less price competitive; the long-term effect will be to thin the ranks of contractors, reduce competition, and further stimulate the "underground economy".

3. To avoid the cost and inconvenience of mandatory bonding, contractors and consumers alike will seek creative methods to avoid the requirement (e.g. by segregating one project into two or more components).

4. The bright line threshold imposed for mandatory bonding is entirely superficial and does not necessarily correlate with the need for a bond. It is conceivable that a contract in excess of the threshold may simply reflect a labor-intensive project to be performed by the contractor without the need for any subcontractors or expensive supplies (e.g. custom millwork).

In addition to the foregoing, there is another very important consideration that has not been satisfactorily addressed. Although the Commission concludes that the proposed reform would be constitutional, I am regrettably not as sanguine. Should a California

3 Park Plaza, Suite 350, Irvine, Californ 49) 720-2323 • Fax (949) 720-2390

appellate court disagree with the Commission's legal analysis and vitiate the statutory good faith payment defense as unconstitutional, then the Commission will have unwittingly succeeded in creating the worst of all possible worlds: double payment jeopardy for the homeowner with a mandatory bonding obligation, as well as the elimination of the preliminary notice requirement, still in place.

It therefore seems clear to me that mandatory bonding should not be a part of any statutory revision at this point. Rather, the Commission would be better served to adopt the alternative approach of simply providing for a good faith payment defense for a limited class of home improvement contracts (e.g. those below the $10,000 threshold). When this new regimen has been tested judicially, then the Commission can, if it so desires, broaden its horizon to deal with the remaining set of home improvement contracts. If and when that occurs, my view is that the Commission would be much better served in looking to direct payment protection, rather than mandatory bonding, as a palliative for the restriction on lien rights.

Having set forth a number of principled objections to the concept of mandatory bonding, I want to add a comment about the specific revisions in the Tentative Recommendation. I am apprehensive about the language proposed for Section 3244.40, which is the crucial provision in these revisions from the standpoint of the homeowner. Subsection (a)(1) seems to create a mine field for the homeowner by suggesting that double jeopardy protection is lost should an installment payment be made either early or late, regardless of any showing of actual prejudice to the lien claimant. If the purpose of these reforms is to protect the innocent homeowner who is unfamiliar with the complexities of the lien laws, this provision may serve to frustrate that purpose by creating a technical argument to be asserted by claimants. Moreover, the efficacy of subsection (a) is largely undermined by the inclusion of subsection (c), unless the omission of the work "timely" in subsection (c) is intentional and substantive (in which event that intention should be spelled out with greater clarity). It therefore seems more sensible to eliminate subsection (c) entirely and restate subsection (a) as follows:

> "(a) A payment is presumed to be made in good faith by the owner to the prime contractor if the payment does not cause the amount remaining unpaid under the home improvement contract to be insufficient to pay all outstanding claims by claimants other than the prime contractor, provided that the owner has received notice of the claim by way of a timely claim of lien, stop notice, or direct payment notice."

I hope that the comments offered above are of some value to the Commission.

Sincerely,

James L. Stiepan

JLS/jrg

Scaffolding & Equipment
18024 South Broadway
Gardena, CA 90248
TEL. (310) 538-1008
FAX (310) 538-1003

MEMBER SIA

MEMBER OF SCAFFOLDING, SHORING & FORMING INSTITUTE, INC.

Oct 30, 2001

California Law Revision Commission
4000 Middlefield Road, Rm. D-1
Palo Alto, CA 94303-4739

Re: Double payment problem in home improvement contracts

After reading the proposed amendments to the mechanics' lien statute, please be advised that these changes would effectively eliminate our organization from any further participation in the residential construction market.

Mandatory bonding becomes cumbersome and provides little practical protection to the subcontractor. Additionally, it will serve to drive up the cost of residential construction. As a subcontractor, we will not find ourselves in a position to determine whether a bond has been provided, and credit terms of sale will cease to exist if protection is not available in the form of a mechanics lien.

It is my understanding that the Commission lacks comprehensive statistics indicating that double payment is indeed, a problem at all. The responsibility to understand and practice the California lien laws is in fact, the responsibility of the homeowner; these laws are not difficult to comprehend and the liability should be shouldered by the homeowner, not shoved onto the subcontractors.

Thank you and regards,

Dennis Highstreet
WACO Scaffolding & Equipment, Inc.

Date: Mon, 5 Nov 2001 14:28:34 -0800
From: "Abdulaziz & Grossbart" <aglaw@earthlink.net>
To: commission@clrc.ca.gov
Subject: MECHANIC'S LIEN STUDY - PRELIMINARY NOTICES

November 5, 2001

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

RE: MECHANIC,S LIEN STUDY ^ PRELIMINARY NOTICES

Dear Commissioners:

This letter is being written on behalf on Builders Disbursements Inc. Builders Disbursements has been in business as a Joint Control Company for over 44 years. To refresh your memory, a Joint Control Company is bonded and licensed by the Department of Corporations. It is not just a check writing service. To further refresh your memory, Builders Disbursements had participated in your study by writing a letter as to the kind of work that they do and the cost thereof.

Builders Disbursements has significant experience with bonds and licensed control companies. Builders Disbursements relies on Preliminary Notices, which have worked well for years. It is their position that if they were a bonding company, they would absolutely not write a bond if there was no Preliminary Notice requirements. Further, as a control company, they would absolutely not enter into a control agreement without having a Preliminary Notice requirement. That is the only manner in which they can handle disbursements and budgeting.

Why change something that has worked well?

Very truly yours,

ABDULAZIZ & GROSSBART

SAM K. ABDULAZIZ

For Builders Disbursements, Inc.

SKA: tmw
Cc: Client F:\wp51\LAWREV\01\BDI.001.doc (WORD)

Law Offices of Abdulaziz & Grossbart
P.O. Box 15458
North Hollywood, CA 91615-5458
(818)760-2000
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Service
PLASTERING, INC.

1090 - 139th AVENUE • SAN LEANDRO, CA 94578
(510) 483-9732 FAX: (510) 357-3183
LICENSE No. 435816

November 5, 2001

California Law revision Commission
4000 Middlefield Rd. Rm. D-1
Palo Alto, CA 94303-4739

Re: **MECHANIC'S LIEN STUDY**

Dear Sirs;

Please keep our subcontractor's lien rights intact for all projects, even those under $10,000 !!!

A good portion of our business is for general contractors on small projects (under $10,000). If we have no lien rights it becomes too expensive to pursue legal action to recover our expenses if the general contractor refuses to pay us.

The preliminary notice instructs the homeowner regarding his obligation to make sure the general contractor provides him with lien releases.

Please do not eliminate this very valuable tool we use to assure that we are paid for the work we perform

Very truly yours,
SERVICE PLASTERING, INC.

Robert G. Brown
President

Document3

LEARNED LUMBER

LUMBER PLYWOOD
WINDOWS AND DOORS
BUILDERS HARDWARE

635 Pacific Coast Hwy., Hermosa Beach, CA 90254 • (310) 374-3406 Fax (310) 374-3410 • El Segundo yard (310) 322-4595 Fax (310) 322-9821

November 11, 2001

VIA FACSIMILE

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

Dear Sirs:

This letter is regarding the Double Payment Problem in Home Improvement Contracts. We are concerned that our ability to enforce our rights to get paid for material supplied on homeowner projects would be severely undermined in the current proposal. Your proposal would allow a homeowner who pays the contractor "in good faith" to ignore the rights of the supplier to be paid for materials shipped to the job. Basically a supplier will have no choice but to sell the material directly to the homeowner, which could cause a whole series of mishaps since a homeowner could not be expected to make the same informed purchasing decisions that a contractor would. This may end up costing the homeowner more in the long run. The proposed payment bond scheme is also not practical in the real world. Most home improvement jobs starts before the ink is dry on the contract and way before a payment bond could be secured.

We believe that "in good faith" language should be specific about getting a signed release from the supplier *or* issuing a joint check. This is the intent of the current lien law. The supplier has rights to file a lien, the homeowner can request a waiver or release of those rights, or the homeowner can issued a joint check. One of the major points of sending the Preliminary Notice is to inform the Homeowner (and others) of the rights of the supplier. The Mechanics Lien Law creates a three party agreement between the homeowner, the supplier and the contractor. It is not "in good faith" to ignore the suppliers rights to be paid.

Please do not hesitate to call if you have any questions.

Yours,

Michael Learned
(310) 322-5858

CATALINA PACIFIC CONCRETE

2025 E. FINANCIAL WAY, P.O. BOX 5025, GLENDORA, CA 91741 • PHONE (626) 852-6200 • FAX (626) 963-9630

November 2, 2001

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

Re: The Double Payment Problem – Tentative Recommendation

Dear Mr. Ulrich:

I have received and have been trying to digest the Commission's tentative recommendation. The solution in the recommendation on contracts $10,000 and under seems workable. We as material suppliers have a very difficult time providing the owner with proper notification prior to the payment to the contractor on these smaller jobs. This is the segment and type of work where an owner can get caught and in that unusual event pay twice. **The recommendation should stop there!**

The rest of the Tentative Recommendation is not workable, creates more problems and is not in the best interest of homeowners or the general public. The recommendation will add to the cost of having work done by a Licensed Contractor and will limit the number of available contractors to do the work. Restrict entry into the industry. And in general confuse owners into thinking they do not have to worry about Mechanic's Liens.

Testimony before the Commission stated this is a very small problem and a very small percentage of the work done. Why is the recommendation encompassing the entire home improvement segment of the industry? This change needs time to be tested and the normal give and take take place. Stop at the small jobs and lets see if this does not solve the problem before you turn the whole industry upside down.

Sincerely,

Frank Collard
Credit Manager

November 7, 2001 SENT VIA E-MAIL ONLY

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

RE: CALIFORNIA LAW REVISION COMMISSION STUDY / MECHANIC'S LIENS / DOUBLE PAYMENT ISSUES

Dear Commissioners:

These are our comments to the Law Revision Commission's Tentative Recommendation to the Legislature, dated September 2001, Study No. H-820. This letter covers both the overall study as well as the Double Payment issue. Because the two will be discussed separately, we are also sending a separate response to the Double Payment issue. It will be no different than this letter, other than the deletion of the comments on the General Revision. This document was prepared prior to receipt of Memorandum 2001-92.

I. SUMMARY OF OUR RESPONSES

At the outset we have stated and still believe that the Law Revision Commission should have determined the scope of the problem before determining the fix. We believe that there was a knee jerk reaction to an alleged double payment problem that dictated the manner in which the "study" was conducted, and therefore the recommended solution.

We also still believe that any curtailment of a mechanic's lien right is unconstitutional; therefore we believe both alternatives of the referenced study are unconstitutional. Even if you had mandated a bond for all home improvement contracts, the manner in which you propose to mandate the bond keeps your suggestions from passing constitutional muster. The reason is that the trigger for the loss of lien and stop notice rights is the payment to the prime. The trigger should be in accordance with present law, which is the filing of the contract and recording the bond, not merely payment to the prime contractor. The fact that there is no true bond protection is the reason that the entire scheme is unconstitutional. The proposals are clearly consumer protection oriented, though the cases for more than 100 years have held the mechanic's laws are to be liberally construed to protect those that improve real property. The Commission has said nothing to overcome the policy inherent in those decisions.

We also do not believe that the proposed Legislation will adequately protect the subcontractors and material suppliers who are not in privity with the owners. Information that is essential to those providers of labor and materials must be conveyed to them, but there does not seem to be a mandated mechanism to do so by the proposals. As an example, the contract between the owner and prime contractor must make reference to the bond and surety, but often times the subcontractor will not have access to that agreement – the material supplier (to a subcontractor) never has access to the prime contractor's contract with the owner.

With these comments in mind, we would prefer the "Alternate" option of a full payment defense limited to contracts under $10,000.00 and no further loss of constitutional rights. We make this statement because the Alternative is less of a taking. We still believe that if the law is unconstitutional, it is unconstitutional as to home improvement projects under $10,000.00, or any other amount whatsoever.

DISCUSSION

II. CONSTITUTIONAL OVERVIEW

A major concern in this area is that if the Legislature agrees with your logic, it could easily leap to the conclusion that any curtailment of lien and stop notice rights, even on commercial and industrial projects, would be constitutional. It would take years for the courts to correct this misconception. Prior to the issuance of the Tentative Recommendation, the issue of the constitutionality of the curtailment of mechanic's liens had been discussed numerous times by not only myself, but other commentators as well. The Tentative Recommendation and Memorandum 2001-71 now puts more emphasis on the issue of constitutionality. We believe that nothing contained in the Tentative Recommendation overcomes those constitutional concerns to support a recommendation that would allow the curtailment of mechanic's liens in any regard.

