STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

REPORT

Mechanic's Lien Law Reform

February 2002

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

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February 11, 2002

To: The Honorable Gray Davis
Governor of California, and
The Legislature of California

This report provides an overview of the Law Revision Commission's study of mechanic's lien law to date, with emphasis on various approaches to addressing the problem of double liability in home improvement projects.

The Commission concludes that a thorough review and revision of the mechanic's lien law (Civ. Code §§ 3082-3267) and related provisions, including parts of the Contractors' State License Law (Bus. & Prof. Code §§ 7000-7191), should be undertaken in order to modernize, simplify, and clarify the law, making it more user-friendly, efficient, and effective for all stakeholders.

This report was prepared pursuant to Resolution Chapter 78 of the Statutes of 2001 and a specific request from the Assembly Committee on Judiciary.

Respectfully submitted,

Joyce G. Cook
Chairperson

MECHANIC'S LIEN LAW REFORM

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MECHANIC'S LIEN LAW REFORM

SCOPE AND STATUS OF STUDY

The Law Revision Commission commenced its study of the mechanic's lien laws in 1999, in response to a request from the Assembly Judiciary Committee to undertake a "comprehensive review of this area of the law, making suggestions for possible areas of reform and aiding the review of such proposals in future legislative sessions."[1] For the most part, the Commission's study of mechanic's lien issues to date has been devoted to the double liability problem faced by homeowners whose prime contractors fail to pay subcontractors and suppliers.[2] The Commission has been focusing on mechanic's liens in the home improvement area because the Legislature has shown special interest in this subject in recent years,[3] and because public commentary at Commission meetings has gravitated to this issue.

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1. See Letter from Assembly Members Sheila James Kuehl (Chair) and Rod Pacheco (Vice Chair), to Nat Sterling, June 28, 1999 (attached to Commission Staff Memorandum 99-85 (Nov. 16, 1999)).

In the following discussion, Commission staff memorandums are referred to in the following format: "Mem. 2000-26 pp. 3-4" for pages in a memorandum, "Mem. 2000-26, Ex. pp. 1-2" for pages in an exhibit, and "Mem. 2000-26 Supp. 2 pp. 1-2" for pages in a supplement.

2. For the Commission's conclusions and recommendation on this aspect of the mechanic's liens study, see *The Double Payment Problem in Home Improvement Contracts*, 31 Cal. L. Revision Comm'n Reports 281 (2001).

3. See ACA 5 (Honda) and AB 742 (Honda) in the 1999-2000 Session; AB 568 (Dutra), as introduced and as amended March 27, 2001, and AB 543 (Vargas), as amended April 16, 2001, in the 2001-2002 Session. Both AB 568 and AB 543 were amended in the Assembly on May 2, 2001, to remove the substantive provisions and add the following intent language:

> It is the intent of the Legislature to revise and reorganize the mechanics' lien and stop notice provisions in Title 15 (commencing with Section 3082) of Part 4 of Division 3 of the Civil Code, and related provisions,

Preliminary work has also been done on a general review and redraft of the mechanic's lien law[4] and related provisions

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with the purpose of modernizing and simplifying the statutes and addressing problems, such as the potential for double payment by homeowners.

The Assembly Committee staff analysis of AB 568, as amended March 27, 2001, includes the following commentary:

> This bill, as proposed to be amended, sets forth a statement of legislative intent regarding the need for revisions of the law governing mechanic's liens and related provisions. As discussed below, the author agreed to amend the bill into legislative intent language at this time in order to create a potential vehicle for related recommendations that are expected to come later this session from the California Law Revision Commission (CLRC or Commission).
>
> *Procedural History*. The introduced version of this bill contained various provisions designed to address problems with mechanic's liens in the home improvement area, and included a homeowner's relief recovery fund. On March 27, 2001, the bill was amended to delete those provisions and replace them with a joint check approach to the problem.
>
> At the request of the Chair, the author agreed to delete the current contents of the bill and replace them with the legislative intent language set out above, in order to serve as a vehicle for recommendations on the subject that are expected to be issued later this year by CLRC. The author also agreed to bring the bill back to this Committee for further hearing at such time that substantive provisions are added to the measure.
>
> *Pending CLRC Study of Mechanic's Lien Laws*. On June 28, 1999, the then chair and vice-chair of this Committee sent a letter to CLRC requesting the Commission to undertake a "comprehensive review of [the law in the area of mechanic's liens and related provisions], including making suggestions for possible areas of reform and aiding the review of such proposals in future legislative sessions." The Commission is currently conducting this study. While its initial focus has been mechanic's liens in the home improvement area, given the particular interest in this subject during the last legislative session, the study is not limited to home improvement contracts. As CLRC has indicated, the entire mechanic's lien statute is ripe for revision and reorganization. (See CLRC Staff Memorandum 2001-18, "Mechanic's Liens: Overview of Reform Proposals," at p. 2 (Jan. 24, 2001).)

