Study H-821 November 18, 2005

First Supplement to Memorandum 2005-43

Mechanics Lien Law
(Material Received at Meeting)

The following material was received by the Commission at the meeting on November 18, 2005, in connection with Study H-821 on mechanics lien law, and is attached as an Exhibit:

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

Exhibit

COMMENTS OF SAM ABDULAZIZ

November 14, 2005

SENT VIA EMAIL ONLY!
sterling@clrc.ca.gov

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

RE: MEMORANDUM 2005-43

Dear Mr. Sterling:

This is a written response to some of the issues you raise in your Memorandum.

Notice of Cessation (Page 8)

Staff questions whether a public agency would ever record a Notice of Cessation. There are instances where the Notice is appropriate and important, particularly in the instance that the public agency terminates the original contractor, or the original contractor is bankrupt or otherwise abandons the project. Then the Notice of Cessation would terminate that project and stop the time for any stop notice or bond claims, protecting the second contractor as well as the public agency from those claims. For Notice of Cessation to be effective, it must be recorded at least 30 days after cessation. Unlike a Notice of Completion, there is no penalty for recording a late Notice of Cessation. Thus, a Notice of Cessation recorded after 45 days would serve the purpose of requiring a Stop Notice to be recorded within 75 days of the cessation on the project (the 45 days given in the hypothetical plus the 30 days as the result of the notice), rather than 150 days (the 60 days in the statute plus the 90 days allowed if no notices are recorded).

There is some discussion that the completion statute presently also deems thirty days of cessation on a public works project to be "completion." However, that still does not shorten the time to file stop notices or bond claims, as does a notice of acceptance or notice of completion.

Notice of Completion (Page 9)

As to the Notice of Completion, and the parenthetical in discussing a Notice of Acceptance, this is one of the most confusing areas of the payment laws affecting public works. On a public work of improvement, many people believe that a notice of acceptance actually provides a second period of time within which one can file a Stop Notice. This issue should be resolved. That is to say, if a project is completed on January 1, 2005, and a Notice of Completion is not recorded at that time, the time to record to a Stop Notice would be on or about March 28, 2005. A problem in the public works sector is that public agencies tend to give acceptance to the projects after a long period of time from completion. There is a large area of the law discussing "completion" and punch list items typically are performed after "completion." If the agency issues a Notice of Acceptance on the same project on September 1, 2005, a Stop Notice now can be recorded by September 30, 2005. Similarly, a bond claim could be recorded by about March 1, 2006, even though it otherwise might have been time barred. There should be consistency within the law and a public agency should have an incentive to issue their Notices of Acceptance prior in time.

Lastly, a Notice of Acceptance is usually not recorded. It is usually issued by the governing body of the public agency (the Board in the case of the School District, or the city counsel in the case of a city project.)

A few years back, we had a problem where notices were recorded, yet they did not show up because the title company did not know how to apply them. It is a rare instance that a public agency actually records anything, though they issue Notices of Acceptance all the time. Thus, the public works statute should use the term "acceptance." Perhaps the public agency should be required to notify all persons who paid the fee along with a Preliminary Notice when a cessation of labor has been deemed to have occurred, or if no notice is provided, the period is not shortened.

Contents of Preliminary Notice (Page 11)

I do not believe that it is appropriate to delete any language in the Preliminary Notice. I believe the information required on a Preliminary Notice such as the Claimant's address and a description of the construction site is necessary to foreclose on the Lien, and is also important for others to determine who is making the claim.

Disciplinary Action for Failure To Give a Preliminary Notice (Page 11)

I have been doing this type of work for 35 years. I am also very much involved with Contractors State License Board matters. I have never seen anyone disciplined for failure to give a Preliminary Notice. The staff's analysis is

appropriate and should be followed. A good example of why the statute is unnecessary is what material suppliers do. Although material suppliers are not covered by Civil Code Section 3098, material suppliers make monetary (as distinguished from legal) decisions all the time. Many of them do not provide Preliminary Notices for materials under $1,000.00 or $2,000.00. That is a cost benefit decision.

Jury Trial (Page 14)

It is generally held that a mechanic's lien; stop notice or other equitable claim is not subject to a jury trial. The question is whether the claimant seeking to enforce a stop notice after the contractor has commenced the summary procedure to release the stop notice is entitled to a jury.