We have read and agree with the analysis and arguments set forth by our colleague and one of your consultants, Gordon Hunt. Mr. Hunt provided to the Commission a concise and accurate report on the state of the law with regard to the constitutionality of mechanic's liens. His historical overview clearly points out any actions or attempts to curtail the use of mechanic's liens would be unconstitutional.

We have continually argued that what had happened in the 1880's is not persuasive. What is persuasive are the most recent cases which we have cited on numerous occasions, which hold that the lien rights provided by the California Constitution are not a taking, and that even amongst sophisticated individuals, the mechanic's lien right cannot be waived. Connolly Development, Inc. v. Superior Court (1976) 17 Cal.3d 803; Wm. R. Clarke v. Safeco Insurance Co of America (1977) 15 Cal. 4th 882; Capitol Steel Fabricators, Inc. v. Mega Construction Co., Inc. (1997) 58 Cal.App. 4th 1049 (applying the same logic to stop notices on a public works project). Further, the California constitution does not distinguish between a 4 to 3 decision and a 7 to 0 decision. Nor does the mandate dealing with mechanic's liens provide for discriminating treatment for the type of contract or contracts under $10,000.00.

Our more detailed comments are as follows:

A. Extent Of The "Alleged" Double Payment Problem

The emphasis is placed upon the word "alleged." The entire study of the revision of the mechanic's lien law came as a result of a single constituent of then-assembly member Honda. From the date the review commenced to this current date, we have continually taken the position that the alleged double payment problem is so insignificant that it does not warrant a major overhaul of the current mechanic's lien laws. Despite these comments, which quite frankly have been echoed by other commentators and one of your consultants, the Commissioners have virtually turned a deaf ear.

We have suggested on numerous occasions that the Commission ask the Contractors' State License Board ("CSLB") to review its complaint records, to obtain an overview of the number of complaints dealing with this specific issue. It is without question that the CSLB receives thousands and thousands of complaints about contractors dealing with different types of issues. Although the task of reviewing the various complaint forms might seem onerous at first glance, the result of that review would be a tremendous benefit in determining exactly what we are talking about. There has been no evidence that the double payment problem is a major problem. In fact, virtually every staff memorandum on the issue of double payments recognized and

conceded that the double payment problem is not a major problem. We concur with Gordon Hunt's statement that, "…radical reform is like dropping a million dollar missile on a one-man tent in the middle of Afghanistan. The replacement is overkill for the alleged crime."

B. Scope Of Special Protections - Home Improvement Contracts

The Tentative Recommendation indicates that it is not unusual that there is special treatment for mechanic's liens because of the class of construction contracts, and gives some examples of how the Legislature has treated this special class of contract. However, the fact that the Legislature has treated this type of transaction differently gives no support to your suggestion of taking away a constitutional right. Some contracts are treated differently, but that treatment cannot impact a constitutional right.

C. The Double Payment Problem In Home Improvement Contracts - Licensed Contractor Limitation

Your citation to Vallejo Development Co. v. Beck Development Co. is not well taken. Vallejo merely reaffirms that states have police power to protect the public. The statement reaffirms that, "the licensing requirements provide minimal assurance that all persons offering such services in California have the requisite skill and character, understand applicable local laws and codes, and know the rudiments of administering a contracting business." This is within the State's police power.

D. The Double Payment Problem In Public Works Contracts

The reference to public works contracts is also not well taken. The lack of mechanic's lien rights on public works projects is nothing more than the exercise of sovereign immunity. Significantly the law now requires a mandatory payment and performance bond. This is to be required by the public entity prior to the commencement of work. The would be claimant even has remedies against the owner – the public entity-- for the failure of the entity to require a bond. C.A. Magistretti Co. v. Merced Irrigation District (1972) 27 Cal. App. 3d 270. The proposals give no such protection to the contractor or material supplier. In Capitol Steel Fabricators, Inc. v. Mega Construction Co., Inc. (1997) 58 Cal.App 4th 1049, the Court of Appeal, following Clarke v. Safeco, held sophisticated commercial contractors could not waive constitutional rights on a public works project. This demonstrates the deference recognized towards lien claimants.

E. Alternative Approach

As mentioned above, we do not agree that either of the proposals, as set out, pass constitutional muster. However, in keeping with the theme that the constitutional right to mechanic's lien is important and the courts must construe our laws in such a fashion, we would prefer the Alternative approach because it takes away less -- not because it is more constitutional -- but there is less of a taking than the primary proposal.

III. PROPOSED LEGISLATION

Below are our comments as to all of the proposed amendments to the statutes, including those formally put forth in the Tentative Recommendation and those General Revisions discussed in Staff Memorandum 2001-71 which did not make it into the Tentative Recommendation.

A. General Revision

The following pertain to the Staff Recommendations in Memorandum 2001-71:

1. Prime Contractor

We agree with the proposal to use the word “prime contractor” throughout the statutes as opposed to various different names such as “original contractor,” “general contractor,” etc. The terms "original contractor" or "original contract" appear in your tentative draft in numerous places. The statutes should be changed to refer to the "prime contract" or "prime contractor" throughout.

2. Preliminary Notice

The requirement of a preliminary notice should remain within the statutes, though we agree that subsection (b) of Section 3097 should be omitted. We agree with the Staff Memorandum, that subdivision (a) of section 3097 works well in the industry and should not be changed. The omission of subdivision (b) should be carried forward into the Recommendations to the Legislature.

3. Lien For Labors Benefits

We would leave this issue to representatives of labor. However we believe that anyone who contributes to a work of improvement should be protected.

4. Time To File Stop Notices

We agree that the time to file stop notices should be consistent with the time to record mechanic’s liens. However, we believe that anyone who contributes to a work of improvement and is not paid should be entitled to enforce his or her constitutional rights at the moment that payments are past due and not have to wait until he or she finishes the job or ceases performance.

The present statutes provide remedies to owners or contractors who feel that mechanic’s liens or stop notices have been served improperly. Release bonds are available for both mechanic’s liens and stop notices. There is an affidavit process that the prime contractor can invoke on public works projects.

5. Attorneys Fees In Actions On Stop Notices

We support the ability to collect attorneys fees in both bonded and unbonded stop notice actions. The current state of the law (Civil Code section 3176) allows for the recovery of attorneys fees in bonded stop notice actions only. We support an amendment to section 3176, however, we suggest that a further amendment be made to section 3176. We have been involved in hundreds of stop notice actions, both bonded and unbonded. There have been numerous instances where those that are required to pay under the stop notice, would refuse to pay attorneys fees in instances where a settlement had been reached prior to the filing of a law suit, despite the fact that a stop notice claimant has incurred attorneys fees. In other words, those responsible to pay the stop notice funds have refused to pay attorneys fees based upon the theory that without a lawsuit being filed, there is no “action,” and therefore no legal requirement to pay attorneys fees. We see no rational basis for the distinction and therefore we suggest that section 3176 should be amended further to eliminate the word “action” and replace it with the word “claim.” The statute would then read, “in any claim against an owner…”

6. Claims Includable In Stop Notices

We agree with the comments set forth in the Staff Recommendations, approving the substance of the proposal to amend Civil Code section 3123(b) to allow a stop notice to include the same claims as available under a mechanic’s lien.

7. Presumption Concerning Use Of Materials

The statements set forth in the Staff Memorandum are a true to life problem for all material suppliers. Material suppliers can overcome this problem by relying upon the person they sold the materials to, to testify on their behalf as to the consumption of the materials purchased by that contractor and subsequent incorporation into the work of improvement. Absent the assistance of the contractor, material suppliers generally have a problem proving that their materials were in fact incorporated. For this reason, we support the creation of a rebut table presumption that once the materials are on site, they were incorporated into the work of improvement.

Perhaps a better proposal would be for the state statutes to adopt the Federal rule. Federal statutes do not require any proof whatsoever that the materials were in fact incorporated into the work of improvement. The delivery of the materials to the jobsite is sufficient to allow a material supplier to recover on a federal project. We would support this form of amendment to the statute, thus eliminating the back and forth arguments and litigation over whether or not the material was actually consumed into the work of improvement.

8. Attorneys Fees In Mechanic's Liens Foreclosure Actions

We disagree with the staff position stated in Memorandum 2001-71, and believe that Mr. Hunt's suggestion to impose attorney's fee liability in mechanic's lien actions should be adopted. Considering the lien will now only apply on residential projects where an owner has not paid his contractor, there is no valid reason not to adopt this proposal.

9. Coverage Of Releases

We agree that the language in the statutory notice creates an ambiguity, which may preserve contract rights, even though the document itself waives any rights to a mechanic's lien, stop notice, or payment bond claim for the same amount. One must remember, however, that the purpose of the statutory lien release is to protect persons not in privity with releasor. As an example, subcontractors and material suppliers provide the conditional and unconditional release forms to their customer, and ultimately, those get passed on to the owner. Subcontractors and material suppliers have no contract rights against an owner. There is no ambiguity in the mind of the courts who strictly construe a statutory release against the releasor's lien rights. As between the prime contractor and the owner, that is the situation where the language may need to be cleaned up. However, that may be best left for another time.

10. Completion

We agree with the proposed revision to Civil Code Section 3086 as it relates to public works projects. We agree that it is a trap for the unwary. The reduction in the time to record a mechanic's lien or file a stop notice should be similar in nature, and there should be no exception because the project is a public works project.

11. Discipline For Contractors' Failure To Provide Information

We agree that there is a problem with the failure to provide accurate and complete information, as outlined in the Staff Memorandum. Prime contractors are sometimes uncooperative and refuse to provide information, to the detriment of subcontractors and material suppliers. The proposal for disciplining prime contractors who refuse to provide the information may be a good suggestion, but it is not a remedy. Subcontractors and material suppliers need the information as to the owner, lender, etc. This information is critical to the processing of the preliminary notice, which is critical to preserving the mechanic's lien and stop notice rights of subcontractors and

material suppliers. Under your proposal, the Preliminary Notice will remain necessary on non-residential projects. Thus, merely disciplining the prime contractor for the failure to provide the needed information will not rectify the real problem, which is essentially putting subcontractors and material suppliers in a position not being able to protect their mechanic's lien and stop notice rights.

In our years of representing contractors in disciplinary matters, we have never seen a situation where a contractor was disciplined for failing to provide information to subcontractors and material suppliers, as required by law. However, we would not take the teeth out of the statute. We might suggest that the Commission go one step forward and provide that the prime contractor will be liable to any material supplier or subcontractor to the harm cause to them by their knowing or willful failure to provide accurate information as to the owner, lender, etc. By doing so, if the subcontractor or material supplier looses the right to recover, they may have the ability to seek further redress from the prime contractor. However, even this suggestion may have no "teeth," as if the contractor is not paying those persons (or has himself or herself filed bankruptcy), there may be nothing to collect in such a suit. Another suggestion could be a civil penalty of an amount sufficient to send a message (i.e., $2,000.00). Civil penalties are a part of the existing Business & Professions Code for other violations. See, e.g., Civil Code section 7160.

12. Requirement For Sending Copies Of Payment Bond

We agree with the first paragraph of the Staff Memorandum. Often times, it is a problem obtaining a copy of the payment bond. For some reason, contractors and owners alike are often reluctant to provide copies of the payment bond to the subcontractors and/or material suppliers.

We would suggest that some formal amendment be made to the statute that requires the owner to provide a copy of the payment bond, or at a minimum, the name, address, telephone number, and bond number of the payment bond surety so that the mechanic's lien and/or stop notice claimant can obtain a copy of the bond.

13. Time To Sue On Stop Notice Release Bond

We agree with the Staff Memorandum set forth in this section. That is to say that the statute of limitations should not begin to run until service of the bond on the claimant.

14. Notice Of Preliminary Notice Mistakes

We also agree that the Preliminary Notice statutes should be amended to pattern themselves after the Arizona law in the event of a mistake. We do not feel that the responsibilities placed upon the owner create a burden or hardship. If the comments are correct that owners will use the inaccuracies placed in the Preliminary Notices as a defense, then it is clear that early on those owners have found and recognized those mistakes -- those owners should not be able to profit from those mistakes by their own inaction.

James Stypin states that as a practical matter, minor non-substantive errors are ignored by the courts. This may be true, but the problem is, what is a substantive error? It is subject to interpretation by courts. Is placing the wrong address in your Preliminary Notice a substantive error? Is naming the wrong prime contractor a substantive error? Why not take care of this problem without resorting to the courts?

Mr. Stypin also suggests that the proposed language "imposes a sweeping burden on the recipient of the Preliminary Notice to perform a clinical analysis of that notice." We do not agree with this statement. As stated above, if the owner is going to raise a mistake contained in the

preliminary notice as a defense to a mechanic's lien or stop notice action, that mistake was obviously found by the owner without any type of "sweeping burden" or "clinical analysis."