The analysis of AB 543 contains similar language. Both of these bills passed the Assembly and are pending in the Senate as of the date of this report.

4. The mechanic's lien is governed by Civil Code Sections 3082-3267. Generally speaking, and as used in this report, "mechanic's lien law" should be taken to include stop notice rights and bond remedies, which are all governed by Title 15 (commencing with Section 3082) of Part 4 of Division 3 of the Civil Code.

in the Contractors' State License Law.[5] This work is continuing as Commission resources permit.[6]

The Commission has conducted its study of mechanic's liens pursuant to its general authority to consider creditors' remedies, including liens, foreclosures, and enforcement of judgments, and its general authority to consider the law relating to real property.[7]

This preliminary report summarizes the main points of discussion in past Commission meetings, and provides references to Commission meeting materials where additional detail may be found, particularly the valuable comments received from Commission consultants, meeting participants, and others who sent letters and email.[8]

GENERAL STATUTORY REFORM

The basic mechanic's lien law has been amended 66 times since its recodification in the Civil Code in 1969.[9] The earlier statute, as recodified in the Code of Civil Procedure in 1951,[10] was amended 39 times. All told, since its original codification in the 1872 Code of Civil Procedure, the mechanic's lien statute has been affected by 148 enacted bills.

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5. See Bus. & Prof. Code §§ 7000-7191.

6. Substantial Commission time and staff resources have been and will continue to be devoted to large, statutorily mandated projects to recommend repeal of provisions made obsolete by the Trial Court Employment Protection and Governance Act, the Lockyer-Isenberg Trial Court Funding Act of 1997, and the implementation of trial court unification. See Gov't Code §§ 70219 (repealed by 2001 Cal. Stat. ch. 745, § 113), 71674. In addition, recent and impending budget cuts will limit the productivity of the Commission's staff.

7. For the text of the most recent legislative authorization, see 2001 Cal. Stat. res. ch. 78, set out as Appendix 2 to the *2001-2002 Annual Report*, 31 Cal. L. Revision Comm'n Reports 1, at 37 (2001).

8. See Appendix *infra* at 389.

9. 1969 Cal. Stat. ch. 1362.

10. 1951 Cal. Stat. ch. 1159.

Today's mechanic's lien statute still contains language dating back to the 1872 codification and before. The 1951 and 1969 recodifications continued much of the pre-existing language, and were not intended to be substantive reforms.[11] This process has taken its toll on a body of law that one California Supreme Court justice labeled "confused and confusing" nearly 90 years ago.[12]

Commentators predictably have different views on the soundness of the existing statute and the scope and desirability of statutory reform. At the Commission's first meeting on mechanic's lien issues, several speakers urged the Commission to "go back to square one" and conduct a thorough review and revision of the mechanic's lien law and related provisions, on the grounds that they are confusing, complicated, and at odds with modern conditions. Others argued that, while some improvements could be made, the statute is basically sound and represents the accumulated improvements from many years' work.[13]

Drafting Approach

The Commission has started the process of redrafting the mechanic's lien law. Depending on the breadth and depth of the revision process, this may be an extended project. There is a strong argument that the mechanic's lien law is in such a poor condition that it would be better to start with a clean

11. See 1951 Cal. Stat. ch. 1159, § 5 (legislative intent as "only a formal revision of the law … [not] an alteration in the public policy … nor in the meaning or substance thereof"); 1969 Cal. Stat. ch. 1362, § 10 (legislative intent "to revise and restate … shall not be construed to constitute a change in … preexisting law").

12. Roystone Co. v. Darling, 171 Cal. 526, 546, 154 P. 15 (1915) (Henshaw, J. concurring).

13. See Minutes of November 1999 Meeting.

slate.[14] However, the Commission has tentatively concluded that it would be better to start with the existing statute and revise it in place. The Commission is concerned that it would not be productive to become mired in a lengthy comprehensive revision of the mechanic's lien law that ultimately could not be enacted. A consensus on the need for reform is easier to build by a detailed review of the existing statute, than by throwing it out and starting with a blank slate or with a model statute.

The Commission's past experience in revising major statutes[15] demonstrates that stakeholders and other interested persons can profitably work together on an overall revision by taking the existing law apart on a section-by-section basis and putting it back together, omitting obsolete provisions, reconciling contradictory provisions, adding new clarifications, and making other useful reforms.