Code of Civil Procedure section 3197 sets forth the grounds for the summary release procedure:

> "If the original contractor asserts (1) that the claim upon which the stop notice is based is not included within the types or classifications of claims referred to in this article, or (2) that the claimant is not one of the persons named in Section 3181, or (3) that the amount of the claim as specified in the stop notice is excessive, or (4) that there is no basis in law for the claim as referred to and set out in the stop notice, he may have the question determined in a summary proceedings in accordance with the provisions of Sections 3198 to 3205, inclusive."

The plain language of the statute includes defenses as to the amount of the claim, as well as a defense that there is "no basis in law for the claim…" This may implicate a jury, as suggested by Staff, though the summary nature of the proceeding would fail if the claimant may demand a jury.

In *Grade-Way Construction Co. v. Golden Eagle Ins. Co.* (1993) 13 Cal.App.4th 826 (a case that held that a surety issuing a stop notice release bond after the commencement of an action or proceeding waives the right to a jury under *Code of Civil Procedure* section 996.440), the Court of Appeal (in its footnote 8) cited the widely known law that mechanic's lien and stop notice claims are equitable, as are claims on release bonds:

> Generally, a mechanic's lien foreclosure action is an equitable proceeding in which there is no right to a jury trial, although there is a right to jury trial to the extent the claimant also seeks a personal judgment against the debtor (citation) . (*Curnow v. Blue Gravel etc. Co.* (1885) 68 Cal. 262, 264, 9 P.

149; *Distefano v. Hall* (1963) 218 Cal.App.2d 657, 662, fn. 6, 32 Cal.Rptr. 770; *Coghlan v. Quartararo* (1911) 15 Cal.App. 662, 666, 115 P. 664; Marsh & Marsh, Cal.Mechanics' Lien Law and Construction Industry Practice (5th ed. 1990) § 4.123, p. 4-125; 8 Miller & Starr, Current Law of Cal.Real Estate (2d ed. 1990) § 26:53, p. 532.) An action on a stop notice also is an equitable proceeding. (*Weldon v. Superior Court* (1903) 138 Cal. 427, 429-431, 71 P. 502; *Calhoun v. Huntington Park First Sav. & Loan Assn.* (1960) 186 Cal.App.2d 451, 459, 9 Cal.Rptr. 479.) In *Stel-Den of America v. Roof Structures, Inc.* (Fla.App.1983) 438 So.2d 882, 885, the court held that "the transfer of the lien to bond does nothing to diminish the nature and characteristics of the lien foreclosure action. It continues to be a proceeding in equity." In *Genninger v. Frank A. Wahlig Co.* (1909 N.Y. City Ct.) 116 N.Y.S. 578, 580, and *Reilly v. Poerschke* (1897 N.Y.Sup.) 19 Misc. 612, 44 N.Y.S. 422, 425, the courts held that the remedy to enforce a surety's obligation on a mechanic's lien release bond is not "by an action at law upon the bond," but by an action "in equity...."

"In our view, the equitable issues which could reasonably be tried by the trial court alone were only those, if any, relating to the manner in which the lien was perfected. The validity of the underlying claim was a legal issue which defendants were entitled to have resolved by a jury." *Selby v. McCarty* (1979) 91CalApp 3rd 517.

Scope of Payment Bond Statute (Page 17)

On page 17 of your Memorandum you deal with the issues of whether state entities are exempt from section 7103(d). I agree with Mr. Hunt that Claimants have assumed for years that to be the case and should be the law.

Very truly yours,
ABDULAZIZ & GROSSBART

SAM K. ABDULAZIZ

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COMMENTS OF DEPARTMENT OF WATER RESOURCES

NOTE. These are excerpts of comments made by John A. Cape, DWR Staff Counsel (received 11/16/05). We have not reproduced Mr. Cape's comments in full due to formatting issues in transmission, but we have selectively reproduced major points. In particular we have omitted a number of fairly technical suggestions. We will take into account all Mr. Cape's comments when we prepare our next draft.

Location of Statute

It is appropriate to move the stop payment notice provisions to the Public Contract Code. Most contractors who do public works contracts and their counsel deal regularly with the PCC and will find it convenient to have these provisions readily available there. In addition, separating them from the mechanics lien law that applies to private works of improvement helps draw a clear distinction between the stop payment notice law, where there is no right to place a lien on the improved property, from the mechanics lien law where that right is the primary incentive for owners to ensure that the contractors' subs and suppliers are paid.