If there are obvious mistakes contained within the preliminary notice that the owner fails to bring to the attention of the claimant, the owner should be estopped from being able to assert those defenses.

15. "Other Completion Issues" -- Notice of Recording Notice of Completion

We also agree with the American Subcontractors Association that there is a the need for legislation that would require the owner to give notice to all people that sent Preliminary Notices that a Notice of Completion has been recorded. We would suggest that legislation apply to both public and private works of improvement.

B. Tentative Recommendation

The following comments apply to certain provisions within the Tentative Recommendation:

1. Enforcement of Claims (Section 3244.40 (c))

We believe that his section may lead to some confusion. The "good faith payment" is the bar to a lien. In this section, it is unclear whether the "good faith belief" is only that the owner believes that "the amount remaining unpaid under the home improvement contract is sufficient to pay the claims of claimants, other than the prime contractor of which the owner has received notice," or a good faith belief he or she has paid the prime contractor in full to date. What if an owner ignores change orders in his or her calculations? Further, when read with subsection (2), it appears that subsection (b) allows a direct payment notice to be sent at any time, which is consistent with your analysis. We would suggest that be included in the Statute(s).

2. "Uncodified (added). Operative Date."

With respect to the delay in the operative dates, we would suggest a longer period of time for the Contractors' Board to complete the regulatory process. It has been more than a year since the Legislature has required the Board to adopt regulations that would add to the Home Improvement Contract requirements. To date, the regulatory process has not been completed. I would suggest that the Act become operative on July 1, 2004.

3. Notice to Owner – <u>Business and Professions Code</u> section 7018.5

You suggest two Notice To Owner forms. We would suggest that you only need one, and it only needs to be given to the tenant or owner on a Home Improvement Project. Further, requiring that the notice be given <u>before</u> the contract was entered into creates a problem with the number of forms being bandied around. We would suggest that the notice be given at the same time, or as part of the contract. If the Commission is concerned that it will end up being lost in fine print, then the Commission can recommend the size of its type to the Legislature.

4. Home Improvement Contract Requirements – <u>Business and Professions Code</u> section 7159(c) (2)

This puts the cart before the horse. If the prime contractor is obtaining a payment bond, he is going to do that after the contract is entered into (unless there is a blanket bond in place). We believe that in many of these cases, the name and telephone number of the surety has not yet been determined and therefore cannot be placed into the contract.

5. Home Improvement Contract Requirements – Business and Professions Code section 7159(b)

The schedule of payments and down payment provisions were written so that there would be no double payment problem. That is to say that if the contractor never got ahead of the owner, the owner would have sufficient funds to pay any lien claimants. In that you have taken away the right to a mechanic's lien, it would seem appropriate to allow prime contractors to collect whatever the prime contractor and the owner can negotiate. The section (including the proposed modification) already allows this when a payment bond is provided.

6. Home Improvement Contract Requirements – Business and Professions Code section 7159(c)(10)

This points out the problem of giving the Notice to Owner prior to entering into the contract. At the beginning, the law states that the Notice to Owner should be given prior to entering the contract. Yet, in this section, the law states that the language of the notice required pursuant to the Notice to Owner statute (section 7018.5), be included in the contract.

7. Swimming Pool Contract Requirements – Business and Professions Code section 7167

We would suggest that the swimming pool requirements only apply to owner-occupied single-family residences. They should not apply to commercial settings or apartment or condominium developments.

IV. CONCLUSION:

Clearly, a lot of consideration has gone into the Tentative Recommendations. We believe the particular "fix" is not merited and should not be implemented without empirical data on its necessity. We further implore the Commission not to ignore the constitutional issues. Because changes obviously will be recommended, we hope the changes suggested herein are incorporated into the proposals.

Very truly yours,
ABDULAZIZ & GROSSBART

SAM K. ABDULAZIZ
KENNETH S. GROSSBART

SKA: tmw

Dixieline Lumber
P.O. Box 85307. SAN DIEGO. CALIFORNIA 92186-5307
TEL (619) 224-4120 FAX (619) 225-8192

SERVING SAN DIEGO COUNTY FOR OVER EIGHTY YEARS

October 29,2001

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

Delivered by Fax to 650-494-1827

RE: Comments to the proposed revision of the Mechanics Lien Laws

Dear Members of the Commission:

For two years your commission has struggled to find a solution to what the commission calls the Double Payment Problems in Home Improvement Contracts. I have followed your struggle closely from the gallery and I am on the mailing list of the commission.

This is a very difficult problem to define in scope and hence a harder problem to solve.

For two years I have seen the commissioners go over scheme after scheme to resolve the problem. I have seen the commission wrestle with full payment defense, bonding, joint control, good faith payment, direct pay and many more. The commission has appeared to want to find an equitable solution for all the parties.

However, it now seems that the Commission is giving in to political pressure and rushing to create a solution to be dropped into a waiting bill. In rushing this into a waiting bill, I believe the Law Revision Commission will not be doing what the Assembly Judiciary Committee wanted the commission to do when it turned the issue over to the Law Revision Commission. The Assembly Judiciary Committee wanted the Commission to find a solution (if there was a solution to be had) to the problem, not destroy the Lien Rights of suppliers and subs.

This was not an easy problem for the Commission to handle. I have seen the Commission be very creative in proposed solutions to the problem of double payment. I do not believe that the 54 page "Tentative Recommendation" H-820 is the Commission's best effort for many reasons.

1. I believe that the Tentative Recommendation is not going to pass the Constitutional test.

I am not an attorney but I believe that these changes proposed will be found to be unconstitutional. At the last hearing in Sacramento the Commissioners wondered aloud and somewhat humorously when discussing the constitutionality of putting a limit of

$10,000.00 or $15,000.00 on non -lienable Home Improvement Contracts. Is the smaller amount less unconstitutional than the larger amount?

The commission knows that they tread on unconstitutional grounds with this proposal but chooses to march ahead anyway

2. Under the Tentative Recommendation, the power to eliminate lien rights on jobs in excess of $10,000.00 lies with the homeowner and or the prime contractor.

When a homeowner chooses not to incur the expense of a bond or when the prime contractor wants to save money, there will be no lien rights for sub contractors or for suppliers to the prime or any of the subs. **This power to extinguish the lien rights of subs and suppliers should not be in the hands of the owner or prime contractor**.

3. Contractors rarely put home improvement contracts in a formal written Home Improvement contract format.

Industry practice is that contracts are done orally or with the acceptance of a bid sheet. To expect a contractor to write a contract, obtain a bond and then file it with the recorder's office in order to give the subs and suppliers security on the job, is just dreaming. It won't happen very often.

Prime contractors don't want suppliers or subs interfering in their relationship with the homeowner. Under today's laws, suppliers find it is next to impossible to determine the prime contractor or the owners true identity. Yes, it's true that we can go and get a copy of the building permit to determine their identities, but that is impractical. A small home improvement contract is over before we can go to the various governmental agencies and get a copy of the permit.

Under the Tentative Recommendation there is no punishment for those contractors not complying. In my opinion, should the Tentative Recommendation be adopted, **the punishment for prime contractors not complying with the law should not be that subs and suppliers lose their lien rights. Subs and suppliers should not get punished for the misdeeds of others**

I strongly suggest that should there be any violation of contractor law, the suppliers and subs would have full lien rights on the job.

4. The Tentative Recommendation fails to recognize that many home improvement contracts are emergency work.

In time of emergency such as fire or flood, work needs to be done immediately to save the home from further damage. In these cases, the contractor doesn't have the time to obtain a bond and file a signed contract with the recorder.

The Tentative Recommendation must provide for such circumstances or subs and suppliers may fail to respond to emergency calls.

The alternative proposal listed on page forty (40) also is an unworkable solution for many of the same reasons as listed above. However, because it limits the scope to Home Improvement Contracts under $10,000.00, Dixieline Lumber agrees that this solution might work.

The alternative proposal tries to protect homeowners when they do small jobs. From my 30 years experience in this business, these are the types of jobs that are most subject to abuse and double payment. The Alternative Proposal does not seek to protect the homeowner doing a million-dollar tear-down and rebuild.

In my experience, small value jobs are done before the homeowner gets a 20 day preliminary notice. The contractor has been paid and is working on another job when the preliminary notice arrives. On larger jobs, there is more of a chance that a contract will actually be written. There is more chance the homeowner has been given information about the lien law as required under current contractors law. The larger jobs require months to complete and the contractor is still on the job when a payment problem arises, thus giving the homeowner more leverage to see that the problem is resolved.

Current lien law is sufficient if the Contractors State License Board enforced the provisions of current law. Owners need written contracts with a notice to owner included. The problem is that the CSLB doesn't have sufficient resources to fully enforce current law.

Tentative solutions the Commission has not explored.

Home Improvement contracts could be declared as unenforceable if not given properly.

Perhaps the Commission could consider giving the owner the right to not pay the general contractor when the contractor fails to give the owner a written, formal, complete Home Improvement Contract that includes a complete notice to owner. Any oral or incomplete contract for home improvement work would be unenforceable. Subs and suppliers would continue to have lien rights if they complied with current preliminary notice law.

This would put the punishment for not complying with State law where it belongs- on the back of the lawbreaker.

This solution is very close to the current solution that the State uses to discourage unlicensed contractors. Under current law, I believe all contracts made by unlicensed contractors are Unenforceable. I believe subs and suppliers still have lien rights even though the prime contractor was unlicensed and breaking the law. Under AB 678 recently passed by the legislature, homeowners can sue unlicensed contractors for any payments made to the unlicensed contractor.

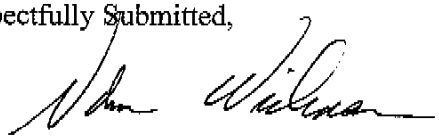
Education is the answer to the double payment problem or at least it could go a long way towards solving the double payment problem. Currently, homeowners know little or nothing of lien law. Contractors too know little or nothing about lien law. What contractors do know about lien law, they don't want homeowners to know because it threatens the contractor's ability to obtain payments form homeowners.

Since many Home Improvement Contracts are not formally written and contractors fail to give homeowners information about lien laws because it is not in the contractors best interest, then why not have cities and counties give homeowners lien law information when a permit is issued. I believe that the governmental agency giving the homeowner lien law information when a permit is issued and making the homeowner sign that they got the lien law information, would greatly help solve the double payment issue.

Currently, the CSLB has brochures that tell homeowners the things to do when working with a contractor. This is the type of education needed for homeowners. Also, contractors would be encouraged to comply with current contractor law if they knew the homeowner would be given information by the city or county when a permit is pulled.

This education suggestion by counties and cities and the idea of rendering a Home Improvement contracts unenforceable are ideas that the commission might consider before they rush to the legislature with a proposal that will endanger the livelihood of thousands of construction companies and small suppliers.

Respectfully Submitted,



Norm Widman
Vice President
Dixieline Lumber Company

WEST COAST SAND & GRAVEL INC

PO BOX 5267
BUENA PARK, CA. 90620
Rod Den Ouden

DATE: November 9, 2001

TO: California Law Revision Commission

FROM: Rod Den Ouden

RE: Double Payment Problem in Home Improvements

California Law Revision Commission,

I have read your proposed changes to the mechanics lien law as it applies to works of improvement for home owners. We are a material supplier doing business in southern California.

The proposed changes assumes that the problem of double payments is severe enough that a remedy is necessary. I believe it would be advisable to get more information to show if this is an isolated problem or something that has become widespread. Our company has not seized property from a home owner in our years of doing business. We have used the lien law to force people to deal with us. We have always been able to resolve a problem before property is seized. Some situations have become difficult, with no real winners, but we have not taken way homes.

Current law is set up very well to give protection to all parties. The home owners already have adequate protection under current law. The difficulty arises because the home owners do not know what their protections are and they do not have the time or resources to thoroughly research the law. It also needs to be defined if this applies to all privately held property or only to home owners. The developers are aware of how the process works but could claim to own their homes.

To require a bond of the contractor would be a good idea. It would be difficult for us to verify if a bond is in place before we ship the material bought from us. Frequently the person ordering the material is a worker, and does not know details beyond getting the work completed. We would prefer to file a claim with a bonding company, and not be forced to put a mechanics lien against some ones property.

The proposal that a home owner who has paid in good faith would not have to pay would give an opportunity for the home owner to get a cheaper price from a contractor because they could leave out payment to the supplier. It would be very difficult for us to establish that a payment was not made in good faith.

I would also propose that the bond required for a contractor be increased substantially. A contractor can be licensed with a bond for $7500.00. This is a very small amount compared to the cost of the work that many contractors are doing.

The California constitution states that a supplier or laborer has a right to be paid for their material or work performed. If the law needs to be modified it should only change our procedure to collect, but not give up our right to collect what is owed to us. It is not possible for us to repossess the material we have sold.