By modernizing the drafting, eliminating archaic and unnecessary language, reorganizing and simplifying the structure of

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14. See, e.g., James Acret's "Draft of Simplified Mechanic's Lien Statute" (Mem. 2001-41, Ex. pp. 1-7). For reactions to this proposal, see Mem. 2001-41 Supp. 1 (Gordon Hunt) & Mem. 2001-41 Supp. 2 (Sam Abdulaziz). Mr. Acret has described the mechanic's lien statute as an "unruly beast that cannot easily be beaten into submission. This writer believes that the mechanics lien statute should be rewritten from scratch rather than redlined. That approach got us to where we are now!" See Letter from James Acret to Stan Ulrich, May 17, 2001 (Mem. 2001-53 Supp. 1, Ex. p. 2). In contrast, Rodney Moss writes that the "problem is that an enormous case law has developed over the years based upon the mechanic's lien law as drafted and those clarifications have become part of the lien law. I do not believe the history of the lien law can be disregarded in any attempt to update and refine the lien law." See Letter from Rodney Moss to Stan Ulrich, May 18, 2001 (Mem. 2001-53 Supp. 1, Ex. p. 3).

15. E.g., the Family Code, the Probate Code, the Eminent Domain Law, the Enforcement of Judgments Law, the Administrative Procedure Act. See, respectively, *1994 Family Code*, 23 Cal. L. Revision Comm'n Reports 1, 5 (1993); *New Probate Code*, 20 Cal. L. Revision Comm'n Reports 1001 (1990); *Eminent Domain Law*, 12 Cal. L. Revision Comm'n Reports 1601 (1974); *Enforcement of Judgments Law*, 15 Cal. L. Revision Comm'n Reports 2001 (1980); *Administrative Adjudication by State Agencies*, 25 Cal. L. Revision Comm'n Reports 55 (1995).

the statute, and using shorter, clearer sections, the statutes can be greatly improved even if no major substantive changes are made. In addition, a simpler and better-organized statute facilitates implementation of policy revisions and technical adjustments in future years as the need arises.[16]

Rectifying General Definitions

Many, if not most, of the definitional provisions in the mechanic's lien statute are poorly drafted, confusing, and disorganized. For example, Civil Code Section 3097, purporting to define "preliminary 20-day notice (private work)," is the longest section in the mechanic's lien statute. It is twice as long as the entire mechanic's lien statute in the 1872 Code of Civil Procedure. Section 3097, amended over 15 times since 1969, is almost a mini-practice guide in itself, containing substantive and procedural material that should be relocated with related substantive sections. Many other supposed definitions are really substantive rules that should be integrated with related provisions.[17]

Some terms are defined and never used, such as "materialman" (Section 3090) and "subdivision" (Section 3105). Others are defined, but largely unused in later provisions, such as "site" (Section 3101), which is ignored in favor of references to land, real property, or jobsite. Some are defined and used only once, such as "notice of nonresponsibility" (Section 3094). Archaic language, such as the references to flumes and aqueducts in the definition of "work of improvement" (Section 3106) should be eliminated or subsumed in general language. Many other examples could be listed.

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16. See, e.g., Mem. 2001-92.

17. See, e.g., Civ. Code §§ 3083 (bonded stop notice), 3084 (claim of lien), 3092 (notice of cessation), 3093 (notice of completion).

Public Contracts

There is no mechanic's lien right in public works.[18] Mandatory bonding and the stop notice remedy provide protection for contractors, laborers, and suppliers on public construction projects. A general body of law concerning stop notices and payment bonds in public works is contained within the mechanic's lien law in the Civil Code.[19] Tentatively, the Commission is considering separating the public and private construction provisions by removing the public works sections from the Civil Code mechanic's lien statute.

The provisions concerning public works could be relocated in the Public Contract Code, which was created in 1982 by pulling sections together from a number of other codes, including the Education Code, Government Code, Streets and Highways Code, and Water Code. This type of reorganization of the mechanic's lien statute would be consistent with the intent of Public Contract Code Section 100, which reads, in part: "The Legislature finds and declares that placing all public contract law in one code will make that law clearer and easier to find."

Contractor and supplier remedies relating to public construction contracts go hand in hand with the provisions governing the contract terms and bidding process. Under the existing scheme, the stop notice procedure seems to be consolidated in the Civil Code, but there are many other bond provisions in the Public Contract Code and elsewhere. These provisions should be reorganized to facilitate use by courts, attorneys, and affected parties.

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18. See, e.g., Civ. Code § 3109 ("This chapter does not apply to any public work.").

19. See, e.g., Civ. Code §§ 3179-3214 (stop notices for public works — 25 sections), 3247-3252 (payment bonds for public works — six sections).