Waiver and Release

My comments strive to foster a process where the public entity, the claimant and the direct contractor will have incentives to reach an early resolution of problems with getting funds to potential claimants. One major omission from the CLRC draft is the procedure for using releases under CC 3262 to get the funds to the contractor and the claimant. In our experience that is by far the most common way that these problems are resolved. We have hardly ever had any use of the affidavit process and the court proceedings have been very infrequent and usually are a last resort for situations where the direct contractor has had a major financial failure on the project or in its overall business operation.

The process in CC 3262 also needs to make clear that the public entity should be required to foster and use the conditional release forms with the issuance of two party checks so that that the contractors' earnings can be disbursed to the contractor and the claimant as soon as possible. We have had a number of situations, especially with small contractors with limited cash reserves, where there have been multiple stop payment notices filed that have been near disasters for the contractor. If there is a delay in receipt of payment from the public entity, or the contractor has insufficient cash flow to keep its payables current then the contractor correctly channels its available funds to cover the labor costs because of the severe sanctions it will incur if it fails to pay its workers and the payroll taxes on time. When cash flow is limited and a subcontractor or supplier gets concerned because it has not been paid on time it will file a stop payment notice to protect its rights. Once the first stop payment notice is filed that ties up those earnings, plus the usual 25% markup by the public entity, usually for many months. Tieing up those funds aggravates the cash flow problem for the contractor so other subs and suppliers don't get paid. They also file stop payment notices so that a domino effect is

triggered which freezes the contractor's earnings in the public entities' hands and no one is getting paid.

I have taken a short cut in the draft by just cross referencing CC 3262 for the release forms. I have also included a requirement that the public entity, when it receives a stop payment claim, must respond to the contractor and the claimant with copies of the forms that can be jointly filed to obtain release of the funds. (There has been a reluctance on the part of some agencies to use a conditional release form with a two party check. There has also been an understanding for many years that the controller would not issue two party checks in this situation. We recently used such forms very successfully on a contract and had no problem obtaining the two party checks from the SCO.)

In my view the emphasis by the public entities should be on finding a way to get the disputed earnings to the contractor and claimant as soon as possible. If they get a two party check for the funds there is a lot of incentive for them to resolve their differences so that they can cash the check. If the disputed funds, plus 25%, are being held by the public entity for months and perhaps for years, the disputes are aggravated and more stop payment claims are triggered because more and more of the contractor's earnings are tied up in the hands of the public entity. I recognize that the affidavit process is available and that the direct contractor can bond around the stop payment claim and get the funds released. Those processes are time consuming and expensive. The release with joint payee checks is the simplest and fastest way for a contractor and the claimant to get the funds that they are entitled to and there should be incentives in the statute that will require the public entities to use that procedure.

My draft also strives to create a substitute for the notice requirement with a $2 payment that is in CC 3185. When it responds to receipt of a stop payment claim the public agency, in addition to providing release forms and instructions to the direct contractor and the claimant, should also be required to provide an estimate of when it expects the contract work will be completed and the notice of completion recorded. That should provide adequate information to the claimant on when it should be prepared to file an action on the stop payment claim if it does not get paid.

§ 44170. Notification of claimant

44170. (a) Within 15 days after reciept of a stop payment notice the public entity shall notify the claimant of the action that it has taken and the amount of funds, if any, that it is withholding in response to the stop payment notice.

(b) Such notice shall include estimated dates for when the public works contract will be completed and when the time will expire within which the stop payment notice must be enforced.

(c) Such notice shall also include conditional and unconditional waiver and release forms that the claimant and the direct contractor may provide to the public entity to obtain release of funds being withheld. Such forms shall be substantially as set forth in Civil Code Section 3262.

(d) Notice under this section shall be by personal delivery or by mail addressed to the claimant and to the direct contractor at the addresses shown on the stop payment notice.

~~(c) A public entity need not give notice under this section unless the claimant has paid the public entity two dollars ($2) at the time of giving the stop payment notice.~~

Completion

This section should not include the topics of acceptance or cessation.

Acceptance is defined in the public works contract as the point where the work is completed to such a degree that the public agency will take over responsibility for care and maintenance of the work. It has no bearing on how or when a Claimant should be entitled to serve a stop payment notice.

I assume that cessation is a suspension or termination of the work such as would occur when a direct contractor walks off the job or the work is terminated by the public agency for cause or convenience. None of those have any bearing on how or when a Claimant should be entitled to serve a stop payment notice.

The entitlement to serve a stop payment notice should be tied to the status of the Claimant's work and not to the status of the Direct Contractor's work. In a multi-year public works contract a claimant may perform all of its work within the first few months or weeks and there is no reason its entitlement to and processing of a stop payment claim should be linked to completion of the direct contractor's work which would be years later.