Rod Den Ouden Credit Manager

Rodney Den Ouden/Credit manager

A.L.L. ROOFING and
BUILDING MATERIALS
CORPORATION...

3645 LONG BEACH BLVD. • LONG BEACH, CA 90807
(562) 595-7531 FAX (562) 426-8389

November 12, 2001

CALIFORNIA LAW REVISION COMMISSION
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

RE: Double Payment Problem in Home Improvement Contracts.

Dear Sirs:

I am the credit manager of A.L.L. ROOFING AND BUILDING MATERIALS CORPORATION with twelve locations serving the state of California. I am writing in response to the tentative recommendation dealing with double payments. I see several problems with your proposals and possible solutions.

First, the assumption is being made that the general contractor or the contractor is informing the homeowner of the mechanics' lien law and the possibility of a notice being sent by a subcontractor or material supplier. The contractors about the mechanics' are not informing the homeowners lien law is the response I receive from our notices.

Second, if an owner pays in good faith to the general contractor, the homeowner is release for all liens. First, the general contractors don't tell the homeowner who their subcontractors or materials suppliers and the possibility of preliminary notices from them. I have several cases where the homeowner has paid the general contractor and then issued NSF check to the subcontractors or uses the funds to pay the bills on another project. Current law says we have twenty days to send a notice what happens when the project goes bad after the twenty days is up or problem occurs between the owner and the general resulting in no payments to the sub contractors.

Third, the bond will not protect the subcontractors and their materials suppliers. The general contractors profit is ten to twenty per cent if the bid is correct. First, many of the projects complete by my roofers are less an $10,000.00 and would not be included. They only way for a sub or materials supplier to be protected is demand payment up front which currently against the current code. Most of the liens we have to file are under the ten thousand. If the bond is purchased and recorded with the county recorder it could take two months to be able to locate the bond at the recorder. Last year Los Angeles

County recorder was taking six months to get the originals back from the recorder and two months before the micro fish where available to view the document. This makes it impossible to verify the bond prior to the start of the project. In addition how stable are the insurance company selling the bonds? We have had several companies were taken over by the insurance commissioner for lack of capitol. In additional we have had several insurance agents' sale policies and never send the money to the surety. Typically, bonding companies are slow pay and usually give the case to an attorney which result in one to two year wait for your money and addition expense not covered. Right now on a contractor's surety bond the attorney takes $750.00 of the $7,500 for attorney's fees. In addition what is going stop the general from doing two contractors instead of one to get around the bond. If the general contractor had used the funds on other project the chances of recovering your money from the general are slim.

Fourth, protective options do not always work. I have requested joint check on homeowner association projects and received acknowledge of the request only to never see a joint check. The general contractor and contractor prefer to keep the materials suppliers out of the loop. Additional bonds cost money, which the homeowners are trying to save and the general is trying not to buy to keep his price.

In addition what is the status of homeowner association projects under this new law? Homeowner association can be large or small are four to five homeowner who take care of the association matter on their own. Management companies usually control homeowner's association payments and do not always uses joint checks. Two, have you consider raising the surety bond higher to protect more homeowners.

I can be reached at (562) 595-7531 or e-mail rcharters@all-corp.com to this matter.

Respectfully,

Richard Charters
Credit Manager

CC: file
Faxed 11/13/2001

GOLDEN STATE FENCE CO.

License No. 299964

870 No. Main Street, Riverside, CA 92501-1016 • (909) 788-5620
35656 North Sierra Highway, Palmdale, CA 93550-9782 • (661) 265-0082
4051 Oceanside Boulevard, Oceanside, CA 92056-5806 • (760) 724-8131
891 Corporation Street, Santa Paula, CA 93060-3005 • (805) 933-4522
2336 North Batavia Street, Orange, CA 92865-2002 • (714) 685-8639

November 8, 2001

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

RE: Double Payment Problem in
Home Improvement Contracts

Dear Members:

I was quite distressed to see you're going to recommend overhauling our lien rights on property when the contractor fails to pay his Materials and Sub Contractors bills.

You're going from one extreme to another!! I do quite a lot of fencing for contractors and this is my only insurance I have to insure payment.

Our State Government has gone to great lengths to educate homeowners of their liability and what's expected of them. We already send out our Pre-Lims. They see that we're a sub-contractor so it's not like they're ignorant of their exposure.

I can't really see small contractors posting bonds. This is not easy to obtain. Does the system need change? Yes!! But please don't sell us Material Suppliers and Sub-Contractors down the river in hopes of insuring a homeowner never pays twice.

How about $50,000.00 contractor bonds instead of $7,500.00? How about Joint Checks? How about more involvement from the Contractors License Bureau? There's a much better way than what you're suggesting.

Continued.....

Please keep in mind we're also homeowners who happen to be contractors and our rights should be as respected and protected as those you're trying to help.

Sincerely,

GOLDEN STATE FENCE COMPANY

Mel Kay

Mel Kay, President

MK/lb

KING'S ROOFING

STATE LICENSE NO. 576154

November 12, 2001

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

To Whom It May Concern:

This is not the way to solve this problem. Once again, the working subcontractor loses again. The general should be required to take out a 100% payment bond to cover all subcontractors regardless of the amount. Without recourse via the building owner, the subcontractor loses. It's time to help the working men, not the paper pushers. Further educate the building owners on lien releases, mechanic liens, etc.

Respectfully,

David King

520 South Third Street • P.O. Box 1542 • Patterson, CA 95363-1542
(209) 892-3386 EX 69 9) 892-5225

RESOURCE
BUILDING MATERIALS
HTTP://WWW.BRICKNSTONE.COM

November 12, 2001

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

Re; "Double Payment Problem in Home Improvement Contracts"

I have some concerns with the Tentative recommendation. The current law is good. The only problem with current law is the homeowners do not know what it is. I believe that money is better spent on making the owners aware of their responsibility.

Under the Tentative Recommendation an owner who pays the contractor in good faith would not be subject to further liability. What does good faith mean? I see potential for a contractor to lower his bid to get a job with the intent of not paying the supplier. This type of law leaves opportunity for an owner and a contractor to cut out paying the material suppliers. Imagine a contractor whose workmanship failed. In order to "settle" a contractor might reduce the contract amount and leave the supplier unpaid.

The proposed bond arrangement is not realistic. It looks good on paper but in reality it would bog down the construction supply chain. It is not feasible to check for bonds on all the jobs for all the related trades that go with each job. It will just create more paperwork and bureaucracy and slow the construction process.

A simpler solution is to make the owners aware of the lien law at the time they pull the necessary permits. The owner is the only party that is suitable to handle the unfortunate situations that may occur as a result of improvements made to their property.

Thank you for your consideration,

Jeff Struiksma
Resource Building Materials

10961 DALE ST.
STANTON, CA 90680-2723
TELEPHONE 714-952-2993
FACSIMILE 714-952-2710

13525 CENTRAL AVE.
CHINO, CA 91710-5106
TELEPHONE 909-627-8568
FACSIMILE 909-627-8264

225 S. TURNBULL CANYON RD.
CITY OF INDUSTRY, CA 91745-1095
TELEPHONE 626-330-3178
FACSIMILE 626-369-0498

BUILDING INDUSTRY CREDIT ASSOCIATION

VIA US MAIL AND FAX

November 13, 2001

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

Re: Double Payment Problem – Commentary

Dear Members of Commission:

I am writing this letter on behalf of BICA's Board of Directors in response to the Tentative Recommendation (including the Alternative Approach) as promulgated by the Commission for solving the Double Payment Problem. BICA is a membership organization made up of more than 800 companies from the building industry in southern California.

BICA's Board of Directors has taken a position OPPOSING both the Tentative Recommendation and the Alternative Proposal in their present form. We believe that the current mechanics' lien law should not be changed as you propose. Our concerns are as follows:

TENTATIVE RECOMMENDATION – Double Payment Issue:

1. We believe the cure is worse than the disease. We do not believe that it has been adequately shown that the "double payment" problem exists to a degree that justifies these changes to the mechanics' lien law.

2. We believe that taking away mechanics' lien rights on home improvement projects without replacing those rights with other remedies of equal effectiveness is unconstitutional. The mandatory bond is really not mandatory. Mechanic's lien rights should remain intact if bonding is not provided for on a project,

3. If the Contractors' State License Board (CSLB) is to be responsible for taking disciplinary action in situations where the contractor fails to get a bond, what form of disciplinary action would the Board take? The disciplinary action needs to be harsh enough to motivate the prime contractor to provide the bond. Has anyone determined what the likely impact would be on the resources and budget of the CSLB in enforcement of this provision?

2351 West Third Street
Los Angeles, California
90057

P.O. Box 60502
Los Angeles, California
90060

213/251/1100

4. The economic consequences of this recommendation are of concern:

-How many small contractors will be put out of business because they cannot get bonding? Will there be less competition giving rise to higher construction costs?

-What will the cost of getting the bond and recording the bond and filing the contract add to the cost of construction?

-Will the prime contractor require the subs to provided payment bonds thereby increasing costs?

5. Have we surveyed the market to see how many surety companies are interested in writing the bonds required by this recommendation? How workable is the idea of using the blanket bond of the prime contractor?

6. The constitutionality of the mechanics' lien law has been upheld in past court cases because the 20-day preliminary notice provided "due process". By removing the requirement for the preliminary notice, how do we maintain that "due process" and with it our constitutional status?

ALTERNATIVE RECOMMENDATION – Double Payment Issue:

1. This is the lesser of two evils. It is certainly simpler. However, since we have very little empirical data on the true nature of the double payment problem, how do we know that removing lien rights on projects under $10,000 will adequately solve the problem perceived?

2. It seems that removing mechanics' lien rights without providing some other form of remedy of equal effectiveness would pose constitutional issues.

On behalf of BICA's Board of Directors and membership, I would like to express our appreciation to the Commission for the effort it has made to improve the mechanics' lien law. However we believe that the existing law maintains a balance of rights between parties and we oppose efforts which would impair that balance. If an effort could be made to enforce the regulations on the books, we believe that the fairness in the system that you are looking for would be realized.

Respectfully submitted,

H. Richard Nash
President

User-Agent: Microsoft-Outlook-Express-Macintosh-Edition/5.02.2022
Date: Tue, 13 Nov 2001 15:53:30 -0800
Subject: Study #H-820 Mechanics Lien Study
From: Doug White <mntair@earthlink.net>
To: <commission@clrc.ca.gov>

I would like to express my concern over the Study #H-820: Mechanic's Lien Study. The purpose of the proposed new legislation, as I understand it, is to protect the consumer in residential building/home improvement projects from General Contractors that do not pay their subcontractors and/or suppliers, causing Mechanic's Liens to be placed on their property. In theory, the proposed legislation sounds effective, however I do not believe the application would work in the specified environment.

The new proposed legislation states that residential jobs with a contract price over $10,000 requires the general contractor to provide a bond for 50% of the contract price. Mechanic's Liens could not be applied in this application. How would this be policed? This would take away the only rights of the subcontractor and supplier to collect from a general contractor that has not paid for work performed or materials supplied. Subcontractors and suppliers have a right to timely payment. Chasing down a general contractor's bond would take time. This would mainly affect small subcontractors that would have difficulty absorbing such a loss of time and money. If collection becomes an issue for smaller subcontractors then no one will want to take on these smaller projects and if they do the price would go up to absorb the ultimate collection costs. The lack of quality subcontractors to perform trades on smaller projects AND the increase in price to perform small jobs will ultimately adversly affect the consumer - the very people this new legislation aimed to protect.

Unethical general contractors are the culprits behind this dilemna. Why are the subcontractors, suppliers, and even the homeowners paying the heaviest burden? The general contractor may or may not have to secure an additional bond. That's it? There are so many ways for them to cheat this system. Are change orders a part of the contract price? If not, then a general contractor could easily under-bid a job to avoid the additional bonding requirements, then add change orders.

There is already an adequate system in place to protect homeowners, subcontractors, suppliers and even the general contractor. Lien Releases are simple forms that could be filled out and submitted to the homeowner before payment to the general contractor. The general contractor would simply provide the homeowner with lien releases from the subcontractors/suppliers. The homeowner does not know about lien releases, you say? Educate them! Require the general contractor to supply the form with the contract. An ethical contractor will not object to doing this, especially if it means they do not have to secure an additional bond. Please remember, the kind of general contractors that were dishonest enough to warrant a look at new legislation are the ones we all have to watch out for. They will always find a way to challenge the law. They give good, honest contractors - generals and subs alike - a bad name, and I for one am tired of it!

Thank you for allowing my opinion.