Completion Issues — Senate Bill 938

The Assembly Judiciary Committee has deferred consideration of Senate Bill 938 (Margett) (2001-2002 legislative session), relating to giving notice of completion, pending receipt of the Commission's report.[20] This bill would require the owner, within 10 days after a notice of completion or cessation is filed, to give notice to subcontractors and suppliers who have given a preliminary notice. Failure to do so would negate the shortening of the lien-filing period normally resulting from such filings, meaning that the 90-day period would apply. As discussed above, the Commission has not completed its comprehensive review of the mechanic's lien statute. The Commission has not considered the issues addressed in SB 938 or formulated a proposal encompassing the notice of completion.[21]

Accordingly, the Commission respectfully requests that consideration of SB 938 (or other bills) not be deferred in anticipation of the Commission's completion of a comprehensive mechanic's lien recommendation.

ADDRESSING THE DOUBLE LIABILITY PROBLEM

The following discussion summarizes the various proposals that have come before the Commission in its consideration of the double liability problem. The Commission's proposal for addressing this issue is set out in a separate Recommendation on *The Double Liability Problem in Home Improvement Contracts* (February 2002),[22] and will not be repeated here. In that

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20. See Assembly Judiciary Committee Analysis of SB 938 (Mem. 2001-53, Ex. pp. 2-6).

21. Nor does the Commission have a position on SB 938. The Commission cannot advocate the passage or defeat of bills pending in the Legislature or the approval or veto of bills on the Governor's desk. See Gov't Code § 8288.

22. This final recommendation follows an earlier Tentative Recommendation on *The Double Payment Problem in Home Improvement Contracts* (September

recommendation, the Commission proposes to protect homeowners from double liability in small home improvement contracts to the extent that payments have been made in good faith to the prime contractor.

As an aid to the Legislature in its potential consideration of future proposals, this report provides an overview of a variety of approaches that have been tried in other jurisdictions, are discussed in the literature, or were suggested by persons who have participated in the Commission's study. Thus, this report reviews the alternatives that were rejected by the Commission as a means to remedy the double liability problem in home improvement contracts. They are grouped in several categories: (1) incremental reforms, (2) reallocating the risk, (3) recovery and reimbursement funds, (4) payment bonds, (5) escrows and withholding, and (6) other approaches.

(1) Incremental Reforms

Some commentators have argued that existing California law is satisfactory or, if any specific problems can be identified, only minor adjustments would be needed to address them. From this perspective, the fact that the existing statute has been amended scores of times is not a defect, but an indicator that existing law has reached a state of balance and refinement through its repeated adjustment over the years (although it is generally admitted that some of the statutory language and the statutory organization are confusing).

In this view, the best approach would be to fine-tune the statute by making whatever incremental reforms are needed to address concrete issues and seek to perfect the statutory balance among stakeholders. This perspective rejects major revisions as potentially destructive of the balance that has

2001), and a Discussion Draft on *Consumer Protection Options Under Home Improvement Contracts* (December 2001).

resulted from 90 years of enactments, amendments, and recodifications following enactment of the direct lien in 1911.[23]

Suggested incremental reforms include requiring better notices to homeowners, increasing the amount of the contractor's license bond, using stepped license bonds, mandating general liability insurance, and requiring the use of joint checks. Each of these proposals is discussed below.

The Commission has not rejected the idea of making some of these incremental reforms, but has concluded that they are not adequate to address the double liability problem. Nevertheless, one or more of these reforms may be appropriate as part of an overall mechanic's lien law reform package.

Better Notice

In home improvement contracts, Business and Professions Code Section 7018.5 requires the prime contractor to give a special notice to the homeowner ("Notice to Owner"). This notice is intended to give the owner a general idea of rights and remedies under the contract. The existing mechanic's lien system also depends on the preliminary 20-day notice given to the owner (and others) by potential lien claimants after work commences or materials are furnished, as prescribed by Civil Code Section 3097. This notice is a crucial step in the process whereby claimants establish and preserve their right to enforce their mechanic's lien and stop notice rights.

Ideally, these notices would provide homeowners with sufficient information to understand their rights, remedies, and risks, and thus enable them to protect their interests sensibly and cheaply by selecting the optimum course of action. In view of the complexity of the mechanic's lien and stop notice remedies and the inherent potential complexity of a construction project, it is perhaps not surprising that the

23. 1911 Cal. Stat. ch. 681.

existing notices do not achieve this goal. No commentators have come forward to defend the language of the current notices.

The Commission believes that the notices and forms used under the mechanic's lien law and Contractors' State License Law should be clearer and more direct, even though the effect of these improvements might be marginal. Statutory notices are usually troublesome, becoming stale because of the burden of amending the statute to make revisions. Consequently, the Commission recommends that, to the extent possible, the specific content of notices and forms should be delegated to regulation by the Contractors' State License Board (CSLB).

