Study H-821 April 13, 2007

Memorandum 2007-11

Mechanics Lien Law: Private Work of Improvement (Analysis of Comments on Tentative Recommendation)

This memorandum continues a discussion of public comments on the private works portion of the Commission's tentative recommendation on *Mechanics Lien Law* (June 2006). The next memorandum will begin a discussion of comments on the public works portion of the recommendation.

Most comments analyzed in this memorandum were attached as exhibits to prior memoranda presented to the Commission. The relevant portions of those comments are summarized and discussed in this memorandum, but are not republished.

The following letter is attached as an Exhibit to this memorandum:

Comments that are supportive of a provision of the proposed law are not discussed in this memorandum, except when comments questioning the same provision have been received, or when the Commission has specifically solicited comment on the provision.

Issues in this memorandum that require discussion have been marked with the following symbol: ☞.

All other issues in this memorandum are presumed to be noncontroversial "consent" issues. The staff does not intend to separately discuss any consent issue, unless a Commission member or member of the public expresses a question or concern about the issue.

Sections of the proposed law reprinted in this memorandum are the latest draft versions of the section, incorporating any revisions approved by the Commission at previous meetings and any non-substantive technical corrections made by the staff.

Any California Law Revision Commission document referred to in this memorandum can be obtained from the Commission. Recent materials can be downloaded from the Commission's website (www.clrc.ca.gov). Other materials can be obtained by contacting the Commission's staff, through the website or otherwise.

Unless otherwise indicated, all citations to statutes in this memorandum are to the Civil Code.

PAYMENT BONDS

A payment bond provides the third of the traditional mechanics lien remedies.

The bond, issued by a surety, guarantees payment to claimants that are not otherwise paid for work performed.

An owner may require a direct contractor to obtain a payment bond as a term of a construction contract. Although the owner ultimately bears the cost of the bond, it is normally the direct contractor that is evaluated by the surety in deciding whether to issue the bond.

A claimant against a payment bond may recover from either the surety on the bond, or from the principal (the person obtaining the bond).

Issues that have been raised relating to the payment bond provisions in the proposed law are discussed below.

TERMS OF A PAYMENT BOND

Proposed Section 7606 states required terms of a payment bond (with emphasis added):

> **§ 7606. Payment bond**
>
> 7606. (a) A payment bond **shall be conditioned for the payment in full of the claims of all claimants and** shall by its terms inure to the benefit of all claimants so as to give a claimant a right of action to enforce the liability on the bond.
>
> (b) ….
>
> **Comment.** Section 7606 restates former Section 3096 without substantive change.
>
> **….**

Terminology

Gibbs, Giden, Locher & Turner LLP (hereinafter "GGLT"), a law firm in Los Angeles, suggests that the use of the term "conditioned" in this section is inappropriate. CLRC Memorandum 2006-39, Exhibit p. 156. It argues that the term suggests a prerequisite that the existing provision of law does not contain, and proposes that the bolded text above be deleted.

The staff respectfully disagrees. Section 7606 is intended to restate existing Section 3096 — which also uses the term "conditioned" — without substantive change. Section 3096 provides as follows:

> 3096. "Payment bond" means a bond with good and sufficient sureties that is conditioned for the payment in full of the claims of all claimants and that also by its terms is made to inure to the benefit of all claimants so as to give these persons a right of action to recover upon this bond in any suit brought to foreclose the liens provided for in this title or in a separate suit brought on the bond. An owner, original contractor, or a subcontractor may be the principal upon any payment bond.

Several other statutory provisions in the existing mechanics lien statute also use the term "conditioned" in referring to the terms of a bond (Civ. Code §§ 3143, 3171, 3196), as do various sections in other codes. Although the term may be somewhat antiquated, substitution of a new term in Section 7606 or removal of the section's first clause could be interpreted as an intent to distinguish the section from these other existing provisions.

The staff does not recommend the change suggested by GGLT in the context of this study.

Applicability to Non-Statutory Payment Bonds

The American Insurance Association, National Association of Surety Bond Producers, and Surety & Fidelity Association of America ("joint surety commenters") argue that the drafting of Section 7606 substantively changes existing law. CLRC Memorandum 2006-39, Exhibit pp. 91-92.

The group asserts that the section has changed a definition of "payment bond" to a substantive provision dictating the coverage of *all* payment bonds in private works of improvement.

That would be a problem, because sureties also issue what are known as common law or *non*-statutory "payment bonds," which are not intended to be a part of the statutory mechanics lien law scheme. The group is concerned that proposed Section 7606 could be interpreted as precluding the issuance of these bonds.

It would seem that existing Section 3096 could be interpreted as causing this problem now. Nevertheless, **the staff sees no harm in making clear that proposed Section 7606 applies only to a payment bond created pursuant to the mechanics lien law:**

§ 7606. Payment bond

7606. (a) A payment bond under this part shall be conditioned for the payment in full of the claims of all claimants and shall by its terms inure to the benefit of all claimants so as to give a claimant a right of action to enforce the liability on the bond.

(b) ….

The joint surety commenters indicate this revision would address their concern.

☞ LIMITATION OF OWNER'S LIABILITY BASED ON PAYMENT BOND

Under existing Section 3235, an owner may limit lien claim exposure on a work of improvement by (1) recording the contract for the project, and (2) obtaining and recording a payment bond of at least 50% of the contract price. Proposed Section 7602 continues the provisions of Section 3235:

§ 7602. Limitation of owner's liability

7602. (a) The court shall limit an owner's liability to the contract price under subdivision (b) if, before the commencement of work, the owner in good faith files the contract with the county recorder and records a payment bond of the direct contractor given by sufficient sureties in an amount not less than 50 percent of the contract price.

(b) If the conditions of subdivision (a) are satisfied, the court shall restrict lien enforcement under this part to the aggregate amount due from the owner to the direct contractor and shall enter judgment against the direct contractor and surety on the bond for any deficiency that remains between the amount due to the direct contractor and the whole amount due to claimants.

Comment. Subdivision (a) of Section 7602 restates the first part of former Section 3235 and the first sentence of former Section 3236 without substantive change. It makes clear that the bond, as well as the contract, must be recorded before the commencement of work. See also Section 7056 (filing and recording of papers).

Subdivision (b) restates the last part of former Section 3235. It replaces the restriction of lien enforcement in cases where it would be equitable, with a restriction of lien enforcement in cases where the sureties are sufficient. See also Code Civ. Proc. § 995.310 (sufficient sureties on bond required). This codifies case law interpretation of former Section 3235 and is consistent with the "in all cases" language of former Section 3236.

….

The liability limitation provision continued in Section 7602 is characterized by one mechanics lien law treatise as the "most significant protection given to an

owner by California law" against lien claims. Marsh, *California Mechanics Lien Law* (6th edition), § 2.9, pp. 2-5 (1999).

The provision potentially allows an owner to eliminate all lien claims, thereby providing one of the few means available to avoid having to pay both a direct contractor and a lien claimant for the same work performed (the "double liability" problem). Based on this protection, the provision was cited by the Supreme Court as one basis for upholding the constitutionality of the entire mechanics lien statute. *Connolly Dev., Inc. v. Superior Court*, 17 Cal. 3d 803, 553 P.2d 637, 132 Cal. Rptr. 477 (1976).

Under specified circumstances, the recording of a payment bond under Section 7602 also allows both lenders and owners to disregard stop payment notices. Sections 7522, 7536.

The use of these protections is reported to be wide-spread among knowledgeable business owners. Marsh, *California Mechanics Lien Law* (6th edition), § 2.9, p. 2-5 (1999). Despite their potential impact, however, the protections are apparently rarely used by individual homeowners, due either to a lack of awareness of the statutory provision, a lack of desire to pay for the bond, or the use of contractors that cannot be bonded.

The Commission has received several comments relating to Section 7602. In response, the staff has recommended more than one revision to the section. Each recommendation is presented separately. Once the Commission indicates which revisions (if any) it wants to implement, the staff will implement the revisions in an appropriate manner.

Nature of Limitation

The joint surety commenters argue that the limit on an owner's liability stated in subdivision (a) of Section 7602 should not be the "contract *price*," but instead should be the contract's *unpaid balance*, as indicated in existing Section 3235. CLRC Memorandum 2006-39, Exhibit p. 91.

It was the Commission's intent in drafting Section 7602 to continue the lien protection provision in existing Section 3235, which in fact limits the owner's lien claim exposure to the unpaid contract balance. The term "contract price" could be interpreted to mean something quite different — namely, the total dollar amount initially agreed to be paid by the owner, without consideration of subsequently made payments.

Ironically, the reference to "contract price" was added to Section 7602 to continue a legislative intent provision in existing Section 3236, which by its terms is intended only to explain Section 3235.

Existing Section 3235 provides:

> 3235. In case the original contract for a private work of improvement is filed in the office of the county recorder of the county where the property is situated before the work is commenced, and the payment bond of the original contractor in an amount not less than 50 percent of the contract price named in such contract is recorded in such office, then the court must, where it would be equitable so to do, restrict the recovery under lien claims to an aggregate amount equal to the amount found to be due from the owner to the original contractor and render judgment against the original contractor and his sureties on such bond for any deficiency or difference there may remain between such amount so found to be due to the original contractor and the whole amount found to be due to claimants.