I suggest the following definition here:

> **41030. Completion of Claimant's Work**
>
> 41030. "Completion of Claimant's Work" means the completion of the work to be provided by the Claimant to or for the Direct Contractor or termination of that work by or for the Direct Contractor for cause or convenience.
>
> **41031. Completion of the Public Works Contract**
>
> 41031. "Completion of the Public Works Contract" means the completion date that is or would be set forth in the recordation of a notice of completion.
>
> **Comment**: These definitions will allow the later sections to be keyed to the time when the Claimant has completed its work or its work has been terminated. That is the point in time where payment to Claimant should be made and issues regarding such payment should be resolved. If they are not, then Claimant's entitlement to serve a stop payment claim would arise.

Disciplinary Action for Failure to Give Preliminary Notice

This section needs to be modified to be consistent with section 43010 which provides that a first tier subcontractor does not have to give a preliminary notice. It also needs to make clear that a penalty for failure to give a preliminary notice only applies if there is an attempt to give a stop payment notice where no preliminary notice has been given.

Without such a change the entities are being deprived of the right to forego the right to make stop payment claims.

> **§ 43060. Disciplinary action for failure to give notice**
>
> 43060. A licensed subsubcontractor is subject to disciplinary action under the Contractors' State License Law, Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code, if the contract price to be paid to the subsubcontractor exceeds $400 and the subsubcontractor gives a stop payment notice and has not given a preliminary notice.

Time for Giving Stop Payment Notice

This timing should be keyed to the completion of the claimant's work as I have defined that term in 41030, above. If the claimant is required to file its stop payment claim within 90 days after it has completed its work or its work has been terminated then on long term contracts those claims can be resolved promptly and will not be piling up at the end of the contract. On short term contracts the deadline of 30 days after recordation of the notice of completion, or 90 days after completion if there is no recordation of a notice of completion would be appropriate.

> **§ 44140. Time for giving notice**
>
> 44140. A stop payment notice is not effective unless given before expiration of the earlier of the following times:
>
> (a) Ninety days after completion~~, acceptance, or cessation~~ of Claimant's work.
>
> (b) Thirty days after recordation of a notice of completion~~, notice of acceptance, or notice of cessation~~ of the public works contract.
>
> (c) Ninety days after completion of the direct contractor's work if there has been no recordation of a notice of completion.

Payment Bond

Staff should take this opportunity to draft payment bond provisions and revisions that would clarify the bonding requirements for public works contracts. Since contractors are required to be licensed and bonded the payment bond threshold could be linked to that requirement instead of having three different thresholds and no requirement in some instances.

COMMENTS OF MICHAEL SCHOENFELD

From: MSchoenfeld@murphyaustin.com
Subject: Civil Code Sections 3097 and 3098 and 3252
Date: November 17, 2005 4:13:37 PM PST
To: sterling@clrc.ca.gov

Based upon our conversation today concening the fact that the California Law Revision Commission ("CLRC") is meeting tomorrow to discuss issues relating to Title 15 of the Civil Code (entitled "Works of Improvement"), I have swiftly prepared this email to address the subjects we briefly discussed earlier today. I am concurrently sending it, prior to it being read and commented upon, to several members of the AGC Legal Advisory Committee for their review, comment and/or amplification. I am not their spokesperson but hope the content below will promote thought and action to correct some problems in Title 15.

This email amplifies the subject I briefly addressed in our conversation today regarding a perceived need to modify and merge the preliminary notice requirements of Civil Code sections 3097 and 3098, include within the new statute a sanction for failing to provide the required notice, and to eliminate the "second bite of the apple" provision found in Civil Code section 3252.

I am a member of the bar and my practice is devoted full time to the practice of construction law. My practice is not dedicated to any constituency of the construction industry. We represent public and private owners, prime contractors, subcontractors, suppliers, design professionals, and construction managers. I am a member of the Associated General Contractors' Legislative and Legal Advisory Committees and it is in my capacity as a member of AGC (and the committees) as well as the need for practitioners and all construction project interests to have laws that make sense and promote balance and fairness that this email is authored and sent.