A number of suggestions for ways to improve the notices are set out in Commission meeting materials.[24] The most highly developed notice scheme, based in part on the CSLB's then proposed Home Improvement Protection Plan ("HIPP 2000"), would (1) change the name of the notice given by the prime contractor at the start of a project from "Notice to Owner" to "Mechanic's Lien Warning," (2) require the prime contractor to obtain written confirmation from the owner that the warning had been received, (3) make failure to give the notice and get confirmation a violation of the Contractors' State License Law, subjecting the prime contractor to discipline, (4) make injuries arising out of the failure to give the warning compensable from the contractor's license bond, and

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24. See Mem. 2000-9, Hunt Report Pt. 2, Ex. pp. 32-40 (CSLB's HIPP 2000 draft of Aug. 1999); Mem. 2000-9 Supp. 1 (CSLB revised HIPP draft of Jan. 2000); Mem. 2000-37 p. 6, & Ex. pp. 9-17 (Abdulaziz drafts); Mem. 2000-47 Supp. 2, Ex. pp. 23-32 (Abdulaziz drafts) & Ex. pp. 33-37 (staff versions). Release forms are discussed, e.g., in Mem. 99-85, Hunt Report Pt. 1 pp. 13-16; Mem. 2000-37, Ex. pp. 22-23 (Gallagher); Mem. 2000-78, Ex. pp. 1-2 (Acret). See also Mem. 2000-37 Supp. 2 pp. 3-4 (LACN).

(5) include a checklist to assist the owner in determining whether all important steps have been taken.[25]

Consumer education in general, bolstered by the use of informative, understandable notices given in a timely fashion, are desirable as a cheap and efficient way to avoid problems from the outset of a home improvement project. Commentators who oppose more substantive changes in the law have argued that if homeowners are adequately informed of their rights and remedies under the law, they can protect their interests without the need to enact any new consumer protections or change the current balance among the various stakeholders.

Improving notices should be fairly simple to implement, because the Contractors' State License Board has the authority and responsibility to protect homeowners and is in a position to prepare the appropriate notice forms and to help educate homeowners and contractors. However, it is unrealistic to think that notice alone is a sufficient response to the double liability problem. The law is too complex to be described briefly and understandably. Recent experience in attempting to rewrite the notices under the existing statute is not encouraging. Even if it were possible, notice alone does not overcome the trouble and expense of deciding what steps to take, particularly where common sense dictates that an owner who makes progress payments as they come due has fulfilled the contractual obligation. Few homeowners, particularly on smaller projects, would be likely to bother with bonding or joint control agencies, even if they understood how to go about it.

Requiring written confirmation of notice from homeowners might help in some cases, and could help address the problem raised in CSLB correspondence concerning whether many prime contractors give the required notice. But common

25. See Mem. 2000-37, Ex. pp. 9-17 (Abdulaziz drafts).

experience with signing preprinted forms suggests that the confirmation may end up being just another piece of paper to be signed with other items, without any real effect.

Increased License Bond

The contractor's license bond could be increased to a level that would provide more protection for homeowners. The basic licensed contractor's bond is set at $7,500.[26] Material and equipment suppliers are not licensed, and provide no bond.[27] Minor works contractors (under $500) are not required to be licensed.[28] The license bond amount appears to be a only a minor barrier to entry into the construction business. Contractors who get in financial trouble will generate claims and have unsatisfied obligations far exceeding the license bond.[29]

License bonds at lower amounts do not need to be underwritten and are economically feasible to the surety companies because of the number of bonds written. An increase from $7,500 to $10,000 would probably not require additional underwriting, and would raise home improvement contractor license fees to the level set in 1994 for swimming pool contractors.

Eight years ago the general license bond was raised from $5,000 to $7,500.[30] Adjusted for inflation, this amount would be over $8,800 in 2001 terms. One commentator has proposed

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26. Bus. & Prof. Code § 7071.6(a). Swimming pool contractors need a $10,000 bond. *Id.* § 7071.6(b).

27. See Bus. & Prof. Code § 7052.

28. Bus. & Prof. Code § 7048.

29. See, e.g., Mem. 2000-47 Supp. 1, Ex. p. 11 (Gallagher letter giving examples of four double payments arising out of one contractor's bankruptcy, ranging in amount from $49,254 to $170,425).

30. 1994 Cal. Stat. ch. 26, § 206.7.

increasing the general $7,500 license bond to $10,000.[31] This $2,500 increase would be more than the adjustment needed to keep pace with inflation, but there is no magic number, and if a 50% increase was justified in 1994, another 33% increase now is probably not out of line. The Lumber Association of California and Nevada has proposed raising the license bond to $20,000.[32]

Increasing the license bond amount for home improvement contractors to $10,000-15,000 or even higher should be relatively simple and would not impose a significant cost on licensed contractors. Bonds at this level should also not impose impracticable levels of underwriting costs and burdens on the surety industry. One marginal benefit of higher license bond levels would be to discourage some financially unsound individuals from entering the contractor ranks. Existing license bond levels are nearly meaningless as funds for homeowner protection. The coverage is minuscule as compared to the potential liability of a contractor who defaults on a number of jobs. Raising the amount high enough to provide a meaningful fund for recovery of double payments would impose costs on all contractors, even though they are not at risk. If the amount is set too high, responsible but unproven contractors might not be able to qualify because sureties would impose greater underwriting requirements above a certain level. This, in turn, would increase the percentage of unlicensed contractors and subcontractors operating in the underground economy.