This section clearly limits an owner's lien claim exposure to the unpaid contract balance. However, existing Section 3236 then states (with emphasis added):

> 3236. It is the intent and purpose of Section 3235 to limit the owner's **liability**, in all cases, **to the measure of the contract price** where he shall have filed or caused to be filed in good faith his original contract and recorded a payment bond as therein provided. ….

The explanatory provision in Section 3236 does not add anything substantive to the lien claim protection provided in Section 3235, and is therefore not strictly necessary. If an owner's lien claim exposure is limited to the unpaid contract balance as provided in subdivision (b) of Section 7602, the owner's total liability on a project (i.e., contractual obligation plus lien exposure) will necessarily be limited to the contract price, whether that limit is expressly stated or not.

The staff therefore recommends **deleting the confusing and unnecessary language from Section 7602**:

> **§ 7602. Limitation of owner's liability**
>
> 7602. ~~(a) The court shall limit an owner's liability to the contract price under subdivision (b)~~ This section applies if, before the commencement of work, the owner in good faith files the contract with the county recorder and records a payment bond of the direct contractor given by sufficient sureties in an amount not less than 50 percent of the contract price.

(b) If the conditions of subdivision (a) are satisfied, the court shall restrict lien enforcement under this part to the aggregate amount due from the owner to the direct contractor, and shall enter judgment against the direct contractor and surety on the bond for any deficiency that remains between the amount due to the direct contractor and the whole amount due to claimants.

Deadline for Recording Payment Bond

The Association of California Surety Companies ("Association") argues that Section 7602's requirement that the payment bond be recorded before the commencement of work is problematic. CLRC Memorandum 2006-39, Exhibit p. 20. The Association further asserts that this requirement represents a change in existing law.

Effect of Requiring Recording Before Commencement of Work

According to the Association, arrangements for a payment bond are normally not finalized until after a construction contract is executed. Since on many projects work may start as soon as the contract is executed, this means that in many cases the bond will not even be delivered to an owner until after work has commenced. Requiring the recording of the bond before commencement of work, according to the Association, would therefore require either a departure from customary bonding practices, or a potentially costly delay in commencing work.

A requirement that the owner record the payment bond before commencement of work can also create an unfair trap for an owner. For example, an owner might obtain a payment bond before work started, but before the bond is recorded an unscheduled action marking the commencement of work could occur (e.g., a supplier dropping off material at a job site). The owner in that situation would have paid the premium for the bond, but wouldn't receive any statutory protection against lien claims and stop payment notices.

Benefit of Requiring Early Recording

On the other hand, there is value in requiring the payment bond under Section 7602 to be recorded at the earliest practical time in the construction process. Until the deadline for recording the payment bond passes, claimants cannot know whether they will have mechanic lien rights on a job, or will have only payment bond rights that the claimant may consider less desirable, or even unacceptable.

A lender also needs to know as soon as possible whether the provisions of Section 7602 will be applicable to a project. Under proposed Section 7536, a payment bond recorded under Section 7602 allows a lender to disregard all stop payment notices (other than from direct contractors). Thus, until the deadline for recording a payment bond under Section 7602 passes, each time a lender receives a stop payment notice it will have to check with the recorder's office to determine whether it is required to honor the notice.

The staff nevertheless agrees with the Association that requiring recording of the payment bond as early as before commencement of work may be problematic. However, notwithstanding the Association's contention to the contrary, such a requirement *may* already be a part of existing law.

Requirement Under Existing Law

Existing Section 3235, the source of proposed Section 7602, requires that the construction *contract* be recorded ("filed") before work commences, but is ambiguous regarding when the *payment bond* has to be recorded:

> 3235. In case the original contract for a private work of improvement is filed in the office of the county recorder of the county where the property is situated before the work is commenced, and the payment bond of the original contractor in an amount not less than 50 percent of the contract price named in such contract is recorded in such office, then the court must, where it would be equitable so to do, restrict the recovery under lien claims ….

Two mechanics lien law treatises indicate that Section 3235 requires both the contract *and* the payment bond to be recorded before commencement of work. One treatise — without explicitly addressing when the bond must be recorded — summarizes Section 3235 as requiring a "combined" filing of the contract and recording of the payment bond, and indicates lien exposure will be limited if the bond is recorded when the contract is filed. Hunt, *California Mechanics Lien and Related Construction Remedies* (3rd edition), § 8.38, p. 555 (Cal. Cont. Ed. Bar 2006).

Another treatise expressly states that the bond must be recorded before commencement of work. Miller & Starr, *California Real Estate* (3rd edition), § 28.39, pp. 136-137 (2006). However, the treatise cites as authority cases interpreting an earlier version of this provision (then Code of Civil Procedure Section 1183), which provided as follows (with emphasis added):

> In case said original contract shall, before the work is commenced, be so filed, **together with** a bond of the contractor

> with good and sufficient sureties in an amount not less than fifty (50) per cent of the contract price named in said contract, … then the court must, where it would be equitable so to do, restrict the recovery under such liens to an aggregate amount equal to the amount found to be due from the owner to the contractor ….

As might be expected, the Supreme Court in *Hollenbeck-Bush Planing Mill Co. v. Amweg*, 177 Cal. 159, 170 P. 148 (1917), held that this version of the section required the bond to be recorded before the commencement of work.

Section 3235 was enacted in 1969, as a replacement for the provisions of Section 1183 reproduced above. However, now that the bolded language above is no longer in the existing provision, a different interpretation of the provision is at least supportable. The absence of the bolded language could mean the Legislature consciously intended to delete the requirement that the bond be recorded before the commencement of work, or the omission could have been inadvertent.

The staff has located no appellate decisions interpreting the text of Section 3235 that would shed further light on this issue.

The staff solicits input from practitioners on current understanding of the issue, including experience in trial courts.

Suggested Change

The Association suggests that Section 7602 should require an owner to record the bond either 30 days after commencement of work, or 30 days after the owner's receipt of the bond, whichever is later.

The Association points out that existing Section 3240 (a statute of limitation for payment bond claims) references a payment bond recorded at any time before *completion* of the work of improvement, demonstrating legislative recognition that a payment bond (although not necessarily a payment bond under Section 7602) may be recorded well into a construction project.

The group also asserts that most bonded projects last six months or more, suggesting that the Association's proposal would still allow for a determination of the applicability of Section 7602 relatively early on in most projects.

Discussion

There does not appear to be any straightforward way to resolve the issue raised by the Association.

The pre-commencement recording requirement now clearly set forth in proposed Section 7602 may cause practical problems. It also might be that the Commission has changed a relatively significant provision of existing law. On the other hand, proposing any different requirement for when the bond must be recorded may also mean changing the same provision of existing law.

It also may be difficult to simply continue existing law on this point.

First, it will likely be impossible for the Commission to ever determine with certainty just what existing law *is* on this point. Reasonable policy and statutory construction arguments can be made for both interpretations. Two treatises indicate that pre-commencement recording of the payment bond is a part of existing law, but a commenter and a literal reading of the existing section indicate it is not.

The only way the Commission could be certain of accurately continuing existing law would be to preserve the ambiguity, by exactly duplicating the language of existing Section 3235. However, given that the provisions of Section 7602 can affect all of a claimant's mechanics lien rights, the Commission may decide it would be undesirable to leave an essential requirement of this section ambiguous.

Influenced in part by the inadequacy of other solutions, the staff recommends that **the Commission craft the most workable provision on this issue**, notwithstanding the fact that the provision may (or may not) change existing law.

The staff does not recommend tying the recording deadline to an owner's receipt of the bond (the second alternative suggested by the Association). Such a deadline would allow no one other than the owner to know precisely when or whether the alternative payment bond remedy provided by Section 7602 was applicable to the project.

Providing some limited "grace period" after commencement of work to allow an owner to obtain and record the payment bond would seem to be a reasonable compromise. But if this approach is chosen, how long a period should be provided?

Thirty days out from commencement of work may be too long a time period. The more days out, the longer participants in the process will be operating without knowing whether the provisions of Section 7602 will be applicable to the job. Smaller jobs might already be completed after 30 days, and even on larger

jobs some claimants would have been required to perform substantial work before knowing what their rights were.

The staff is not sufficiently familiar with construction practice to know how much time is typically required to obtain a bond, or how much of that time is typically after commencement of work. **The staff solicits input from practitioners on these issues, and defers making any further recommendation on this issue pending discussion at the Commission meeting.**

Sufficiency of the Surety

The joint surety commenters argue that Section 7602's continued requirement that the payment bond be issued by "sufficient" sureties is unworkable. CLRC Memorandum 2006-39, Exhibit pp. 88-89, 91. The group suggests that a new provision be added to Section 7602 instead requiring that the bond be issued by an admitted surety insurer.

Differences Between Admitted Surety Insurer and "Sufficient" Surety

According to general bond law, a surety on any statutory bond is "sufficient" if it is an admitted surety insurer, or if it meets certain other specified statutory requirements. Code Civ. Proc. §§ 995.510, 995.650, 995.660.