Sincerely,

Angela White
Partner
Mountain Air

Mary Ann Egan
ATTORNEY AT LAW
900 College Avenue

(707) 571-8304
FAX (707) 542-2358
Santa Rosa, California 95404

November 14, 2001

Via fax (650) 494-1827 and regular mail

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

Re: Mechanics liens for home improvement contracts

Dear Mr. Ulrich:

I am concerned about the effect of the proposed legislation on design professionals.

As you know, architects, registered engineers, and licensed land surveyors have lien rights under Civil Code section 3110. Design professionals normally contract directly with the property owner when rendering professional services. Because of this direct contractual relationship with the property owner, design professionals become "original contractors" under the mechanics lien law. [See Civil Code section 3095.]

As the proposed legislation currently stands, it appears that any design professional who contracts directly with an owner would be considered to be a "prime contractor" and would be required to obtain a payment bond. Placing such a requirement on design professionals appears to be an unintended consequence of the proposed legislation.

In performing the design, engineering and planning services normally provided to property owners, design professionals are not subject to regulation under the Contractors License Law. Since the Contractors' State License Board is the entity charged with regulating and enforcing the proposed bonding law, treating design professionals as prime contractors under the proposed legislation would certainly cause considerable confusion when it came to enforcement of the law.

I am not aware of any circumstance under current California law where a design professional is required to obtain a bond in order to perform design, engineering or planning services. I strongly urge the Commission to exempt design professionals from the proposed bonding requirement.

Very truly yours,

MARY ANN EGAN
MAE/mh

SCP | SURETY COMPANY of the PACIFIC
6345 BALBOA BOULEVARD, BUILDING 2, SUITE 325, ENCINO, CALIFORNIA 91316-1517
REPLY TO: POST OFFICE BOX 10289, VAN NUYS, 91410-0289
PHONE: (818) 609-9232
EXTENSION NO. 270

November 15, 2001

VIA FAX (650) 494-1827

California Law Revision Commission
Attention: Stan Ulrich, Assistant Executive Secretary
4000 Middlefield Road, Room D1
Palo Alto, CA 94303-4739

RE: STUDY H-820, STAFF DRAFT, TENTATIVE RECOMMENDATIONS DATED SEPTEMBER 11, 2001

Dear Mr. Ulrich:

In February 2001 I sent you a letter regarding your study and the concept of a blanket payment bond as the most cost effective option for meeting a state mandated bonding requirement on home improvement contracts. In reviewing your September 2001 Tentative Recommendation I note that in Section 3244.20(c) this blanket payment bond is being included as an option. I do think this is beneficial for all parties involved because I sincerely believe this will be the least burdensome process for all parties involved as well as the least costly. For example, there will not be any direct cost passed on to the customer, rather this would simply be part of the contractor's annual overhead cost.

On page 39 of the referenced draft there is a note regarding Subdivision C that explains that "the determination of standards for blanket payment bonds is delegated to the Contractors State License Board. See Section 3244.70 (CSLB Regulatory Authority)." In this regard, it would seem important for the CSLB to have sufficient flexibility in determining standards and then drafting an acceptable blanket payment bond for use. Section 3244.20(c) consists of two sentences which discuss how the blanket bond should provide "equivalent coverage" to the individual payment bond described in Section 3244.10. Not being experienced in drafting legislation, I must admit that the second sentence is not completely clear to me as to its practical import. It seems to me that reference to "home improvement contracts on a quarterly or semi-annual basis" could perhaps be understood in a few different ways. Does it refer to how often a review of the contractor's total home improvement contracts would be conducted or does it provide a time frame as a basis for calculating the total value of those contracts, or both?

As mentioned in my February 2001 letter, the efficiency of the blanket payment bond is tied to the fact that the surety need only review the contractor account on an annual basis (as opposed to say a quarterly basis). It may well be that there is no contradiction here between that fact and the language in the second sentence of Section 3244.20(c). I merely bring this point to your attention and note the practical issues involved.

As you know, the CSLB recently issued a report entitled *Using Surety Bonds and Insurance to Protect Consumers* and on page 22 of that report they discuss the work of the CLRC with respect to H-820 and discuss briefly some ideas about determining the penal sum of a blanket payment bond. The observation is made that by reducing the required penal sum of the blanket bond, surety participation might be increased. While that is probably true, I think another important point would be that by reducing the required penal sum, more small to mid-sized contractors will be able to qualify for these bonds. The CSLB report then goes on to state "For example, a blanket bond covering 20% of all contracts could be chosen."

Returning now to the comment that the CSLB would be responsible for determination of standards for blanket payment bonds, and the need for flexibility in their exercise of this responsibility, I question the use of the term "equivalent coverage" in describing the blanket bond (as it relates to the individual payment bond). It could be argued that the coverage might not be strictly equivalent inasmuch as the blanket payment bond "would cover all home improvement contracts, not just those over $10,000" (see footnote 18 on page 9) and if the term of the blanket payment bond is for one year yet the penal sum of the bond is less than 50% of annual sales. I am unsure whether words such as "comparable" or "similar" would provide more flexibility for the CSLB in determining standards for blanket payment bonds than would the word "equivalent". At any rate, I thought it appropriate to raise the issue.

Thanks again for providing the opportunity for interested parties to present ideas. Should you wish to discuss any points raised in this letter, please feel free to contact the undersigned.

Sincerely,

George Peate
Sr. Vice President-Underwriting

ASSOCIATED ROOFING CONTRACTORS OF THE BAY AREA COUNTIES, INC.

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November 13, 2001

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

Re: Tentative Recommendation, The Double Payment Problem in Home Improvement Contracts

Dear Commissioners:

This Association represents union roofing contractors and manufacturers and suppliers of roofing materials and equipment in 14 Metropolitan San Francisco Bay Area Counties. We are writing today to register our opposition to your September 2001 Tentative Recommendation regarding the Double Payment Problem in Home Improvement Contracts. We believe that the proposals contained therein are unwarranted, unfair and unconstitutional.

In the first instance, we find the fact that "the Commission does not have comprehensive statistics indicating the magnitude of the problem" very troubling. The first step in the review process should have been to determine the scope of the alleged "problem" so that an appropriately measured response could be crafted. Borrowing from the regulatory arena, you should have first established the "need" and only then proposed a solution. In the absence of a reasonably reliable sense of the scope of the alleged "problem", how can you justify any remedial legislative action whatsoever, much less the wholesale abrogation of (home improvement) contractors' and suppliers' mechanic's lien rights proposed in the Tentative Recommendation?

In our experience, the "double payment problem" arises very infrequently. In my 11+ years with the Association, I have heard of only two cases involving roofing contractors. The experience of my colleagues in other construction trades is similar. If the "problem" is indeed limited, it seems patently unfair to impose the considerable cost of surety bonds on every owner (for surely these costs will be passed on from prime contractors to owners) when very few subcontractors and/or suppliers will ever need to make claims upon them.

We respectfully submit that a lien recovery fund achieves the same ends as your proposals at much less cost to consumers. Although a surcharge on contractors' license fees is "unfair" to those contractors who pay their subcontractors and suppliers, such a scheme does have the virtue of spreading the cost over a wide plane and hence reducing (and perhaps eliminating) the added cost to consumers of doing business with home improvement contractors. Indeed, a lien recovery fund is an ideal vehicle for an appropriately measured response to the "double payment

problem" because license fee surcharges can readily be adjusted up or down to ensure that sufficient funds are available to satisfy claims. Moreover, unlike the Tentative Recommendation, which sacrifices the lien rights of subcontractors and suppliers with respect to home improvement contracts of less than $10,000 as a "risk of doing business", a lien recovery fund protects both the consumer and each and every unpaid contractor, subcontractor and supplier.

No consumer should have to pay twice for the same work. By the same token, however, no contractor, subcontractor or supplier should be faced with the prospect of not being paid for the work they have performed or the materials they have supplied for a home improvement project. A lien recovery fund that protects consumers from the "double payment problem" while simultaneously ensuring that all contractors, subcontractors and suppliers are paid for their goods and services would probably pass constitutional muster. A scheme such as you have proposed, which protects consumers, but provides payment assurance only to some contractors, subcontractors and suppliers (those involved in projects over $10,000) is surely unconstitutional.

We respectfully urge you to abandon the proposals set forth in the Tentative Recommendation and adopt in their stead a measured, fair and constitutional response to the "double payment problem" -- the creation of lien recovery fund.

Thank you the opportunity to comment on the Tentative Recommendation.

Sincerely,

William T. Callahan, Jr., Ph.D.
Executive Director

LAW OFFICES OF
GILL AND BALDWIN, LLP
130 N. Brand Boulevard
Suite 405
Glendale, California 91203

November 15, 2001

Via E-Mail

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

Re: California Law Revision Commission
The Double Payment Problem in Home Improvement Contracts

Dear Commissioners:

I write to set forth shortcomings in Tentative Recommendation #H-820.

While it is apparent that significant time and resources were expended in its preparation, the paucity of evidence that there is a "Problem" requiring legislative action is disturbing. The proposal to change a system that has worked well for Californians for ninety years without an objective demonstration of need gives rise to great concern.

Essential to problem solving is identification of the problem. The Tentative Recommendation recognizes that there is "currently no good measure of the magnitude of the double payment problem". Only 61 cases occurring over a three year period are mentioned. During the same three year period, there were undoubtedly hundreds of thousands of building permits issues, projects performed and payments made without any apparent injustice to the parties involved. Undaunted by the lack of evidence that a problem exists, the Tentative Recommendation proceeds to deliver a solution. No substantive reason for the Tentative Recommendation is presented. To base a proposed change in constitutional rights on such a flimsy basis trivializes the rights to be restrained and demonstrates a lack of commitment to the numerous statements throughout the Tentative Recommendation that purport to recognize the very serious matter of balancing the rights of various parties in a constitutional dispute. Restraint in the use of governmental power is at least as important to our society as is its use. It is fundamentally wrong to limit anyone's constitutional rights without a clear need to do so. There is no such showing.

The concept of different rules for different size contracts invites tremendous misunderstanding. It eliminates the bonding requirement for contracts under $10,000.00.

It is suggested (p. 11, line 10) that many of the abuses occur in smaller home improvement contracts. In a creative use of examples, the same page includes the recognition (p. 11, line 36) that such small matters "would likely fall in the range of unforeclosable liabilities." So there is a problem, but there isn't a problem. Again, the glaring lack of objective evidence regarding the nature and magnitude of the problem, or the very existence of such a problem, demands further fact gathering before legislation is drafted.

One area ignored by the Tentative Recommendation is the protection already in place under the Contractors License Laws. Injured homeowners have a much greater likelihood of recovering against the contractor's license bond than do subcontractors or suppliers.

The proposed prohibition on service of stop notices until payment is due to the subcontractor or supplier makes no sense. Payment terms between the parties are often in conflict. Payment to the prime contractor often occurs before payment is due to the subcontractor or supplier. Denying the right to serve a stop notice actually encourages the problem that the Tentative Recommendation seeks to avoid. The stop notice is the very document that will tell the owner of the unpaid amount. That seems to be precisely what the authors of the Tentative Recommendation wish to accomplish. If received before payment is made, it will very effectively provide the owner with the opportunity to avoid double payment. If payment has already been made, the owner has no stop notice obligation. Why change? The grossly undefined "direct payment notice" creates more problems. When could such a notice be served? What is required of the parties? How does it differ from, or relate to, existing stop notice statutes? Why is all "fleshing out" left to the Contractors' State License Board? "Fleshing out" is not what this term requires - there is no skeleton. How do we know that the direct payment notice does not involve "other consequences" (which, by the way, are not impediments in the real world to resolution of this type of dispute)? These are not regulatory issues - the detail set out in the existing mechanic's lien, stop notice and bond statutes belies the suggestion that anything short of rationally considered, publicly discussed legislation is appropriate to address such a proposal. Did the staff run out of time to prepare the Tentative Recommendation?

Contrary to the assertion in the Tentative Recommendation, filing contracts and bonds with the county recorder is not an approach that is familiar to contractors, subcontractors or material suppliers. Indeed, the Tentative Recommendation refers to Professor Lefco's belief that the current option for recording a bonded contract under Civil Code Section 3245 is "the least often used". Perhaps that should change.

Why not simply mandate implementation of the existing Section 3245 provisions in all Home Improvement Contracts? No reduction in constitutional rights would be implicated, all of the potential victims (owner, subcontractors, suppliers) would be protected at the expense of the potential victimizer (the prime contractor). The Legislature obviously believed that such bonds are good public policy because the statute exists. Arguments about availability of such bonds must rely on speculation because of the limited use of the section to date. **Uncertain** concerns that **some** "worthy contractors" might have difficulty obtaining bonds don't justify the **certain** elimination of mechanic's lien rights for **all** worthy subcontractors and material suppliers. Shouldn't the Legislature implement all available remedies short of limitations on constitutional rights before resorting to the constitutional alternative? Especially given the weak evidence of a problem, what's the rush?