Stepped License Bonds

Another way to make license bonds more effective would be to provide for increases in the license bond amount depending on how much business the contractor does annu-

31. See Mem. 2000-37, Ex. pp. 7-8 (Abdulaziz).

32. See Mem. 2000-37 Supp. 2 p. 4.

ally in the home improvement field. Step bonding would scale the license bond protection more appropriately to the volume of business, providing a larger fund to compensate those injured by contractor violations or failures, and also imposing higher standards on larger contractors through the surety underwriting process.

The Commission concluded that step bonding could be a useful improvement of the home improvement business in the long term, but that the proposal did not directly address the double liability issue. In general, the Commission does not believe that license bonds in affordable amounts would be sufficient to cover the double payment losses when a contractor (large, medium, or small) goes bankrupt or abandons a number of projects, leaving subcontractors and suppliers unpaid.

Liability Insurance

All licensed contractors (or only home improvement contractors) could be required to maintain a $100,000 general liability insurance policy.[33] The Department of Insurance has argued that the contractor's license bond is an "illusory" protection and that the public is misled into thinking they are protected by the bond when in fact they could rarely recover.[34]

Liability insurance would relieve pressure on the license bond, leaving a greater fund for dealing with double payment problems. Insurance requirements might also help improve the overall integrity of the contractor pool, leading to better consumer protection. But it isn't clear how liability insurance

33. See Mem. 2000-37 pp. 8-10 (discussing background of insurance proposal in one version of SB 1524 (Figueroa) in 1999-2000 legislative session); *id*. Ex. p. 8.

34. See Senate Committee on Business and Professions, Consultant's Analysis of SB 1524, as amended April 3, 2000.

would address the double payment problem, so the Commission has not pursued this proposal.

Joint Checks

Joint checks issued to the prime contractor and subcontractor (or some other combination of potential lien claimants) are a commonly recommended approach to avoiding double payment problems.[35] Joint checks are not a certain protection, however, even if the release form requirements of Civil Code Section 3262 are met, because endorsement may take place without any payment from the co-payee, or the check back to the endorser may bounce, leaving the lien claimant unpaid.[36]

Joint checks should work as a way of making sure that the joint payees, by their endorsements, signify that they have been paid the amount due in agreed proportions under their contract. Common sense dictates that a subcontractor should not be able to endorse the check and then come after the homeowner if the prime contractor does not actually pay the subcontractor. The subcontractor, as a responsible businessperson, can take whatever protective steps are needed or assume the risk of nonpayment. To endorse a joint check and give a release, and then assert lien rights following nonpayment makes no sense. Regardless of whether the release form

35. This approach was recognized in Bentz Plumbing & Heating v. Favalaro, 128 Cal. App. 3d 145, 151-52, 180 Cal. Rptr. 223 (1982); see also Post Bros. Constr. Co. v. Yoder, 20 Cal. 3d 1, 569 P.2d 133, 141 Cal. Rptr. 28 (1977); Re-Bar Contractors, Inc. v. City of Los Angeles, 219 Cal. App. 2d 134, 32 Cal. Rptr. 607 (1963); Crystaplex Plastics, Ltd. v. Redevelopment Agency, 77 Cal. App. 4th 990, 92 Cal. Rptr. 2d 197 (2000) (forged endorsement); Acret, *Representing the Prime Contractor*, in California Mechanics' Liens and Related Construction Remedies § 7.43 (Cal. Cont. Ed. Bar, 3d ed. 1999) ("Because of the 1993 revisions to [Civil Code Section 3263], it is doubtful that mere endorsement of a joint check constitutes a release of lien, stop notice, and bond claims.").

36. See also Mem. 99-85, Hunt Report Pt. 1, pp. 13-16 (releases).

mechanism is fixed generally,[37] endorsement of a joint check by a licensed contractor or a material supplier should act as a complete release to the extent of the payment. In Arizona, when a material supplier endorses a check he "will be deemed to have been paid the money due him, up to the amount of the joint check so long as there is no other agreement between the owner or general contractor and the materialman as to the allocation of the proceeds."[38]

Joint checks have the advantage of being a familiar practice and easy to understand. If the practice were bolstered by a rule making endorsement equivalent to release pro tanto of mechanic's lien rights, joint checks could be emphasized in notice forms required to be given to the homeowner. Joint checks provide an easy way to avoid double payment problems in comparatively simple projects. Amendments along these lines should be a part of the general review of the mechanic's lien statute, as the issue is not necessarily limited to home improvement contracts or small construction jobs. However, *mandating* the use of joint checks would create more problems than it would solve, and would be unenforceable. In a more complex project, joint checks would become burdensome, because the owner would have to write a large number of checks to cover each subcontractor. The protection would tend to break down when sub-subcontractors and lower-tier suppliers are involved. It may even be difficult to write a single check jointly to the prime contractor, subcontractor, and supplier without creating difficulties.