An "admitted surety insurer" is a surety that qualifies for and is issued a certificate of authority by the Insurance Commissioner. Code Civ. Proc. § 995.120. A non-admitted surety (identified under general bond law as a personal surety), in order to be deemed "sufficient," must satisfy less precisely defined requirements, including but not limited to property ownership and net worth. Code Civ. Proc. § 995.510. These provisions are all incorporated in the proposed law. Proposed Section 7140.

The joint surety commenters argue that it is important for all participants in the construction process to be able to easily determine, at the time a payment bond is first recorded, whether the status of the surety issuing the bond satisfies the requirement of Section 7602. The group asserts that "sufficiency" is too imprecise a standard to allow for that determination, as under both existing and the proposed law no participant is provided an opportunity to challenge the surety's sufficiency when the bond is first recorded. (Contrast a lender receiving a bonded stop payment notice, who is statutorily authorized to insist, when the bond is delivered, that the bond be issued by an admitted surety insurer.)

The group alleges that by the time the sufficiency of a surety on a payment bond becomes an issue — for example, when a claimant is unable to recover on a bond claim — it will be too late to substitute a different surety, and the legislative objective of the provision continued by Section 7602 will thus be thwarted.

Requirement of Admitted Surety Insurer in Proposed Law

The proposed law provides for five different types of bonds on a private work of improvement: a mechanics lien release bond, a stop payment notice release bond, the bond that accompanies a bonded stop payment notice to a lender, a bond provided as security for certain large projects, and a payment bond.

Of these bonds, under the proposed law only the payment bond is never required to be obtained from an admitted surety insurer. (The bond that accompanies a bonded stop payment notice to a lender initially need not be obtained from an admitted surety insurer, but the lender can require the claimant to obtain a new bond from an admitted surety insurer.)

Two years ago, the Commission declined to adopt a suggestion from another commenter to require a payment bond to be issued by an admitted surety insurer. CLRC Memorandum 2005-24, pp. 3-4; Minutes (July 2005), p. 4.

At a later meeting, however, the Commission decided to change existing law and require that a stop payment notice release bond be issued by an admitted surety insurer. CLRC Memorandum 2005-34, p. 8; Minutes (June 2006), pp. 2-3.

A stop payment notice release bond is similar to a payment bond, in that each is typically obtained by an owner or direct contractor, and each has the effect of substituting a bond remedy for a claimant in place of another mechanics lien remedy. (A lien release bond is similar for the same reason, but existing law already requires that bond to be issued by an admitted surety insurer.)

The Commission received no adverse comments on that change relating to a stop payment notice release bond when the tentative recommendation was circulated for comment.

Recommendation

In light of the important consequences of a payment bond recorded under Section 7602, it would be beneficial to all participants to know at or near the outset of a project whether all requirements of Section 7602 have been satisfied. Requiring a payment bond to be issued by an admitted surety insurer would

provide greater certainty, at the time the bond was recorded, whether the surety's status met the requirements of Section 7602.

Moreover, the proposed law already provides for all other types of mechanics lien bonds to be issued by an admitted surety insurer. In light of its potential impact on a claimant's lien rights, it seems at least as important to require that a payment bond also be issued by a regulated and presumably solvent surety.

The staff recommends the following changes to the proposed law:

> **§ 7602. Limitation of owner's liability**
>
> 7602. (a) The court shall limit an owner's liability to the contract price under subdivision (b) if, before the commencement of work, the owner in good faith files the contract with the county recorder and records a payment bond of the direct contractor ~~given by sufficient sureties~~ in an amount not less than 50 percent of the contract price.
>
> (b) ….
>
> **§ 7606. Payment bond**
>
> 7606. (a) A payment bond under this part shall be conditioned for the payment in full of the claims of all claimants and shall by its terms inure to the benefit of all claimants so as to give a claimant a right of action to enforce the liability on the bond. The bond shall be given by an admitted surety insurer.
>
> (b) …
>
> **Comment.** Section 7606 restates former Section 3096 without substantive change, except to add a requirement that the bond be given by an admitted surety insurer. ….

Amount of Payment Bond

The joint surety commenters also question Section 7602's requirement that the bond amount need be only 50% of the contract price, rather than 100%. CLRC Memorandum 2006-39, Exhibit p. 91.

The group asserts that sureties determine the fee to be charged for a payment bond based on the *contract price* for the work of improvement, rather than on the penal sum of the bond. Therefore, according to the group, allowing an owner to obtain only a "partial" bond (i.e., a bond for an amount less than the full contract price) does not provide an owner with any cost savings. The joint surety commenters therefore suggest that the section should mandate full protection for claimants.

The joint surety commenters explained this counter-intuitive aspect of payment bond pricing to the staff in a telephone conversation and email

exchange. Exhibit p. 1. To the extent any Commission member wants to hear more about payment bond pricing calculations, the staff can explain further at the meeting.

However, the 50% bonding requirement has been a part of mechanics lien law for at least the last 95 years, and the staff is not convinced the requirement has no legitimate basis. Unless the Commission is interested in exploring the issue further, **the staff does not recommend changing the amount of the payment bond required by Section 7602.**

STATUTORY AUTHORITY FOR PAYMENT BOND

Section 7600 provides statutory authority for an owner to require a direct contractor to obtain a payment bond:

> **§ 7600. Public policy of payment bond**
>
> 7600. An owner may require a payment bond or other security as protection against a direct contractor's failure to perform the contract or to make full payment for all work provided pursuant to the contract.
>
> **Comment.** Section 7600 restates the second sentence of former Section 3236 without substantive change.
>
> ….

Howard B. Brown, a Manhattan Beach attorney, contends that the language of Section 7600 blurs the distinction between a payment bond (which guarantees payment to unpaid claimants) and a performance bond (which guarantees completion of the contracted for work). CLRC Memorandum 2006-39, Exhibit pp. 26, 44.

The joint surety commenters agree with Mr. Brown, and also argue that drafting this provision as a separate section in the proposed law removes its original context and conceals its true meaning. CLRC Memorandum 2006-39, Exhibit p. 90.

Section 7600 restates the second sentence of former Section 3236 (bolded below):

> 3236. It is the intent and purpose of Section 3235 to limit the owner's liability, in all cases, to the measure of the contract price where he shall have filed or caused to be filed in good faith his original contract and recorded a payment bond as therein provided. **It shall be lawful for the owner to protect himself against any failure of the original contractor to perform his contract and make full payment for all work done and materials**

furnished thereunder by exacting such bond or other security as he may deem necessary.

The joint surety commenters argue that the Legislature would not have needed to provide, as a stand alone provision, that "it shall be lawful" for an owner to require a bond or other security when hiring a contractor. The group argues that the second sentence of Section 3236 was instead intended to dispel a potential negative implication created by the first sentence of Section 3236 — namely, that if an owner failed to follow the referenced payment bond procedure described in Section 3235, the owner would then be precluded from insisting on any *other* bond or security.

The commenters thus propose the following revision to Section 7600:

§ 7600. Public policy of payment bond

7600. Notwithstanding Section 7602, an ~~An~~ owner may require a performance bond, a payment bond, or other security as protection against a direct contractor's failure to perform the contract or to make full payment for all labor, service, equipment and material provided pursuant to the contract.

The staff agrees that Section 3235 provides authority for an owner to require a performance bond, in addition to a payment bond. ("It shall be lawful for the owner to protect himself against any failure of the original contractor *to perform his contract* ….") Although probably not necessary — since Section 7602 already references "other security" — the staff sees no problem in adding an explicit reference to a performance bond in the section.

However, the staff does not believe the introductory clause suggested by the joint surety commenters would be helpful. Section 7600 is not inconsistent with Section 7602, and the cross-reference would likely generate more confusion than clarity.

The staff therefore recommends that **Section 7600 be revised as follows**:

§ 7600. Authority for Payment Bond or Other Security

7600. An owner may require a performance bond, payment bond, or other security as protection against a direct contractor's failure to perform the contract or to make full payment for all work provided pursuant to the contract.

Comment. Section 7600 restates the second sentence of former Section 3236 without substantive change.

….

Proposed Section 7608 (with emphasis added) indicates who may make a claim against a payment bond:

> **§ 7608. Limitation on part**
>
> 7608. (a) This part does not give a claimant a right to recover on a direct contractor's payment bond given under this chapter unless the claimant provided work to the direct contractor or **one of the direct contractor's subcontractors** pursuant to a contract between the direct contractor and the owner.
>
> (b) Nothing in this section affects the stop payment notice right of, and relative priorities among, design professionals and holders of secured interests in the property.
>
> **Comment.** Section 7608 restates former Section 3267 without substantive change.
>
> ….

Ambiguity

Granite Rock Company ("Graniterock"), a material supplier and contractor, argues that the bolded language above is ambiguous, as it leaves unclear whether a "direct contractor's subcontractor" includes a direct contractor's *sub*-subcontractor (i.e., a lower tier subcontractor working for another subcontractor). CLRC Memorandum 2006-39, Exhibit pp. 4-5. If it does not, claimants on a job who work for sub-subcontractors would be precluded by this section from pursuing a claim against a payment bond.

Graniterock urges the section should be revised to make clear that these claimants have the same payment bond rights as all other claimants on a work of improvement.