I have read and agree with the analysis and arguments set forth by my colleague and one of your consultants, Gordon Hunt. Mr. Hunt provided to the Commission a well reasoned report on the state of the law with regard to the constitutionality of mechanic's liens. He clearly points out that such actions or attempts to curtail the use of mechanic's liens would be unconstitutional. Apparently the Legislative Counsel came to the same conclusion.

Cases from the 1880's are not persuasive. Recent cases hold that the lien rights provided by the California Constitution are not a taking, and that even amongst sophisticated individuals, the mechanic's lien right cannot be waived. ***Connolly Development, Inc. v. Superior Court*** (1976) 17 Cal.3d 803; ***Wm. R. Clarke v. Safeco Insurance Co of America*** (1977) 15 Cal. 4th 882; ***Capitol Steel Fabricators, Inc. v. Mega Construction Co., Inc.*** (1997) 58 Cal.App. 4th 1049 (in which I had the pleasure of acting as both trial and appellate counsel, applied the same logic to stop notices on a public works project). Case law makes no distinction between a 4 to 3 decision and a 7 to 0 decision any more than does the number of votes supporting successful legislation.

The current scheme has been in place, for all to learn and understand, at least since 1911. Over ninety years where the Tentative Recommendation can identify only 61 cases where an injustice may have occurred. Surely there are areas of public concern where extant significant issues require legislation. As one who has almost exclusively represented owners, prime contractors, subcontractors and material suppliers for many years, I appreciate the need for fairness to all participants in the construction process. Contrary to the tone of the Tentative Recommendation, the homeowner has significant ability to protect himself or herself; much more ability than does the subcontractor or supplier. The Tentative Recommendation recognizes that unpaid subcontractors and suppliers are also victims of the "Problem". We should

not further penalize a class of victims to resolve the issue. Require additional education of consumers, add the mandatory bond requirement and see if the process works.

Very truly yours,

Kirk S. MacDonald

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Legislative Committee: Report on Task Force "A" Issues

During the last Legislative Committee meeting, the Committee appointed itself as a Task Force to examine the issues that arose out if the SB 2029 Surety & Insurance Reports. The Committee set its priorities. (See Attachment 1: Task Force Priorities.)

The Task Force directed staff to report a number of issues and recommend possible approaches. This report addresses Issues 1.1 and 3.1 by describing the mandatory payment bond approach being proposed by the California Law Revision Commission and by exploring a step bond.

This report specifically provides:

A brief introduction to relevant surety concepts.
A description of the California Law Revision Commission's payment bond proposal and a discussion of the pros and cons.
An update on issues relevant to step bonding.
A step bond proposal.
A guarantee fund for sureties.

The Report on Task Force "B" and "C" identifies additional issues the Legislative Committee may want to address at the November 29, 2001, Legislative Committee Meeting.

Task Force A: Surety Bond Issues

INTRODUCTION

Surety bonds are a well-understood method of making compensation available to consumers harmed by licensed contractors. Right now, California homeowners are protected by only one bond, the contractors' license bond. It is a blanket bond, available as both a payment and performance bond. The penal sum of the bond is $7,500 for most construction projects and $10,000 for swimming pools. Consumers often believe that the bond amount is available for *each* project. It is not. This bond includes all the bond money available to all the claims against the contractor.

As noted in the SB 2029 Surety and Insurance Report, if a contractor violates the law and causes damage to only one consumer, the $7,500/$10,000 bond can be meaningful. But, the bond becomes increasingly ineffective when there is more than one claim against the bond.

On the other hand, increasing this one-size- fits- all bond to comprehensively cover multiple complaints will promptly result in sureties denying bonds to contractors who have poor credit or, who work part-time or for low wages. Since maintaining a contractor's license bond or equivalent is mandatory for continued licensing, an across-the-board raise of the penal sum of the bond would not just limit the work the contractor can perform, it would limit who may be licensed.

Thus, instead of simply suggesting that the penal sum of the contractor's license bond be raised, staff has examined other ways to use bonds.

BOND APPROACHES FOR DIFFERING TYPES OF HARM

Bonds are traditionally used to address two types of harm: the failure to pay laborers, subcontractors and suppliers, and failure to perform. Each will be examined separately. But first, a few words on the value of surety underwriting.

As noted in the "Surety and Insurance Report," the surety never writes a bond intending to pay it. Instead, the surety underwrites so that surety won't have to pay.

The message of the surety company in writing any bond other than the contractor's license bond is—we checked this contractor out. She pays her bills. She completes her work. We don't get complaints about her. And the complaints we get are quickly resolved. We're betting she'll say in business and her work will meet trade standards.

Based on this analysis, the surety writes the bond.

Thus, the point of a bond is to prevent the need for restitution rather than to provide restitution. No matter whether the bond is a payment bond or a performance bond, the

underwriting process can bring needed review to a contractor's credit and payment history, thereby increasing the chances that the project will be properly completed.

Bonds for Payment Problems

The "payment" discussed in this segment refers to whether laborers, subcontractors and suppliers are paid for their contribution to a project. The payment issue that has been given the most attention in the past three years is the double payment problem—the situation that arises when a homeowner pays the prime contractor but the contractor fails to pay laborers, subcontractors and suppliers. Under California's Mechanics' Lien Law, the homeowner can be forced to pay again or face foreclosure. Under present law, the homeowners is made responsible for whether the contractor pays subs and suppliers but is given neither the information nor the tools to manage that responsibility.

For those Board members who are not well versed in the problems of residential mechanics' liens, a background paper, "Don't Lien on Me," is provided in this packet.

For its part, industry maintains that the double payment problem is comparatively small. Industry rightly asserts that most contractors pay their bills.

Knowledgeable consumers agree that only a small percentage of consumers are forced to pay twice and even less face foreclosure. Consumers would tell you, however, that the lien is a big problem for the people who do have to pay twice. Likewise, it is a big problem for homeowners who are frightened by the possibility of liens and whose credit is harmed by liens even if these liens are not ultimately perfected.

Two years ago the Legislature acknowledged the problem of residential mecahancis' liens and requested that the California Law Revision Commission (CLRC) review the situation and propose a solution. Right now, the CLRC is circulating a draft of its proposed solution. CLRC's proposal will be offered to the Legislature in January of 2002.

<u>California Law Revision Commission Draft Proposal</u>

The proposal:

Requires each home improvement contractor to secure a payment bond of 50% of the contract amount (or equivalent) for each home improvement contract over $10,000. (Cost: about 1 to 2 % for those contractors who can qualify).

- Creates a good-faith full payment defense for homeowners

- Forcefully argues that California's Constitution allows a property owner to defend against a mechanics' lien by demonstrating payment to the prime contractor.

- Retains subcontractor and material supplier lien rights when homeowner does not pay but dispenses with all 20-day preliminary notices. They are unnecessary under the plan.

- For contracts under $10,000, allow a subcontractor or supplier to require the homeowner to pay the sub or supplier directly. If these subs and suppliers fail to notify the homeowner before the homeowner pays, the subs and suppliers would lose their lien rights unless the homeowner fails to pay.

The only solution better than this kind of payment bond is to simply adopt a good faith payment defense for all homeowners. If the contractor is paid but fails to pay subs and suppliers, no lien may be filed.

If that solution is rejected, however, as it has been over the years, a payment bond is a very good solution. A good faith payment would free the homeowner from the risk of liens and the bond would protect the rights of subs and suppliers. For their part, subcontractors and suppliers would maintain their lien rights but against the bond, not the homeowner.

Problems/ Drawbacks

There are three major problems with the CLRC approach. First, a number of contractors who are otherwise qualified may not be eligible for this bond. You may say that this is a good thing. A contractor with poor credit is not a good choice to perform home improvement work. On the other hand, the Legislature has traditionally rebuffed any barriers to entry into the construction industry.

Second, the CLRC's approach would add 1 to 2% to the cost of all home improvement contracts. Given the economic downturn, this might be the wrong year to propose additional expenses to businesses. Adding this kind of across-the-board expense to all contracts in order to protect a relatively small number of consumers may not be considered good business.

This doesn't mean, however, that we should not address the problem. Even before the recent economic downturn, California contractors went bankrupt carrying extraordinary liabilities—more than 807 million dollars of liabilities were claimed in bankruptcy actions in 2000. While these are industry-wide figures, they reverberate in the home improvement arena, where bankruptcies always include losses to homeowners, subcontractors and suppliers.

I continue to be in contact with Assemblyman Dutra's staff on a possible alternative or supplement to the CLRC's bond approach that would protect homeowners from liens without mandating that every contractor carry these bonds. This alternative proposal "Mechanics' Lien Prevention for Homeowners" is also provided in this packet.

The third reason that a bond dedicated to payment issues might be contra-indicated is that this payment bond will not address the larger problem for home improvement projects—poor workmanship. While, as noted above, underwriting these bonds will help identify contractors who are bad credit risks, the actual bond beneficiaries of this mandatory bond would be limited to unpaid laborers, subcontractors, and material suppliers.

Bonds for Performance Problems

As noted above, the underwriting process of a mandatory payment bond can bring needed review to a contractor's credit and payment history, thereby increasing the chances that the whole project will be properly completed.

But the process does not directly address performance problems. A homeowner may defeat some liens by arguing that the reasonable value of the work (the amount that can be claimed in a lien action) is not the same as the amount the homeowner is being charged. But, for the most part, the payment bond targets payments, not performance.

Performance bonds guarantee that the contract will be adequately performed.

Blanket Bonds

Task Force Issues 1.1 and 3.1 direct staff to present information about using bonds to provide consumer restitution and, more specifically, restitution through the use of blanket bonds.

1. CALBO Building Permit Data Not Available

For your information, staff has finally succeeded in getting information about whether building permit data could be accessed to help staff or individual surety companies to assess the amount of work each contractor was performing. Apparently, even though all this information exists, it is not in a form that can be efficiently accessed to identify the individual contractors. Types of contractors, work by counties, aggregate figures on new homes vs. remodels, all these are available. But data about individual contractors is not readily available. Perhaps someday, but not now. Thus, in working toward a step based blanket bond approach, we must have another way to set the penal sum of the blanket bond.

2. Self-Report

As noted in the Surety and Insurance Report, under Business & Professions Code section 7159 (g), the Board may approve a blanket bonds for contractors who register approved payment and performance bonds covering all contracts the contractor agrees to perform. Contractors seeking Board approval must report the aggregate of their yearly contracts as the basis for the bond. Staff does not recommend adopting an honor system for any large scale tracking of aggregate contracts.

3. Quasi- Nevada Approach

Probably the simplest solution would be to take a page from Nevada's bond strategy and require the contractor to carry a blanket bond that limits the size of the contracts a contractor may agree to perform. For example, in the proposal outlined below, a $25,000 bond would limit a contractor to contracts of no more than $50,000.

Although this will provide little dollar for dollar protection, it would perform some important functions. Unlike the contractor's license bond, this additional bond would be more comprehensively underwritten, providing needed review of the creditworthiness and track record of contractors.

I assume that when the surety is determining how much to charge in bond premiums, the surety will review the amount of work the contractor performs as a way to establish the surety's exposure. For example, if a contractor performs 500 $15,000 jobs each year, there is more chance that the surety will have to pay a claim or claims than if the contractor performed only 12 jobs each year.

Of course, I do not need to mention that if a plan could be developed like the proposal outlined in the report on Mechanics' Lien Prevention for Homeowners, the cost of blanket bonds could decrease considerably because the cost of liens would be taken out of the mix.

Proposal

Under this blanket step bond proposal, the Legislature will continue to mandate that all contractors carry the contractors license bond. For purposes of discussion, we will not examine raising the penal sum at this time.

Each contractor who seeks to perform **home improvement contracts** over $10,000 would be required to carry an additional bond as follows:

Mandatory bond	**Additional bond** (required for contractors performing home improvement work in their capacity as a prime contractor).	**Contract limit**
Present contractor's license bond (clb) - $7,500	none	Contracts up to $10,000
$7,500	$7,500	Contracts up to $15,000
Service and repair contractors with more than 3 employees performing service and repair work. $20,000		
clb - $7,500	$15,000	Contracts up to $30,000
clb- $7,500	$25,000	Contracts up to $50,000
clb- $7,500	$30,000	Contracts over $50,000

These figures are merely a starting point for discussion.

Adopting a step proposal of this nature would address a number of the Board and the Legislature's concerns. The proposal:

> Places responsibility for bonding in the surety industry, a place more suited to decisions about bonding than the board.
> Matches the pattern of damages found in CSLB's complaints.
> Places limits on the work a contractor with poor credit can perform.
> Does not act as a barrier to entry into the contracting profession and does not force existing contractors out.
> Does not require expensive and extensive government evaluation of contractor's financial records.