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37. See, e.g., Mem. 2000-78, Ex. 1-2 (Acret proposal on release forms).

38. See case cited in G. Lefcoe, Real Estate Transactions 1050 n.25 (1993). For additional discussion of joint checks, see Mem. 2000-26, Ex. 1 (Loumber); Mem. 2000-37, Ex. 24 (Gallagher). For language concerning joint checks in the "Notice to Owner," see Mem. 2000-9, Ex. pp. 34, 36; Mem. 2000-37, Ex. p. 12.

(2) Reallocating the Risk

The market functions most efficiently if risks associated with doing business are allocated rationally. The party to a transaction should have a reasonable way to assess and allocate risk, and the assumption of a level of risk should be compensated fairly. The mechanic's lien provides a mechanism for shifting to the homeowner the risk that would normally fall on the subcontractor or supplier. It is difficult, time-consuming, or expensive for the homeowner to effectively minimize the risk. The subcontractor and supplier, on the other hand, should be more knowledgeable and experienced in these matters, and can spread the risk over a number of jobs. Yet they are enabled by the mechanic's lien to forgo the usual degree of care expected in commercial transactions. Blind reliance on mechanic's lien rights tempts subcontractors and suppliers into not using standard credit practices, since they can always rely on the lien (which, in fact, may turn out to be worthless).[39]

Some of the more interesting proposals address this problem head-on by making structural adjustments that would invoke normal market functions to correct the double payment problem, as well as the associated problem of subcontractors and suppliers simply not getting payment at all. These proposals include direct payment options, a defense based on good-faith payment, and requiring privity as a condition to lien rights.

Direct Payment

Under a direct payment scheme, subcontractors and suppliers would not have lien rights unless they request payment directly from the owner. This simple concept puts the respon-

39. See also Mem. 2000-9, Ex. p. 1 *et seq*. (Honda analysis of mechanic's lien marketplace in connection with ACA 5 and AB 742); Mem. 2000-9 Supp. 2, Ex. pp. 15-18 (Acret).

sibility for assessing and assuming risk on the subcontractor or supplier where it logically belongs. They would choose whether to rely on the creditworthiness of their customer, or request direct payment in order to preserve lien rights. The underlying assumption of the direct payment concept is that subcontractors and suppliers are in a position to make a rational assessment of their customer's reliability and decide whether to assume the risk of failure or nonpayment by their customer. If they are not comfortable assuming that type of business risk, they can follow the direct payment procedure or do what the current system expects the inexpert homeowner to do — i.e., resort to joint control or bonding protections or fashion some other type of business-based remedy.[40]

Subcontractors and suppliers are in a far better position than the homeowner to judge the contractor's reliability and fiscal soundness. They are far more likely to have an ongoing relationship with the contractor, so they can more readily assess whether requiring direct payment is advisable. This approach makes the home improvement construction market more rational.

The confusing preliminary notice would be unnecessary under the direct payment scheme. In the usual case, where the subcontractors and suppliers are content to rely on their customer, the homeowner would be spared the blizzard of notices and could pay the prime contractor as progress payments fall due without further worries.

If a subcontractor or supplier decides to use the direct payment option, the resulting notice would make more sense because it would apply to a concrete situation and describe an action to be taken.

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40. For proposals and commentary on the direct pay approach, see Mem. 2000-37 pp. 13-18; *id*. Ex. pp. 19-25 (Gallagher); Mem. 2000-37 Supp. 2, Ex. pp. 1-2 (Gallagher); Mem. 2000-47 p. 1; *id*. Ex. pp. 1-3 (staff draft statute); Mem. 2000-47 Supp. 1, Ex. pp. 12-13 (Abdulaziz); Mem. 2000-78, Ex. pp. 9-13 (Gallagher).

Permitting subcontractors and suppliers to request payment directly from the homeowner would disrupts the customary relation between the prime contractor and the subcontractor and other business customers. By choosing direct payment, the subcontractor would in effect be saying that the prime contractor isn't financially reliable. Direct payment also has the potential of exposing the prime contractor's mark-up to the homeowner, which presumably the prime contractor would not want. For this reason, it is likely that general contractors would oppose statutory implementation of a direct payment regime.