GGLT notes this same ambiguity, but urges only that the ambiguity be clarified, one way or another. CLRC Memorandum 2006-39, Exhibit p. 92.

The joint surety commenters also point out the ambiguity, but argue that a payment bond remedy should *not* be available to claimants that work for sub-subcontractors. CLRC Memorandum 2006-39, Exhibit p. 157.

The latter group asserts it is relatively easy for a direct contractor to monitor subcontractors with which the direct contractor has a direct contractual relationship, and ensure that those subcontractors are meeting their payment obligations (thus limiting claims against the direct contractor's payment bond).

However, the joint surety commenters assert it is much more difficult for a direct contractor to keep control of subcontractors further down the line, thereby

increasing the likelihood of payment bond claims from claimants who work for those sub-subcontractors. The joint surety commenters' ultimate contention appears to be that the more potential bond claims a surety must anticipate on a given job, the less likely it will be that the surety will be able to issue the bond.

Fairness and Constitutionality

However, if Section 7608 was interpreted to preclude certain claimants from making a claim against a payment bond, in certain circumstances those claimants would be left with no mechanics lien remedy at all.

As previously discussed, Section 7602 allows an owner to eliminate the lien claim rights of all claimants on a private work of improvement, by meeting the section's requirements. Further, Sections 7522 and 7536 allow an owner and lender to disregard stop payment notices given by all claimants (other than direct contractors), if a payment bond is recorded under Section 7602.

An interpretation of Section 7608 that would allow for certain claimants on a work of improvement to have no mechanics lien rights at all would seem significantly unfair. Moreover, given that lien rights have a constitutional basis, the section interpreted in such a manner likely could not pass constitutional muster, at least as to the affected claimants.

Case Law

The ambiguity in Section 7608 is also present in existing law. Section 3267 provides (with emphasis added):

> 3267. Nothing contained in this title shall be construed to give to any person any right of action on any original contractor's private or public work payment bond described in Chapter 6 (commencing with Section 3235) or Chapter 7 (commencing with Section 3247), unless the work forming the basis for his claim was performed by such person for the principal on such payment bond, **or one of his subcontractors**, pursuant to the contract between the original contractor and the owner.
>
> Nothing in this section shall affect the stop notice rights of, and relative priorities among, architects, registered engineers, or licensed land surveyors and holders of secured interests on the land.

However, the ambiguity in Section 3267 has been expressly addressed by a published appellate opinion, at least in the context of a public work. In *Union Asphalt, Inc. v. Planet Ins. Co.*, 21 Cal. App. 4th 1762, 27 Cal. Rptr. 2d 371 (1994), the court interpreted Section 3267 as allowing *any* claimant that provides work to

a direct contractor to make a claim against that direct contractor's payment bond, including those claimants working for the direct contractor's sub-subcontractors.

An argument might be made the *Union Asphalt* decision is not strictly controlling in a private work of improvement, as part of the court's rationale involved reconciling Section 3267 with another section in the mechanics lien statute that relates only to public works. However, the staff has located no appellate decision questioning the applicability of the *Union Asphalt* decision to private works.

A representative of the joint surety commenters has since informally acknowledged the possible application of the *Union Asphalt* decision, as well as the incongruity of restricting the payment bond rights of a claimant whose lien rights have been eliminated by the provision continued in Section 7602. The group has thus modified its position, and now requests only that proposed Section 7608 continue the ambiguity present in existing law, to allow future litigants to argue that *Union Asphalt* should not be followed, at least in cases in which Section 7602 is not applicable.

Recommendation

In the course of this study the Commission has often chosen to preserve existing statutory ambiguity, as doing so is usually the safest course of action. Nevertheless, in this instance the staff recommends that **the ambiguity in Section 7608 be clarified, to provide that a "direct contractor's subcontractor" includes subcontractors at every level**.

The staff's recommendation is based primarily on the interplay between this provision and the other remedy provisions of the mechanics lien statute, which seems to allow for no other interpretation of the ambiguity in Section 7608.

The staff is also influenced by the fact that, despite this ambiguity arguably being resolved by the *Union Asphalt* decision in 1994, three separate entities chose to comment on the Commission's continuation of existing language in the proposed law. The interest in the issue suggests that, notwithstanding the *Union Asphalt* decision, clearer statutory text could be a benefit to a substantial number of practitioners.

The staff recommends that **Section 7608 be revised as follows**:

> **§ 7608. Limitation on part**
>
> 7608. (a) This part does not give a claimant a right to recover on a direct contractor's payment bond given under this chapter unless

the claimant provided work to the direct contractor ~~or one of the direct contractor's subcontractors~~, either directly or through one or more subcontractors, pursuant to a contract between the direct contractor and the owner.

(b) ….

Comment. Section 7608 restates former Section 3267 ~~without substantive change~~ , but clarifies that claimants providing work to subcontractors at every level have a right to recover against a direct contractor's payment bond as provided in this section. See *Union Asphalt, Inc. v. Planet Ins. Co.*, 21 Cal. App. 4th 1762, 27 Cal. Rptr. 2d 371 (1994).

….

STATUTE OF LIMITATION FOR CLAIM AGAINST PAYMENT BOND

The general deadline for bringing a claim against a payment bond is four years from the date the claim accrues. Code Civ. Proc. § 337(1). Proposed Section 7610 shortens this time period to six months after completion of the work of improvement, if the bond is recorded before completion of the work of improvement:

§ 7610. Statute of limitations against surety on recorded bond

7610. If a payment bond is recorded before completion of a work of improvement, an action to enforce the liability on the bond may not be commenced later than six months after completion of the work of improvement.

Comment. Section 7610 restates former Section 3240, and broadens it to cover enforcement of any liability on the bond, not limited to the liability of the surety. Cf. Code Civ. Proc. § 996.440 (judgment on bond against principal and sureties). It supersedes former Section 3239 (provision shortening statute of limitations).

….

Rodney Moss, an attorney with Moss, Levitt & Mandell in Los Angeles, believes Section 7610 is an incomplete statement of existing law. CLRC Memorandum 2006-39, Exhibit p. 2. Mr. Moss asserts that under existing law, in order for the limitation period to be shortened to six months, language to that effect must actually appear in the text of the bond. However, Mr. Moss does not take a position on whether this requirement should be continued in the proposed law.

The staff solicits further input from Mr. Moss or any other practitioner as to the presence of this requirement in existing law. The staff does not read

Sections 3239 and 3240, the relevant sections in existing law, as containing this requirement.

Pending input to the contrary from practitioners, **the staff does not recommend a revision to Section 7612 to require that language shortening the enforcement limitation period be included in the bond.**

The joint surety commenters suggest that the leadline (heading) of this section be revised to instead read "Statute of limitations for suit on recorded bond." CLRC Memorandum 2006-39, Exhibit p. 92.

While the leadline of a section is not part of the law and has no legal significance, **the staff agrees with the joint surety commenters' suggestion, and will make the suggested change**.

The Association of California Surety Companies urges that a payment bond recorded by an *owner* under Section 7602 should be deemed to satisfy the "requirement of the *surety*" to record under Section 7610. CLRC Memorandum 2006-39, Exhibit p. 120.

The Association's concern has already been addressed. Existing Section 3240 provides for a shortening of the limitation period to six months only if the *surety* records the bond prior to completion. However, proposed Section 7610 no longer contains this requirement, instead providing that a recording of the bond by *anyone* prior to completion (which would include an owner recording under Section 7602) will shorten the limitation period.

However, to more precisely track the language of existing Section 3240 (which references a payment bond "given pursuant to this chapter"), the staff recommends that **Section 7610 be revised as follows**:

> **§ 7610. Statute of limitations against surety on recorded bond**
>
> 7610. If a payment bond <u>under this part</u> is recorded before completion of a work of improvement, an action to enforce the liability on the bond may not be commenced later than six months after completion of the work of improvement.

Copy of Payment Bond to Claimants

In the tentative recommendation, the Commission solicited public comment on whether the proposed law should require that an owner provide a copy of a recorded payment bond to each claimant that has given preliminary notice. The proposed consequence for failure to do so would be a tolling of the provisions of Section 7610, until a copy was provided.

There was no public support for that idea.

Mr. Moss responded that he did not believe such a requirement would be wise, as it has not been a requirement in the past. CLRC Memorandum 2006–39, Exhibit p. 2.

The Associated General Contractors of California (AGC) indicates it would support a slightly different requirement: that an owner provide a copy of the payment bond to a claimant "upon request." Third Supplement to CLRC Memorandum 2006-48, Exhibit p. 29. The consequence for failure to provide the bond after written request proposed by AGC would be a tolling of the limitation period in Section 7610 for 60 days.

In light of the lack of any consensus support for adding this notice requirement, **the staff does not recommend its incorporation in the proposed law.**

☞ PRELIMINARY NOTICE PRIOR TO PAYMENT BOND CLAIM

Proposed Section 7200 provides that, as a prerequisite to pursuit of any mechanics lien remedy, certain claimants must give preliminary notice within 20 days of the start of the work for which a remedy is claimed.