What kind of bond should this be? A license bond or a civil bond? Staff recommends that, if reforms are made to reduce impediments to consumer access to the contractor's license bond (See Surety and Insurance Report), the payout criteria should be that a violation of the contractors' license law can be proven. If these impediments are not addressed, staff would propose that payouts be based on a civil damages standard.

This proposal would not bring into the system enough money to adequately compensate consumers harmed by licensed contractors. There is too much risk and money involved. This proposal would, however, make some additional money available for damages. More important, however, the proposed bond requirement would place new controls on who may perform larger contracts. To work without the requisite bond would be cause for discipline.

Guarantee Fund

Issue 6.3 Propose legislation creating a guarantee fund for admitted sureties.

This proposal comes from the California Department of Insurance (CDI). In its letter supporting the SB 2029 Surety & Insurance Report, CDI recommended legislation creating a guarantee fund for sureties. Staff is exploring this recommendation and expects to have a report by the date of the Legislative Committee meeting on November 29, 2001.

* * * * *

Attachment 1:Priority List

Task Force "A"

Recap of high priority issues

ISSUE 1.1 Examine using bonds to provide consumer restitution but delay any comprehensive bond proposals until CLRC's mandatory bond proposal is evaluated by the Legislature.

ISSUE 3.1 Evaluate a blanket step bond approach to home improvement contracting but wait on main bond issues until the CLRC's mandatory bond proposal is evaluated by the Legislature.

ISSUE 5.2 If CLRC's mandatory payment bond approach is adopted, the preference for homeowners in contractor's license bond law may not be necessary.

Likewise, if a home improvement step bond approach is adopted, preference for homeowners in contractor's license bond law may not be necessary.

If, however, the license bond remains the only source of restitution, the preference must be established in a way that does not refuse bond payouts to non-homeowners.

NEW ISSUE 6.3 Propose legislation creating a guarantee fund for admitted sureties.

Task Force "B"

Recap of Medium Priority Issues

ISSUE 5.3 Recommend Task Force evaluate staff's proposal to define "willful" as found in the Penal Code.

ISSUE 5.4 (b) Recommend that the Task Force evaluate proposal requiring a bond payout upon certain findings being made in arbitration awards and in final orders of the Registrar.

As noted in Issue 3.1, however, a new step bond dedicated specifically to home improvement might be a better solution than increasing the contractor's license bond. Creating a home improvement step bond would put the increased coverage in the home improvement industry where it is needed instead of spreading it out among all commercial contractors.

ISSUE 5.5	Should the Legislature consider increasing the current penal sum? Before recommending an increase in the contractor's license bond, wait until CLRC's proposal is evaluated by the Legislature.
ISSUE 5.8	Propose legislation raising the jurisdictional amount for surety bond claims brought to small claims court.
ISSUE 5.9	Task Force to review proposal to amend Code of Civil Procedure Section 386.6 (a) to exclude sureties from securing fee and cost reimbursement from contractor's license bonds in an interpleader action or alternative**.**

Task Force "C"

Recap of low priority issues.

Issue 6.1	If Commercial General Liability Insurance (CGL) is not mandated, propose legislation defining the term "insured."

Attachment 2

Don't Lien on Me!

Mechanics' Liens Placed on California Home Improvement Projects

Before hiring Olympic Roofing Company to replace her roof, Julie O., a Rancho Cordova homeowner, checked with the Contractors State License Board to see if Olympic had any complaints. Nothing derogatory showed on the license and the price was right. Julie hired Olympic. After the roof was finished, Julie paid.

Julie was shocked when a few weeks later she got notice that a roofing material supplier had recorded a lien on her home. Olympic's owner had disappeared without paying the material supplier and some subcontractors. After doing some research, Julie found that at least 10 other homeowners in her area had also been slapped with liens. Julie and most of these Rancho Cordova homeowners had to pay a second time to get the liens removed. These homeowners are but a few of the California homeowners threatened with liens every year. Like Julie, many pay twice.

How can this happen? How can a homeowner hire a contractor, pay the contractor for the work, and then have to pay again?

What's the Problem?

California's mechanic's lien law allows an unpaid laborer, subcontractor, or material supplier to place a lien on property. The idea underlying mechanics' lien law is that a property owner should not be unjustly enriched by the contributions of another. Since the value of the labor, goods and services has been incorporated into the value of the property, lien rights allow the lien claimant to make a claim on that value.

This strategy makes sense when a property owner fails to pay the contractor. If the contractor is not paid, the contractor *can't* pay the laborers, subcontractors and suppliers. This strategy does not make sense when the contractor has been paid.

Over the years, commercial property owners have developed various mechanisms to protect themselves from liens. The lien prevention device most used by commercial property owners is a complicated conditional and unconditional release system. This system may work for commercial construction. But California homeowners lack the background and

knowledge that would make this system work for home improvement. The main drawbacks are:

- Unlike commercial property owners, homeowners do not know their peril. They just don't "get" that they can pay and still owe.

- California's strategy for notifying homeowners of the mechanics' lien problem is to have the prime contractor provide lien information to the homeowner. Often the contractor fails to provide this notice. The contractor's failure to provide the notice, however, has no effect on lien rights. Julie O. had no idea that an unpaid material supplier could take a property interest in her home, forcing her to pay a second time for her roofing materials.

- Even if the homeowner had been given lien information, the present Notice is inexplicable at best. See the attached Notice to Owner.

- Even if the homeowner received and understood the notice, most of the lien prevention measures described in the Notice are not available and/or unworkable. A description of the deficiencies of the Notice to Owner appears below.

How big is the problem?

Industry representatives claim the problem is small. In testimony before the California Law Revision Commission (CLRC) and the Assembly Select Committee on Construction Fraud, industry repeatedly asserted that the problem was small; few homeowners lose their homes through foreclosures as a result of mechanics' liens. This statement may be true. Foreclosures may be rare. But these statements beg the question. The question should be: how often do homeowners have to pay twice? And after that question, we should ask how many homeowners have their credit negatively affected by these liens even though they ultimately cleared?

The Rancho Cordova consumer paid the contractor who failed to pay the material supplier. The material supplier filed a lien. The contractor could not be found to make good on his contract. This was the case for all 10 of

the homeowners involved in the Olympic case. All but one of the homeowners paid twice.

These homeowners were rightly fearful that the lien would destroy or disrupt their credit. A recorded lien claim places a cloud on the property title, affecting the homeowner's ability to borrow money or sell the property. Threatened with foreclosure, these homeowners did not know how to defeat the lien.

Homeowners pay because they don't know what else to do. An attorney might be helpful to defend against the lien or even to explain the process. But, an attorney would cost money, sometimes, more money than the homeowner owes on the lien. Often the homeowner can't take the risk of having to pay the lien and the attorney.

What causes a contractor not to pay?

The main reason contractors do not pay is because they don't have the money. The contractor has gotten too far ahead financially. Instead of paying the material supplier for this job, the contractor uses the money to pay some other subcontractor or material supplier owed from a previous job. When a contractor gets too far ahead for too long, he or she will ultimately go bankrupt.

CSLB's experience with contractors who go bankrupt is that long before the bankruptcy, the contractor's performance deteriorates. Payments are delayed. Quality deteriorates as the contractor struggles to stay above water. Unpaid suppliers file liens. Finally, the contractor files for bankruptcy. Thus, delays, liens, poor workmanship and abandonment, all accompany the contractor on the way to bankruptcy.

Unfortunately for consumers, contractor bankruptcy has no effect on a lien filed by a material supplier or subcontractor. Even if the homeowner has invoices and cancelled checks demonstrating that the contractor was paid the money intended to cover the material, the lien rights remain.

What's being done to prevent these liens?

Notice to Owner

The law presently requires contractors to present homeowners with a notice called the Notice to Owner. This notice is designed to inform homeowners of the dangers of liens.

The problems with the Notice to Owner include:

- Present law relies on the contractor to convey this notice to the homeowner. Yet, contractors routinely fail to present homeowners with the Notice. Even when the Notice is given, it is often mixed in with the other contract gobbledygook homeowners can't face reading. Like the notices in real estate transactions, the notices are read only rarely.

- The Notice is extremely confusing and difficult to read. The idea that the homeowner could pay a contractor and still be faced with a lien is hard to understand. The Notice does not help. Instead it provides a bewildering array of ways to prevent liens, most of which are ineffective. Frankly speaking, the Notice is so intimidating that it is this writer's belief that the few homeowners who actually read the Notice are not informed by it.

What are the various approaches to lien prevention?

The Notice describes four approaches to lien prevention-- signed releases, joint control accounts, joint checks, and payment and performance bonds.

Signed Releases

The Notice to Owner suggests that consumers can protect themselves from mechanics' liens by getting signed releases. The law governing home improvement contracts requires contractors to provide full and unconditional releases of mechanics' liens. Although this requirement is rarely honored, when it is complied with, it misleads consumers into thinking that liens can be avoided by getting releases from the contractor. In addition, another form, the 20- day Preliminary Notice, which is designed to alert the homeowner to the possibility of liens, also stresses this approach.

How does the release system work (or not work)?

The release system is designed to allow a property owner to track when potential lien claimants have been paid. (Here as before, the potential lien claimants – subcontractors, laborers and material suppliers -- are all referred to as "suppliers").

Here is how the system is designed to work. When it is time for a payment, the contractor brings the owner a conditional release signed by the relevant supplier. The owner pays the contractor for the work of the supplier. The idea is that the owner will not make another payment before receiving an unconditional release from the relevant supplier. The contractor pays the supplier. The paid supplier gives the contractor an unconditional release. The contractor gives the owner the unconditional release with the next demand for payment. This process is designed to insure that the property owner will not be faced with liens down the road. There are many problems with the release process.

The releases are complicated. When the contractor presents the homeowner with a bill for a scheduled payment that includes the work of the supplier, the contractor must also provide a release signed by the material supplier. Unfortunately, this release is only a conditional release. It is not effective unless the material supplier is actually paid. Once the supplier is paid, the supplier is supposed to provide the contractor with an unconditional release. Then the contractor is supposed to give the unconditional release to the homeowner.

Subs and suppliers rarely provide the matching unconditional release. Even when the contractor is routinely paying the bills, subs and suppliers resist the effort of providing these releases. The supplier has been paid and now has no incentive to provide these releases. When a paid supplier fails to provide an unconditional release, the homeowner has no way of distinguishing a situation where the supplier is paid from a situation where the supplier has not been paid. This creates a difficulty in tracking.

The amount of protection varies depending on timing. In home improvement projects that take weeks and months to complete, the homeowner may find out that the contractor has not paid supplier and then withhold a later payment until this is cleared up. Under situations where the project is completed quickly, however, the homeowner may not know that the supplier has not been paid until all the contract money has been released. This is particularly true with short-term projects like roofs and sunrooms.

Other parts of the release system are equally complicated. In order to perfect a release, the material supplier must meet strict procedural requirements. One requirement is that the Preliminary Notice, a notice sent by the material supplier to the property owner to inform the owner of the possibility of a lien, must be sent within 20 days of the start of work. If it is not sent timely, the lien cannot be perfected.

Problem 1. The Preliminary Notice is not "preliminary." The Notice can be sent up to 20 days *after* work has started. This means there is no protection for homeowners who have short timelines on their jobs. Roofs are a good example. The Preliminary Notice is still valid even if the work is completed and the homeowner has paid the contractor.

Problem 2. The text of the present Preliminary Notice is at once easy to misunderstand and actively misleading.

The homeowner is encouraged to ask the contractor for a signed release by the sub or supplier sending the notice. Few consumers actually understand this notice until a lien claim is filed. Consumers often believe that a release from the contractor is enough. More often, however, consumers believe that a signed *conditional* release can protect them. This is not true. If the contractor fails to pay the subcontractor, this release will not help.

Problem 3. Business people working in commercial construction understand that there is only one Preliminary Notice no matter how many services are provided or goods delivered later. Homeowners do not understand this. Homeowners do not understand that a release through January 1, 2001 does not cover work done or services provided after January 1, 2001, although there will be no additional Preliminary Notices.

Finally, the release system is of no use whatever if the contractor fails to pay the supplier. The release system relies on the homeowner paying the contractor and the contractor paying the supplier. A signed unconditional release can only be secured after the contractor has paid the supplier. Thus, this system enables a homeowner to track the possibility of liens and breathe a sign of relief when the unconditional releases come in but does very little to prevent liens.

This release system may be effective in commercial transactions. This brief review of the system indicates, however, that it is too complicated

for the average homeowner to navigate, particularly when the homeowner has no power to make the contractor actually pay subs and suppliers.