There is a real problem that exists in the laws cited above. It concerns the lack of balance and the inequities that result from such a situation. Currently the law has different rules for the provision of a preliminary notice on a public works project and a private project. There may be historical reasons for the different notice requirements for private and public works projects but they frankly escape me at this time. While it is true that on private projects there are generally private lenders (not normally found on public works) and on public works projects there is no requirement that a first tier subcontractor provide a 20-day preliminary notice (as contrasted with the opposite requirement on a private works project) and the remedies are different (no lien rights on public projects and bonds are infrequently found on private projects), there does not appear to me to be a reason for different notice requirements and the distinction in the notice

requirements can (and has) led to harm as a result and there is no valid reason to allow such a possibility to continue.

The fact that a first-tier sub on a public works project does not have to give notice to the owner or prime has now been identified to be a problem as there are certain claimants that an owner and prime may not know about. These include union trust funds. While a sub on a private job needs to identify in the preliminary notice the trust funds it is signatory to, the same is not true on a public works job as no preliminary notice is required. Therefore, there is no way a prime or owner is provided notice of what union trust funds who are signatories to first tier subs may claim money via stop notice or bond claims. Recently, an AGC member on a public works project experienced a double payment problem due to the fact that a first tier sub was a signatory to a trust fund agreement, the sub was fully paid off but did not pay the union trust fund and at the end of the job the trust fund claimed entitlement and the sub couldn't pay. The answer is that the prime gets stuck and had no reasonable ability to protect itself. Had a 20 day preliminary notice been required, including listing of all trust funds potentially claiming entitlement to funds (the same requirement that exists on a private job), the prime would have been able to protect itself. Why should the result on a public project be different than a private project? I cannot think of a valid reason. The fairness and equity of the checks and balances which are set up in the work of improvement section of the civil code is missing from this area and needs to be corrected. We all agree that the trust fund should be paid. We all should also agree that notice of their existence should be given so the prime can protect itself and avoid a risk of double payments should a sub not honor its obligations. A hole exists to permit such a problem to occur and it is our responsibility to close the hole.

The historical basis for having a different set of rules for the preliminary notice requirements for public and private projects appears to no longer exist or be viable. It is my suggestion that the two statutes, 3097 and 3098, be merged into one preliminary notice requirement for all projects. The key word is notice. Once notified the conditional and unconditional waivers in 3262 (d) can be used to protect this circumstance from arising again should the parties use the statutory forms and protection that exists. To allow these holes or gaps undermines the integrity and protection the laws are enacted to avoid.

My suggestion is not burdensome on subs. Most who perform public work also perform private work in my experience as well. Therefore, they are aware of the preliminary notice requirements. Further, to be licensed, the qualifiers are educated about the preliminary notice requirements and, simply stated, it is good practice to send such a notice when a job is started regardless of what tier a sub may be.

The need to plug this hole exists and upon reflection I cannot think of a valid reason why there are different rules for public and private projects. I recommend the CLRC seriously consider merging the two statutes.

As far as Civil Code section 3252, the "second bite of the apple" up to 75 days after completion assuming no notice of completion has been recorded raises a real problem. Anecdotally, the provision was enacted because of a perception (without any evidence) that the change in the law requiring anyone claiming against a payment bond must provide a preliminary notice may harm some bond claimants. After more than a decade I know of no facts ever arising that illustrate that this provision is needed. To the contrary, it is my belief that the provision harms and penalizes those who follow the requirements and rewards those who do not by allowing belated claims to be filed. This is unfair and inconsistent with the notions of fairness and balance throughout the work of improvement sections. This provision undermines the orderly payment of funds as a bond principal must always keep an eye on the possibility that someone may be lurking in the shadows who did not provide a preliminary notice and therefore cannot file a stop notice (or record on a private project a mechanics lien) but the claimant could, belatedly, submit a late preliminary notice and make a payment bond claim. Adding insult to injury is the fact that the claimant not only gets rewarded for its lack of diligence, but the claimant can recover attorneys fees to pursue its payment bond claim whereas no such right exists for a stop notice or mechanics lien foreclosure action. This remedy is properly deleted.

Finally, I propose that the failure to provide a 20 day preliminary notice on a timely basis should have more teeth than the loss of stop notice or lien rights. If the failure or late provision of the 20 day notice causes actual damages against the party who should have received the notice (as an example, if the notice was not given or was given late and the identity of the trust fund was not disclosed and the prime needs to make a payment to the trust fund and the prime does not get reimbursed by the sub promptly), there should be some sanction arising from the failure to act as required which causes damages. The sanction could range from forfeiture of the claim (no prelim notice given) to monetary (double or treble damages). There needs to be a disincentive for people to violate the rules.

I look forward to speaking with you further on this matter.