Section 7612 provides that, as an alternative to complying with Section 7200, a claimant may enforce a claim only against a payment bond by instead giving notice of the claim to the principal and the surety on the bond, a specified number of days after completion of the entire project:

> **§ 7612. Notice prerequisite to enforcement**
>
> 7612. A claimant may not enforce the liability on a payment bond unless any of the following conditions is satisfied:
>
> (a) The claimant has given preliminary notice to the extent required by Chapter 2 (commencing with Section 7200).
>
> (b) The claimant has given notice to the principal and surety within the earlier of 75 days after completion of the work of improvement or 15 days after recordation of a notice of completion. The notice shall comply with the requirements of Article 4 (commencing with Section 7100).
>
> **Comment.** Section 7612 restates former Section 3242 without substantive change. See also Sections 7100-7116 (notice). The former limitation to a contract entered into on or after January 1, 1995, is omitted due to lapse of time. It supersedes former Section 3239 (provision shortening statute of limitations).
>
> ....

Ambiguity

The staff notes that subdivision (a) as drafted may be ambiguous.

Certain claimants are not required by Chapter 2 of the proposed law to give preliminary notice (e.g., laborers). Has such a claimant "given preliminary notice *to the extent required by* Chapter 2…" (Section 7612(a)), thereby allowing that claimant to enforce the liability on a payment bond without give any advance notice of a claim at all?

While existing Section 3242 is less that crystal clear on the issue, the section's language more clearly suggests that some type of advance notice must be given by *all* payment bond claimants seeking to enforce a payment bond claim:

> 3242. (a) With regard to a contract entered into on or after January 1, 1995, in order to enforce a claim upon any payment bond given in connection with a private work, a claimant shall give the 20-day private work preliminary notice provided in Section 3097.
>
> (b) If the 20-day private work preliminary notice was not given as provided in Section 3097, a claimant may enforce a claim by giving written notice to the surety and the bond principal as provided in Section 3227 within 15 days after recordation of a notice of completion. If no notice of completion has been recorded, the time for giving written notice to the surety and the bond principal is extended to 75 days after completion of the work of improvement.

The staff solicits input from practitioners on this issue. However, absent a consensus contrary interpretation of existing law, the staff recommends that **Section 7612 be revised as follows**:

> **§ 7612. Notice prerequisite to enforcement**
>
> 7612. A claimant may not enforce the liability on a payment bond unless any of the following conditions is satisfied:
>
> (a) The claimant has given the preliminary notice ~~to the extent required~~ described by Chapter 2 (commencing with Section 7200).
>
> (b) The claimant has given notice of the claim to the principal and surety within the earlier of 75 days after completion of the work of improvement or 15 days after recordation of a notice of completion. The notice shall comply with the requirements of Article 4 (commencing with Section 7100).

Alternative Notice Provision

Several commenters have urged the deletion of subdivision (b).

Graniterock asserts that the existing section was a legislative compromise when enacted in 1995, intended to address the fact that prior to that date

payment bond claimants were not required to provide any notice at all before pursuing a claim against a bond. CLRC Memorandum 2006-39, Exhibit pp. 7-8.

However, Graniterock argues that the "second chance" aspect of the compromise continued in subdivision (b) serves only to reward neglectful claimants, and causes diligent direct contractors who are trying to administer effective waiver and release programs to be subjected to surprise claims after a job is already completed. Graniterock argues this is a particular problem because there is a legislative trend to preclude direct contractors from withholding retention payments to subcontractors. As a result, a first tier subcontractor will typically be fully paid early in a job, and a second tier subcontractor or supplier can then give notice of a claim against the direct contractor's payment bond when recourse is no longer available against the paid first tier subcontractor.

The Association of California Surety Companies asserts that subdivision (b) is inequitable, and "totally counter intuitive to the framework of the lien and payment bond law." CLRC Memorandum 2006-39, Exhibit p. 121.

The Association points out that the subdivision exposes a direct contractor to double liability similar to that which an owner faces with regard to lien claims. The group argues that unless claimants are required to provide notice of a potential bond claim soon after providing their work, a direct contractor as principal on a payment bond may be held responsible for paying a claimant's bond claim after having already paid the claimant's employer in full for exactly the same work.

The Associated General Contractors of California ("AGC") "strongly believes" subdivision (b) should be discontinued, but recognizes the legislative difficulty in attempting to repeal a provision that was only enacted in 1995. Third Supplement to CLRC Memorandum 2006-48, Exhibit pp. 28-29. AGC nevertheless argues that no logical reason exists to allow a claimant to pursue a bond claim, after the claimant has forfeited lien and stop payment notice rights by failing to serve a preliminary notice. The group joins other commenters in noting that allowing a late alternative notice leaves direct contractors with bond liability exposure that they "cannot predict, cannot protect against, and cannot recapture by withholding funds."

Dual Mandatory Notices

The joint surety commenters have a slightly different position, asserting that claimants should be required to give both the preliminary notice specified in

subdivision (a), *and* the second notice specified in subdivision (b). CLRC Memorandum 2006-39, Exhibit pp. 92-93. However, the group believes if that revision cannot be accomplished, the group joins the other commenters in urging the next best alternative would be to delete subdivision (b).

The joint surety commenters argue that the two notices in Section 7612 each serve different and important purposes, and that neither is an adequate substitute for the other. The group asserts (as does the Association of California Surety Companies) that the primary purpose of a preliminary notice is to advise of *potential* claimants and claims *before* any problem occurs, so the direct contractor can ensure that timely contractual payment is made to these claimants. The notice in subdivision (b) is primarily designed to provide notice to a direct contractor that a failure to pay has *in fact* occurred, and allow a direct contractor to take whatever steps are deemed appropriate to rectify the situation.

A direct contractor relying on submitted preliminary notices to keep track of potential claimants won't necessarily know about potential *bond* claimants (who need only give the second notice described in Section 7612). Similarly, a direct contractor relying on submitted bond claim notices to keep track of claimants seeking enforcement in court will be completely unaware of bond claimants seeking court enforcement based solely on the long ago given preliminary notice.

Previous Legislative Attempts at Revision

Graniterock also argues that there have been previous legislative attempts to delete this provision, and apparently expects these attempts to continue in the future. Graniterock believes it would be better to delete the provision in subdivision (b) as part of a comprehensive revision of the entire statute, rather than wait for a piecemeal deletion that may do harm to the overall integrity of the statute.

Recommendation

The staff believes there is considerable merit to each of these arguments. Moreover, similar comments have been submitted to the Commission over the course of this study by other commenters. Nevertheless, this "second chance" provision in Section 7212 appears to have been a political compromise on an important issue struck between competing interest groups. What's more, we're told that prior attempts to repeal the provision have failed.

Deleting the provision would therefore seem to be too controversial for this study, and is not recommended by the staff.

MISCELLANEOUS REMEDIES

In addition to payment bond remedies, the proposed law also provides certain miscellaneous remedies on a private work of improvement, including required security for an owner on certain large projects, required prompt payment of progress and retention payments, and the giving of a stop work notice.

SECURITY FOR LARGE PROJECTS

The proposed law, continuing a section of existing law enacted in 2001, requires an owner on certain defined large projects to provide security to ensure payment of the direct contractor. Sections 7700 through 7716. The security may take the form of a specially described payment bond, irrevocable letter of credit, or escrow account.

AGC points out several procedural details relating to the payment bond that are not addressed in the proposed law. Third Supplement to CLRC Memorandum 2006-48, Exhibit p. 29. AGC notes that the proposed law does not specify consequences for failure to provide the bond, who may be the beneficiary on the identified bond, who may sue on the bond, who is permitted to obtain the bond, or what the limitation period is for bringing an action on the bond.

While detail relating to these items might be helpful to practitioners, no such detail is provided in existing law. In the absence of any demonstrated hardship or confusion, **the staff does not recommend that the Commission formulate new substantive law in this area, in the context of this study.**

Escrow Account

Section 7726 (with emphasis added) sets forth requirements for the escrow account that may be established as security:

> **§ 7726. Escrow account**
>
> 7726. An escrow account under this chapter shall satisfy all of the following requirements:
>
> (a) The account shall be designated as a "construction security escrow account."

(b) **The account shall be located in this state** and maintained with an escrow agent licensed under the Escrow Law, Division 6 (commencing with Section 17000) of the Financial Code, or with any person exempt from the Escrow Law under paragraph (1) or (3) of subdivision (a) of Section 17006 of the Financial Code.

(c) The owner shall deposit funds in the account in the amount provided in Section 7728. This chapter does not require a construction lender to agree to deposit proceeds of a construction loan in the account.

(d) The owner shall grant the direct contractor a perfected, first priority security interest in the account and in all funds deposited by the owner in the account and in their proceeds, established to the reasonable satisfaction of the direct contractor, which may be by a written opinion of legal counsel for the owner.

(e) The funds on deposit in the account shall be the sole property of the owner, subject to the security interest of the direct contractor. The owner and the direct contractor shall instruct the escrowholder to hold the funds on deposit in the account for the purpose of perfecting the direct contractor's security interest in the account and to disburse those funds only on joint authorization of the owner and the direct contractor, or pursuant to a court order that is binding on both of them.

Comment. Section 7726 restates portions of former Section 3110.5(b)(3) without substantive change.