Joint Control Accounts

A second strategy for protecting against liens is a joint control account. This system is adequately described in the SB 2029 Surety and Insurance Report. Suffice it to say that, while this may be a good idea, right now it is not routinely available.

Payment and Performance Bonds

Again, as noted in the SB 2029 report, homeowners rarely choose bonds. They do not understand the need and many contractors would not qualify for these bonds.

The California Law Revision Commission is working on a proposal for mandatory payment and performance bonds for home improvement contracts of $25,000 or less. This approach is examined below.

Joint Checks

Of the solutions presently suggested, a joint check is by far the simplest. When the contractor presents a bill for the supplier's work, the homeowner writes a joint check. There are a number of problems with this approach. First, like all the other suggestions, the homeowner who most needs to know about the lien problem will not be given the Notice and, therefore, won't know to try this approach. Second, contractors will persuade homeowners that a joint check will just hold things up.

Finally, simple as it is, this approach may be impractical. The days are gone, if they ever were, when the contractor and subcontractor can drop into bank together to cash a check.

Summary

The approaches suggested to consumers on how to protect themselves from liens are not effective.

"Notice to Owner"

"Under the California Mechanics' Lien Law, any contractor, subcontractor, laborer, supplier, or other person or entity who helps to improve your property, but is not paid for his or her work or supplies, has a right to place a lien on your home, land, or property where the work was performed and to sue you in court to obtain payment.

This means that after a court hearing, your home, land, and property could be sold by a court officer and the proceeds of the sale used to satisfy what you owe. This can happen even if you have paid your contractor in full if the contractor's subcontractors, laborers, or suppliers remain unpaid.

To preserve their rights to file a claim or lien against your property, certain claimants such as subcontractors or material suppliers are each required to provide you with a document called a "Preliminary Notice." Contractors and laborers who contract with owners directly do not have to provide such notice since you are aware of their existence as an owner. A preliminary notice is not a lien against your property. Its purpose is to notify you of persons or entities that may have a right to file a lien against your property if they are not paid. In order to perfect their lien rights, a contractor, subcontractor, supplier, or laborer must file a mechanics' lien with the county recorder which then becomes a recorded lien against your property. Generally, the maximum time allowed for filing a mechanics' lien against your property is 90 days after substantial completion of your project.

TO INSURE EXTRA PROTECTION FOR YOURSELF AND YOUR PROPERTY, YOU MAY WISH TO TAKE ONE OR MORE OF THE FOLLOWING STEPS:

(1) Require that your contractor supply you with a payment and performance bond (not a license bond), which provides that the bonding company will either complete the project or pay damages up to the amount of the bond. This payment and performance bond as well as a copy of the construction contract should be filed with the county recorder for your further protection. The payment and performance bond will usually cost from 1 to 5 percent of the contract amount depending on the contractor's bonding ability. If a contractor cannot obtain such bonding, it may indicate his or her financial incapacity.

(2) Require that payments be made directly to subcontractors and material suppliers through a joint control. Funding services may be available, for a fee, in your area which will establish voucher or other means of payment to your contractor. These services may also provide you with lien waivers and other forms of protection. Any joint control agreement should include the addendum approved by the registrar.

(3) Issue joint checks for payment, made out to both your contractor and subcontractors or material suppliers involved in the project. The joint checks should be made payable to the persons or entities which send preliminary notices to you. Those persons or entities have indicated that they may have lien rights on your property, therefore you need to protect yourself. This will help to insure that all persons due payment are actually paid.

(4) Upon making payment on any completed phase of the project, and before making any further payments, require your contractor to

provide you with unconditional "Waiver and Release" forms signed by each material supplier, subcontractor, and laborer involved in that portion of the work for which payment was made. The statutory lien releases are set forth in exact language in Section 3262 of the Civil Code. Most stationery stores will sell the "Waiver and Release" forms if your contractor does not have them. The material suppliers, subcontractors, and laborers that you obtain releases from are those persons or entities who have filed preliminary notices with you. If you are not certain of the material suppliers, subcontractors, and laborers working on your project, you may obtain a list from your contractor. On projects involving improvements to a single-family residence or a duplex owned by individuals, the persons signing these releases lose the right to file a mechanics' lien claim against your property. In other types of construction, this protection may still be important, but may not be as complete.

To protect yourself under this option, you must be certain that all material suppliers, subcontractors, and laborers have signed the "Waiver and Release" form. If a mechanics' lien has been filed against your property, it can only be voluntarily released by a recorded "Release of Mechanics' Lien" signed by the person or entity that filed the mechanics' lien against your property unless the lawsuit to enforce the lien was not timely filed. You should not make any final payments until any and all such liens are removed. You should consult an attorney if a lien is filed against your property."

Attachment 3

Mechanics' Lien Prevention for Homeowners

Enough has been written about the mechanics' lien double payment problem. There is no need to further describe the bewilderment of homeowners who pay their contractors in good faith only to be threatened or slapped with a lien when these contractors fail to pay the subcontractors and material suppliers.

Enough homeowners have complained about how even liens that are ultimately cleared negatively affect the homeowner's credit.

Enough too has been said about how the mechanics' lien prevention requires "inside" knowledge that homeowners do not have and cannot easily acquire. Notices of the lien risk arrive weeks after the work is completed and after the contractor has been paid. In fact, the notices required by law and designed to provide needed information are widely perceived as inadequate in describing the problem and almost useless in describing a solution.

Can the California Law Revision Commission's Proposal be Enacted?

The California Law Revision Commission's proposal would work to prevent these liens but can it be enacted?

Probably not. The CLRC proposes a mandatory bond covering 50% of the contract price for contractors over $10,000. The cost for such a bond is estimated to be 1 to 2% of the each contract for the contractors who are eligible for these bonds.

Contractors will oppose the bond solution, arguing that some otherwise qualified contractors will not be eligible for the bond. Contractors will also claim that the problem is small—just a few contractors who don't pay their bills. Why should everyone be required to carry these bonds when the problem is limited to a few? Note, however, that if the problem were so small, subcontractors and suppliers would not be so persistent asserting their lien rights.

That said, this might be the wrong year to propose additional expenses to businesses. In an economic slow down, adding this kind of expense to all contracts in order to protect a relatively small number of consumers cannot be good business.

This doesn't mean we should not address the problem. Even before the recession, contractors went bankrupt carrying extraordinary liabilities—more than 807 million dollars of liabilities claimed in 2000. While these are industry-wide figures, they reverberate in the home improvement arena, where bankruptcies always include losses to homeowners, subcontractors and suppliers.

Problem Statement

Boiled down, the problem for consumers is that they do not know their peril. They don't know about the possibility of liens. It makes no sense to homeowners that they can pay and then have to pay again.

As noted above, the notice from the subcontractors and suppliers (the 20-day preliminary notice) often arrives *after* the contractor has been paid. Almost more important, even if they get the various notices, homeowners are not given any foolproof suggestions on how to prevent these liens. The notices pretty much tell homeowners to pay the contractor and then chase around after the contractor, the subcontractors and suppliers trying to get lien releases.

Proposed Alternative Solution

The best solution is for the Legislature to declare that a good faith payment by a homeowner extinguishes the lien right. This proposal has been rejected in the past. The CLRC payment bond is a great solution, but homeowners and contractors alike may balk at the additional expense. But a viable alternative to a universally mandated bond might be to allow the homeowner to opt out of the mandatory bond by agreeing to take responsibility as follows:

First, the Legislature would set up the notice system within the home improvement contract so that prime contractors must notify consumers that the subcontractors and suppliers have lien rights that must be dealt with and require that the issue be dealt with during contract negotiations and not when it is too late. The contract would indicate how the problem payment will be handled. Second, the subcontractors and suppliers would be required to provide their lien warning notices before the homeowner pays the contractor. Third, the law would require the subcontractors and suppliers to choose which method the homeowner should use to pay these subs and suppliers.

Let's look at the timing issue first. Right now a "20-day preliminary notice" can be received 20 days *after* the homeowner has already paid the contractor and still be valid. While commercial property owners may know about, expect, and plan for this late notice, homeowners do not. The tenets of consumer protection and common sense rules of fair play require that a homeowner be told of the risk in time to respond.

As for the information in the notice, the Legislature could give subcontractors and suppliers three choices:

Choice 1: Subcontractors and suppliers would tell the homeowner:

> "When your contractor tells you it is time to pay for the work I have completed (or the materials I have provided), you must notify me when you pay the contractor."

This notification provides an early warning system for subcontractors and suppliers. Right now, subcontractors and suppliers do not know when the contractor is paid. This is one of the reasons subcontractors and suppliers rely on lien rights. They can't tell when to expect payment and they want to continue to sell additional goods and services to the contractor. Knowing that the contractor has been paid but has failed to pay is information that can and should result in subcontractors and suppliers declining to advance additional credit to contractors. This contrasts favorably with the present plan, which encourages subcontractors and supplier to lend the unknowing homeowner's equity to the contractor without any risk assessment.

Under this option, the homeowner gets the benefit of a good faith defense by telling the subcontractor and suppliers that the contractor has been paid. If this isn't enough protection, subcontractors and suppliers might chose 2.

Choice 2: Send a notice to the homeowner that says:

> "When your contractor tells you it is time to pay for the goods and services I have provided, pay the contractor in a joint check made out to the both me and the contractor."

Joint checks are a long established means of addressing the construction lien problem. There have been incidents, however, where one or the other of the joint check recipients takes the other's money. We should be sure that, in any event, the homeowner is relieved of lien obligations. Thus, subcontractors and suppliers who choose this plan would be affirming that a joint check would be ok with them.

Choice 3: If the subcontractors and suppliers are worried about the complications of two or more parties having to sign the check to cash it, they can send the homeowner a notice that says:

> "When your contractor tells you it is time to pay for the goods and services I have provided, pay me directly."

If the homeowner ignores the notice, then the liens hold.

To bring us full circle, there is actually a choice 4. A contractor (or homeowner) who doesn't want to deal with all this can get a bond to cover all payments or hire a joint control firm. Then subcontractors and suppliers won't worry about getting paid.

Note: A perk for subcontractors and suppliers might be for the Legislature to adopt the CLRC idea that the lien right continues to exist without the need for a 20-day notice replacement. Right now, thousands of subcontractors and suppliers send these notices not because the contractor can't be trusted to pay but because they want to retain their rights against the property owner.

Recap

Under this proposal, homeowners get real consumer protection from mechanics' liens when the source of the lien is that the contractor who has been paid fails to pay subcontractors and suppliers. This is made possible by two changes to existing law. The 20-day preliminary notice would be replaced with a Mechanics' Lien Prevention Notice that is only valid if it arrives before the homeowner pays for the goods and services described and tells the homeowner how payment is to be made. If the contractor and homeowner think this process is too cumbersome, they can choose to protect the rights of subcontractors and suppliers by using joint control accounts or bonds. A homeowner who knowingly ignores the rights of the subcontractors and suppliers would be subject to liens but only if the contractor fails to pay.

Note: A version of this proposal, Direct Pay, was offered to the CLRC last year. At that time, the CLRC rejected Direct Pay on grounds that, compared to the full payment defense, Direct Pay would be too complicated for consumers. No one can disagree. A full payment defense would be best for consumers. But, when a full payment defense is paired with a mandatory performance bond that adds cost to the contract, the homeowner with a reasonable straightforward project might sensibly choose to pay the subcontractors and suppliers directly as proposed here.

In fact, this proposal is more complicated than the present system. The present system is not complicated at all. The consumer does nothing to prevent liens. The consumer doesn't know action is necessary and wouldn't know what to do even if they knew action was necessary. I believe consumers would prefer to have a way to prevent liens that isn't just luck.

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November 16, 2001

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Re: The Double Payment Problem in Home Improvement Contracts

The California Law Revision Commission's, (CLRC) tentative recommended changes to the California Mechanic Lien statues are very disconcerting. These specific statues have been in place for almost beyond the limits of memory. I personally am not a proponent of changing these statues as written. I am not convinced they need to be changed and I trust the proposed revisions are not the result of a potential political firestorm.

Any changes made to the existing statues should be equitable to all concerned parties... there needs to be parity. The existing statues provide a mechanism for specific trades to recover such amounts that may be due under the terms of their contract in the event of non payment by the Owner or Prime Contractor.

This mechanism, the right to lien a residential property, cannot be summarily eliminated from the statues unless it is replaced by a mechanism which allows the claimant to recover the amount that may be due under the terms of their contract. To achieve parity in the CLRC's proposed surety bond scenario, a surety bond should be required on all home improvement contracts for 100% of the contracted amount with the Prime Contractor. Further, the procedure to recover said funds from the surety should not be a time consuming, complicated process, and payment by the surety should be made in a timely manner.

Respectfully,

Earl Clark

Earl Clark
General Credit Manager
Pacific Coast Building Products

EC/bm