Staff Note. It is unclear what it means for an escrow account to be "located" in this state. Do deposits to the account have to be held in the form of bullion on site? Suppose the escrowholder deposits receipts to, and issues checks drawn against, an account in a financial institution that is headquartered elsewhere? Should this requirement be dropped as essentially meaningless?

Location of Escrow Account "in this State"

The somewhat ambiguous requirement that the escrow account be "located" in this state is a part of existing Section 3110.5(b)(3). Neither the existing statute nor any appellate decision clarify the requirement. The Staff Note raised various questions about the requirement, including whether it should be continued at all.

In response to this last question, Sam K. Abdulaziz, an attorney with Abdulaziz, Grossbart & Rudman in North Hollywood, asserts without further explanation that the requirement has a practical meaning for purposes of an action in rem. CLRC Memorandum 2006-39, Exhibit p. 19. The staff presumes this means that if contractor needed to bring an action directly against the funds in escrow (as opposed to against a person), it is much easier to do so if the funds are physically located within the state of California.

GGLT offered its belief that the requirement is designed to allow parties to avail themselves of California escrow laws, and save a direct contractor from having to travel to an out of state bank or file suit in another state in order to obtain the funds in escrow. CLRC Memorandum 2006-39, Exhibit p. 159. The group urges that the requirement not be deleted, and instead be retained as a default provision in the absence of a mutual agreement to use an escrow account in a different location.

The staff recommends that **this requirement remain in Section 7726 as drafted.**

Escrow Account Holder as Construction Lender

GGLT also asks whether the holder of the escrow account established under this section would be included within the definition of "construction lender" in proposed Section 7004. CLRC Memorandum 2006-43, Exhibit p. 148. If so, the holder would then be subject to all other provisions of the proposed law relating to construction lenders, including the right to receive preliminary notice, and the obligation to comply with stop payment notices.

GGLT says it believes that, under current law, the holder of this escrow account is not subject to stop payment notices from subcontractors and material suppliers. GGLT urges that the definition of "construction lender" in Section 7004 be modified to make this clear.

Section 3110.5, which Section 7726 purports to continue without change, was only enacted in 2001, and there does not yet appear to be an appellate decision interpreting any of its provisions. Further, none of the leading mechanics lien law treatises address the issue raised by GGLT.

The staff is not certain of the basis for GGLT's belief, and is awaiting a response to the staff's informal inquiry. Looking only at the text of the existing law, the holder of an escrow account described in Section 3110.5 *would* appear to be a "construction lender." Existing Section 3087 (with emphasis added) provides:

> 3087. "Construction lender" means any mortgagee or beneficiary under a deed of trust lending funds with which the cost of the work of improvement is, wholly or in part, to be defrayed, or any assignee or successor in interest of either, **or any escrow holder or other party holding any funds furnished or to be furnished by the owner or lender or any other person as a fund from which to pay construction costs**.

This language is continued without substantive change in proposed Section 7004.

The staff solicits input on this issue from practitioners. In the absence of consensus to the contrary, however, the staff recommends that **both Sections 7004 and 7726 remain as drafted.**

PROMPT PAYMENT STATUTES

The proposed law continues provisions relating to an owner's and a direct contractor's obligation to make prompt payment of progress and retention payments. Sections 7800 through 7822.

The Association of California Surety Companies asserts that these provisions have no application to a surety. CLRC Memorandum 2006-39, Exhibit pp. 121-122. The Association points out that a surety only become involved in the construction process when the principal on a bond fails to make a required payment, and further notes that surety obligations are separately governed by other provisions of law in the Insurance Code.

The Association therefore suggests, "so that there is no misunderstanding on this issue," that a new Section 7804 be added to the proposed law, providing:

> This chapter does not apply to, or create any liability, against any surety which provides a bond, or on any bond provided by a surety, pursuant to Part 6 of Division 4 of this Code.

The staff agrees that no provision in either existing or the proposed law relating to prompt payment expressly imposes any duty or liability on a surety. However, if an owner or contractor subject to these provisions that was the principal on a bond failed to comply with a provision, the staff is not certain the surety on the bond might not be obligated to comply with the provision, as a guarantor of the owner or contractor.

The staff has located no appellate decision addressing this issue.

The staff solicits comment from practitioners on the issue. However, in the absence of clear consensus, the staff recommends that **the proposed law leave this issue for future resolution by the courts or the Legislature.**

STOP WORK NOTICES

A stop work notice is a procedure allowing an unpaid direct contractor to stop work on a project, after complying with certain requirements.

Terminology

The notice is defined as follows:

> **§ 7830. "Stop work notice" defined**
>
> 7830. "Stop work notice" means notice given under this article by a direct contractor to an owner that the contractor will stop work if the amount owed the contractor is not paid within 10 days after notice is given.
>
> **Comment.** Section 7830 restates a part of the first sentence of former Section 3260.2(a) without substantive change. This article is limited to a private work of improvement. See Section 7050 (application of part).
>
> ….

The proposed law changes the term used for this procedure in existing law from the relatively cumbersome "10-day stop work order" to "stop work notice." However, GGLT believes this newly created term may be confused with "stop payment notice," and suggests that a term such as "work suspension notice" be used instead. CLRC Memorandum 2006-39, Exhibit p. 158.

The staff solicits input from practitioners as to whether some term other than "stop work notice" would be more clear to practitioners. (Use of the word "notice" in the new term is essential, in order to incorporate the general notice provisions of the proposed law.)

GGLT also suggests that language in existing law indicating that this remedy is available only in private works of improvement should be retained, since the similar sounding "stop payment notice" is available in both private and public works.

The staff believes the language in the section Comment makes sufficiently clear that this remedy is available only in private works of improvement.

When Notice May Be Given

Section 7832 specifies when a direct contractor is permitted to give a stop work notice:

> **§ 7832. Stop work notice**
>
> 7832. If a direct contractor is not paid the amount due pursuant to a written contract within 35 days after the date payment is due under the contract, and there is no dispute as to the satisfactory performance of the contractor, the contractor may give the owner a stop work notice. The notice shall comply with the requirements of Article 4 (commencing with Section 7100).

Comment. Section 7832 restates a portion of the first sentence of former Section 3260.2(a) without substantive change.

….

Mr. Abdulaziz argues that 35 days is too long for a direct contractor to have to wait to give the notice, particularly since the direct contractor must wait another 10 days after the notice is given before an actual work stoppage is authorized. CLRC Memorandum 2006-39, Exhibit p. 19. Mr. Abdulaziz asserts that common practice in the industry is to have a contract provision allowing for a work stoppage as soon as payments are past due.

Existing Section 3260.2 contains the same 35 day requirement as proposed Section 7832. Moreover, the staff does not see a problem with allowing Section 7832 to serve as a statutory backup to more stringent contractual agreements the parties may reach.

While policy justifications for modifying the 35 day statutory requirement in Section 7832 may exist, **the staff does not recommend doing so in the context of this study**.

Procedural Prerequisites

Section 7834 sets forth certain additional notices that must be given in conjunction with a stop work notice:

§ 7834. Additional notice

7834. A direct contractor that gives an owner a stop work notice shall give the following additional notices:

(a) At least five days before giving the stop work notice, the contractor shall post notice of intent to give a stop work notice.

(b) At the same time the contractor gives the stop work notice, the contractor shall give a copy of the stop work notice to all subcontractors with which the contractor has a direct contractual relationship on the work of improvement.

(c) The notices required by this section shall comply with the requirements of Article 4 (commencing with Section 7100).

Comment. Section 7838 restates former Section 3260.2(c), except that provisions that appear to suggest that a subcontractor may give a stop work notice are deleted.

See also Sections 7012 ("direct contractor" defined), 7016 ("work" defined), 7026 ("material supplier" defined), 7028 ("owner" defined), 7044 ("subcontractor" defined), 7112 (posting of notice).

Mr. Abdulaziz suggests that this section should include a requirement that the notice be posted "in a prominent place." CLRC Memorandum 2006-39, Exhibit p. 19. Mr. Brown also urges that the section provide more detail as to how the notices referenced in the section must be given. CLRC Memorandum 2006-39, Exhibit p. 46.

These issues have already been addressed by a modification to the section approved by the Commission incorporating the general notice requirements of the proposed law.

Contractor Immunity During Work Stoppage

Existing Section 3260.2(c), enacted in 1998, provides a direct contractor and the direct contractor's surety with immunity from certain delay or damage claims arising from a work stoppage, if the direct contractor complies with statutory stop notice requirements. Subdivision (a) of proposed Section 7838 continues this provision:

> **§ 7838. Immunity from liability**
>
> 7838. (a) The direct contractor or the direct contractor's surety is not liable for delay or damage that the owner or a subcontractor may suffer as a result of the direct contractor giving a stop work notice and subsequently stopping work for nonpayment, if the notice and posting requirements of this article are satisfied.
>
> (b) ….
>
> **Comment.** Section 7838 restates former Section 3260.2(c), except that provisions that appear to suggest that a subcontractor may give a stop work notice are deleted.
>
> See also Sections 7012 ("direct contractor" defined), 7016 ("work" defined), 7026 ("material supplier" defined), 7028 ("owner" defined), 7044 ("subcontractor" defined).

Mr. Abdulaziz asserts that proposed Section 7838(a) does not continue the immunity provided by Section 3260.2(c) to *subcontractors*, from damage claims made by lower tier subcontractors or material suppliers. CLRC Memorandum 2006-39, Exhibit p. 133. Mr. Abdulaziz urges that Section 7838 include this immunity.

GGLT agrees. CLRC Memorandum 2006-39, Exhibit pp. 158-159.

The staff agrees. Existing Section 3260.2(c) (with emphasis added) provides:

> (c) Notwithstanding any other provision, the original contractor or his or her surety, *or subcontractor or his or her surety*, shall not be liable for any delays or damages that the owner or contractor of a subcontractor may suffer as a result of the original contractor

> serving the owner with a 10-day stop work order, and subsequently stopping work for nonpayment if all of the posting and notice requirements described in subdivision (a) are met. ….

The Commission did not continue the italicized language in order to avoid creating an inference that a subcontractor can *give* a stop work notice.

However, regardless of who *initiates* a work stoppage, the stoppage could expose a subcontractor to liability claims from entities in contractual privity with the subcontractor (e.g., lower tier subcontractors and suppliers).

The staff recommends that **this subcontractor immunity be restored to Section 7838(a):**

> 7838. (a) The direct contractor or the direct contractor's surety, or a subcontractor or a subcontractor's surety, is not liable for delay or damage that the owner or a subcontractor may suffer as a result of the direct contractor giving a stop work notice and subsequently stopping work for nonpayment, if the notice and posting requirements of this article are satisfied.
>
> ….

Limit on Contractual Liability When Stop Work Notice Given

The first sentence of existing Section 3260.2(c) — continued by proposed Section 7838(a) — provides that a direct contractor shall have no liability for "delay or damage" suffered by a subcontractor, as a result of a lawful work stoppage. The second sentence of Section 3260.2(c) — continued almost verbatim by proposed Section 7838(b) — provides a second protection from liability for a direct contractor:

> 7838. (a) ….
>
> (b) The direct contractor's liability to a subcontractor or material supplier resulting from stopping work under this article is limited to the amount of monetary damages the subcontractor or material supplier could otherwise recover under this part for work provided up to the date the subcontractor ceases work, subject to the following exceptions:
>
> (1) The direct contractor's liability continues for work provided up to and including the 10 day notice period and not beyond.
>
> (2) This subdivision does not limit monetary damages for custom work, including materials that have been fabricated, manufactured, or ordered to specifications that are unique to the job.

However, in continuing the language from the second sentence of existing Section 3260.2(c), Section 7838(b) has also continued several arguable drafting problems from Section 3260.2(c).

Ambiguity

The provision continued by Section 7838(b) seems to address a direct contractor's *contractual* obligation to subcontractors, for work done *prior* to a work stoppage.

However, the references in the subdivision to "liability … *resulting from* stopping work" and "monetary damages" are confusing. The former seems temporally incorrect, and the latter is on its face inconsistent with the blanket immunity against damage claims granted by Section 7838(a).

To clarify, the staff recommends that **Section 7838 be revised as follows**:

> 7838. (a) The direct contractor or the direct contractor's surety is not liable for delay or damage that the owner or a subcontractor may suffer as a result of the direct contractor giving a stop work notice and subsequently stopping work for nonpayment, if the notice and posting requirements of this article are satisfied.
>
> (b) The direct contractor's liability to a subcontractor or material supplier ~~resulting from stopping~~ after the direct contractor stops work under this article is limited to the amount ~~of monetary damages~~ the subcontractor or material supplier could otherwise recover under this part for work provided up to the date the subcontractor ceases work, subject to the following exceptions:
>
> (1) The direct contractor's liability continues for work provided up to and including the 10 day notice period and not beyond.
>
> (2) This subdivision does not limit ~~monetary damages~~ liability for custom work, including materials that have been fabricated, manufactured, or ordered to specifications that are unique to the job.

Contractual Liability Protection for Subcontractors

In Section 3260.2(c), the liability limitation discussed above is granted to both direct contractors *and* subcontractors in the event of a work stoppage. By deleting a reference to subcontractors when this provision was continued in Section 7838(b), the Commission inadvertently deleted the applicability of the provision to subcontractors.

The staff recommends that this provision's applicability to subcontractors be continued in Section 7838(b).

However, in deciding whether to restore this applicability, the Commission will also need to decide whether to continue the provision exactly as stated in the second sentence of Section 3260.2(c), which makes the liability limitation applicable only to an "*original*" subcontractor:

> 3260.2. (c) …. An original contractor's or original subcontractor's liability to a subcontractor or material supplier resulting from the cessation of work under this section shall be limited to the amount of monetary damages the subcontractor or material supplier could recover under the mechanic's lien law for goods and services provided up to the date the subcontractor ceases work ….

"Original subcontractor" is not a term either defined or used anywhere in the existing mechanics lien statute, nor is it referenced in the legislative analyses of the bill enacting Section 3260.2. It also does not appear to be a legal term of art, as the staff has not found the term defined in case law, treatises, or other statutes.

There also does not appear to be any plausible policy justification for limiting the protection Section 7838(b) provides during a work stoppage to any particular subgroup of subcontractors. All would appear to be similarly situated — none are responsible for the stoppage, and all are precluded from getting paid during the stoppage. It would seem clearly incongruous if during this same stoppage some of these subcontractors should nevertheless continue to be contractually obligated to pay their *own* subcontractors and suppliers, while not being paid themselves.

This reference to an "original" subcontractor in the second sentence of Section 3260.2(c) also seems misplaced because the reference does not appear in the provision in the first sentence of Section 3260.2(c), granting subcontractor immunity against damage claims. If there existed some theoretical policy justification for restricting the contractual liability limitation in the second sentence of Section 3260.2(c) to a particular subgroup of subcontractors, that policy justification would likely be applicable to the immunity provision in the first sentence of Section 3260.2(c) as well.

The staff solicits input from practitioners on this issue.

However, in the absence of contrary input, the staff recommends that **Section 7838(b) be made applicable to all subcontractors**:

> (b) ~~The~~ A direct contractor's or subcontractor's liability to a subcontractor or material supplier resulting from stopping work under this article is limited to the amount of monetary damages the subcontractor or material supplier could otherwise recover under

this part for work provided up to the date the subcontractor or material supplier ceases work, subject to the following exceptions:

(1) The direct contractor's or subcontractor's liability continues for work provided up to and including the 10 day notice period and not beyond.

(2) This subdivision does not limit monetary damages for custom work, including materials that have been fabricated, manufactured, or ordered to specifications that are unique to the job.

The revision adding a reference to "material supplier" near the end of subdivision (b) is intended to correct an almost certain inadvertent omission from the text of Section 3260.2(c). As the provision expressly refers to a contractor's liability to a material supplier, the described limitation on that liability only makes sense if it also contains a reference to a material supplier.

☞ **Notice of Informal Resolution of Dispute**

Proposed Section 7840 continues another subdivision of existing Section 3260.2. Section 7840 provides that upon resolution of a dispute giving rise to a stop work notice, the direct contractor shall post notice of the resolution, and give notice to all subcontractors with which the direct contractor has a direct contractual relationship:

§ 7840. Notice of resolution of dispute or cancellation of stop work notice

7840. On resolution of the dispute or the direct contractor's cancellation of the stop work notice, the contractor shall post, and give subcontractors with which the contractor has a direct contractual relationship on the work of improvement, notice of the resolution or cancellation. The notice shall comply with the requirements of Article 4 (commencing with Section 7100).

Comment. Section 7840 restates the second paragraph of former Section 3260.2(a) without substantive change. ….

Terminology

The phrase "on resolution of the dispute" may be ambiguous, as no context is provided in the text of the section. The staff recommends that **the section be revised as follows**:

7840. On resolution of the ~~dispute~~ claim in a stop work notice, or the direct contractor's cancellation of the stop work notice, the contractor shall post, and give subcontractors with which the

> contractor has a direct contractual relationship on the work of improvement, notice of the resolution or cancellation. ….

Proposed New Duty for Subcontractors

Mr. Abdulaziz urges that the proposed law add a new provision requiring a subcontractor who receives a notice under Section 7840 to relay the notice to its own subcontractors and suppliers. CLRC Memorandum 2006-39, Exhibit p. 19.

In analyzing this suggestion, the Commission needs to realize that the same issue arises in a related context, the giving of the stop work notice itself. Proposed Section 7834 provides (with emphasis added):

> **§ 7834. Additional notice**
>
> 7834. A direct contractor that gives an owner a stop work notice shall give the following additional notice:
>
> (a) At least five days before giving the stop work notice, the contractor shall post notice of intent to give a stop work notice. The notice shall comply with the requirements of Article 4 (commencing with Section 7100).
>
> (b) At the same time the contractor gives the stop work notice, *the contractor shall give a copy of the stop work notice to all subcontractors with which the contractor has a direct contractual relationship on the work of improvement*.

If it makes sense to require subcontractors to relay *resolution* of a stop work notice dispute to lower tier subcontractors and suppliers, it would seem equally appropriate to require subcontractors to relay the original stop work notice.

Lower tier subcontractors and suppliers would clearly benefit from being directly informed of both the stop work notice, as well as the notice of resolution in Section 7834. While the posting of these notices (already required by the proposed law) is of some value, posted notices can be knocked down or missed, and some subcontractors and suppliers may not be on the site at the time the notices are posted.

However, since a direct contractor will often not know the identity of lower tier subcontractors and suppliers, the only way to provide direct notices to these *lower* tier subcontractors and suppliers would be to require *upper* tier subcontractors to send the notices down the distribution chain.

Thus, the downside of such a requirement is that it would impose a new duty — and a new cost — on upper tier subcontractors, that are not a part of existing law.

The staff solicits input from practitioners (particularly subcontractors and those who represent subcontractors) as to whether this new notice obligation would on balance be a desirable addition to the proposed law.

The staff defers making a recommendation on the issue, pending that input and discussion at the meeting.

☞ **Judicial Resolution of a Disputed Stop Work Notice**

Proposed Section 7844 sets forth procedures for resolving a disputed stop work notice:

> **§ 7844. Judicial proceeding**
>
> 7844. If payment of the amount due is not made within 10 days after a stop work notice is given, the direct contractor or the direct contractor's surety may in an expedited proceeding seek a judicial determination of liability for the amount due.
>
> **Comment.** Section 7844 restates former Section 3260.2(d) without substantive change. See also section 7052 (jurisdiction and venue).
>
> See also Section 7012 ("direct contractor" defined).
>
> **Staff Note.** It's not clear what sort of expedited proceeding is referred to here. Is this a trial setting preference, or something else? The statute lacks detail. It may be best to simply delete the reference to expedition.

Terminology

The staff recommends **the following clarifying revision to the section, to avoid confusion based on the two references to "the amount due"**:

> 7844. If payment of the amount ~~due~~ claimed is not made within 10 days after a stop work notice is given, the direct contractor or the direct contractor's surety may in an expedited proceeding seek a judicial determination of liability for the amount due.

"Expedited Proceeding"

Echoing the Staff Note, GGLT asserts Section 7844 should provide details for the "expedited proceeding" referenced in the section. CLRC Memorandum 2006-39, Exhibit p. 133. In particular, the firm suggests the section should indicate whether a decision at the "expedited proceeding" referenced in the section would supersede a binding arbitration proceeding.

However, even if the Commission provides no further detail, GGLT urges the Commission to retain the reference in the section to an expedited proceeding.

CLRC Memorandum 2006-39, Exhibit p. 159. The firm indicates that even though in its experience most judges are not familiar with the provision continued by Section 7844, the potential impact of a work stoppage requires an expressed legislative preference for expedited resolution.

The staff does not recommend that the Commission attempt to provide any detail relating to the "expedited proceeding" referenced in Section 7844, in the context of this study.

However, even without detail, the staff believes the reference alone has value, as it provides parties with at least some basis to persuade a local court to award the dispute priority over other items on the court's calendar.

The staff therefore also recommends that the reference remain in the section as drafted.

GGLT also questions why the expedited proceeding referenced by this section must be "judicial," wondering why the parties couldn't agree to a third party neutral, a dispute review panel, or arbitration. CLRC Memorandum 2006-39, Exhibit p. 159.

The staff notes that Section 7844 does not *preclude* the parties from seeking any of the types of alternative resolution identified by GGLT. Rather, the section only grants parties that seek a judicial resolution expedited access to the courts that likely otherwise could not be obtained.

The staff does not recommend any revision to the section related to this inquiry.

Reciprocal Right of Owner

GGLT also argues that Section 7844 should grant an owner, who can also suffer significant damage from a work stoppage, a reciprocal right to an "expedited proceeding" to resolve the stoppage. CLRC Memorandum 2006-39, Exhibit p. 159.

Despite representing a change in the law, the staff believes the suggestion has some appeal, and **solicits input on the issue from practitioners.**

The language of the stop work provisions in existing law suggests the Legislature's focus was directed toward providing unpaid direct contractors a vehicle to recover *earned* compensation, as quickly as possible. However, a stop work notice can also lawfully be given when the contractor's right to payment is in dispute. A contractor in such a situation (at least one that has other projects)

could attempt to use a stop work notice and a subsequent prolonged work stoppage as negotiating leverage against the owner.

Given that the Legislature has decided that a work stoppage based on an unresolved stop work notice is significant enough to warrant expedited judicial attention, fairness would seem to dictate that *either* party affected by the stoppage should be permitted to obtain this expedition. More importantly, it would seem that neither party affected by the dispute should be allowed greater negotiation leverage, based on unequal access to the courts.

Pending significant objection from practitioners, the staff recommends **that Section 7844 be revised as follows:**

> **§ 7844. Judicial proceeding**
>
> 7844. If payment of the amount due is not made within 10 days after a stop work notice is given, the direct contractor, ~~or~~ the direct contractor's surety, or an owner may in an expedited proceeding seek a judicial determination of liability for the amount due.
>
> **Comment.** Section 7844 restates former Section 3260.2(d) ~~without substantive change~~, and additionally allows an owner to seek a judicial determination of liability for the amount due in an expedited proceeding.
>
> ….

Respectfully submitted,

Steve Cohen
Staff Counsel

Exhibit

COMMENTS OF AMERICAN INSURANCE ASSOCIATION, NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS, AND SURETY & FIDELITY ASSOCIATION OF AMERICA

From: Steve Cohen
Sent: Monday, March 05, 2007
To: Gallagher, Edward
Subject: California Law Revision Commission mechanics lien revision - questions on new topic

Mr. Gallagher,

Greetings again. On page 4 of your September 29, 2006, letter, discussing our proposed Section 7602, your group suggests that the payment bond referenced in the section should be for 100% of the contract amount, rather than 50%. In support, you note that since the cost of the bond is based on the contract amount and not on the penal sum of the bond, the 50% requirement provides no savings to the owner or direct contractor.

Can you better explain why the pricing on the bond is set up this way? If the surety's exposure is less based on a lower penal sum, why wouldn't be charged premium be less? Is this a universal pricing practice among sureties? Assuming it is (and always has been), what do you think was the rationale for the existing statute requiring the bond to be for only 50%?

Thanks again for your continuing help in clarifying your group's comments.

Steve Cohen
California Law Revision Commission
scohen@clrc.ca.gov

From: egallagher@surety.org
Subject: California Law Revision Commission mechanics lien revision - questions on new topic
Date: March 5, 2007
To: scohen@clrc.ca.gov

Surety is regulated as a type of insurance, and each surety company is required to file its rates with the state insurance departments and to charge the filed rates. It is normal, standard industry practice to measure the risk by the contract amount and to base the premium computation on the contract amount including any increases or decreases. The surety's risk is the cost to complete the work and pay the subcontractors and suppliers, and the contract amount is the best measure of that risk. The penal sum of the bonds is a cap on the surety's liability, and if it is small enough in relation to the contract amount, that cap would certainly be significant. The standard in the industry is to take both factors into account and charge the lower of two alternate premiums. The alternate based on the bond penalties, however, recognizes that most of the risk is in the first part of the penal sum and that underwriting costs are largely the same unless the bond penalties are very small compared to the contract amount. Thus, the alternate computation is to apply the filed end rate (computed to be applied to the contract amount) to four times the aggregate penalties of the two bonds.

The Surety Association publishes, and files with the state insurance departments, a Manual of Rules, Procedures and Classifications for Fidelity, Forgery and Surety Bonds. Our member companies are not required to use the SFAA Manual, but it is the closest there is to an industry standard in rating surety bonds. I will fax you copies of pages C-3 and C-4 of the SFAA Manual containing the Rules for rating contract surety bonds. Please note that paragraph C states the general rule that the premium is computed based on the contract price, including any adjustments to the contract price during performance. Paragraph F, however, provides a limit of a Maximum Premium based on the aggregate penalties of the performance and payment bonds.

In House Report No. 106-277 dated July 30, 1999, on the Construction Industry Payment Protection Act, the Committee on Government Reform explicitly found that the premiums for contract surety bonds are based on amount of the contract. The Report states at page 4:

> Bonds are priced on the basis of a percentage of the contract amount. Market conditions and prevailing industry practices set the percentage. A single premium is typically charged for both the performance bond and the payment bond. A separate premium is charged for a payment bond when one is provided without an attendant performance bond. It is the Committee's understanding that an increase in the size of the Miller Act payment bond, beyond the current amount, will not increase costs to the Federal Government. Surety bond premiums are calculated based on contract amount. A significant portion of a surety company's total cost involves the underwriting costs. An increase or decrease to the payment bond penalty does not significantly affect the underwriting process and, consequently, the underwriting cost.

I can also fax you a copy of the Report if you want it (I will have to look for a copy).

Section 7602 deals with payment bonds on private projects and what is sufficient to protect laborers, subcontractors and suppliers. Perhaps when it was enacted, the Legislature believed that the original contractor would subcontract only a part of the work, and it was safe to give the owner flexibility in requiring the bond. By contrast, under Civil Code Section 3247, a 100% payment bond is required on public works.

If you need anything else let me know. It might be easier to explain over the telephone.