Another problem with providing a statutory direct payment alternative is that it could become the norm, instead of the exception, and would thus burden the owner with paperwork that should have been funneled through the prime contractor. Material suppliers have remarked that they would be likely to give direct payment notices routinely to protect their lien rights, rather than rely on the creditworthiness and reliability of their contractor-customer. On the other hand, another commentator has argued that subcontractors and suppliers would be reluctant to ask for direct payment if they wanted to continue working in the home improvement business.[41] In other words, it is suggested that there might be a blacklist of subcontractors and suppliers who exercised the direct payment option, and that prime contractors as a group might be unwilling to give business to them.

Protection of Good-Faith Payments

A homeowner's full payment in good faith to the prime contractor could be recognized statutorily as a discharge of the claims against the owner's property and a defense against

41. See Mem. 2000-78, Ex. pp. 4-5 (Streltzer).

further mechanic's lien claims from anyone not in privity with the owner.[42]

This approach directly addresses the double payment problem, protecting owners from the possibility of having to pay subcontractors or suppliers for amounts that have been paid in good faith under the contract terms.[43] In mechanic's lien law, this approach is known as the New York rule, limiting the lien to the unpaid amount:

> If labor is performed for, or materials furnished to, a contractor or subcontractor for an improvement, the lien shall not be for a sum greater than the sum earned and unpaid on the contract at the time of filing the notice of lien, and any sum subsequently earned thereon. In no case shall the owner be liable to pay by reason of all liens created pursuant to this article a sum greater than the value or agreed price of the labor and materials remaining unpaid, at the time of filing notices of such liens ….[44]

The Commission considered this option early in its study, but tabled it, and other risk allocation ideas, until all the other options could be reviewed. Ultimately, the Commission returned to the good-faith payment protection as the best approach to protecting consumers under small-scale home improvement contracts. The Commission's proposal is explained in the Recommendation on *The Double Liability*

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42. See Mem. 2000-9 Supp. 2, Ex. p. 15; Mem. 2000-26 pp. 12-14; Mem. 2000-37 pp. 10-12; see also Mem. 2000-37 Supp. 1, Ex. pp. 3-4 (Moss); Mem. 2000-47 Supp. 1, Ex. p. 13 (Abdulaziz); Mem. 2000-63 Supp. 1, Hunt Report Pt. 3, pp. 2-3.

43. For historical background and discussion of constitutional issues, see Mem. 2000-26 generally (staff analysis); Mem. 2000-26 Supp. 1 (Abdulaziz); Mem. 2000-9 Supp. 2, Ex. pp. 6-14 (Honda).

44. N.Y. Lien Law § 4 (Westlaw 2000).

Problem in Home Improvement Contracts,[45] and will not be repeated here.

Privity Requirement

Returning the law to the era before enactment of the "direct lien" in 1911, this proposal would grant lien rights only where there is a direct contractual relationship (privity) between the owner and the claimant. This approach is even simpler than the full payment defense because it would prevent attachment of the lien in the first place and would not depend on a determination of whether good faith payments have been made to the prime contractor.[46]

Requiring privity as a precondition for lien rights is a simple approach based on familiar contract principles. In reaction, subcontractors and suppliers could be expected to create a clearinghouse of information on reliable contractors and would use other mechanisms to protect their interests and ameliorate the risk of doing business. The marketplace would be expected to respond by developing appropriate mechanisms as in other fields of commerce.

However, requiring privity would impose an additional burden on subcontractors and suppliers, by forcing them to deal with the owner in addition to their customer. Similarly, a privity requirement would impose additional burdens on the owner. The owner presumably wants the prime contractor to deal with subcontractors, or the owner probably would not have sought the services of the prime contractor in the first

45. This final recommendation follows an earlier Tentative Recommendation on *The Double Payment Problem in Home Improvement Contracts* (September 2001), and a Discussion Draft on *Consumer Protection Options Under Home Improvement Contracts* (December 2001).

46. See Mem. 2000-63 Supp. 1 pp. 1-2 (Acret proposal). For historical background and constitutional issues, see Mem. 2000-26 generally (staff analysis); see also Mem. 2000-26 Supp. 1 (Abdulaziz); Mem. 2000-9 Supp. 2, Ex. pp. 6-14 (Honda). The concept underlying a privity requirement could also be implemented statutorily as part of the direct payment proposal discussed *supra*.

place. The prime contractor's markup is justified because of the time and expense of managing the project, including engaging and supervising subcontractors. Imposing a privity precondition to mechanic's lien rights would subvert this relationship and would cause significant disruption in the construction marketplace.

(3) Recovery and Reimbursement Funds

About 15 states have some sort of general recovery fund protecting homeowners from double payment "damages." Two states (Utah and Michigan) have funds protecting lien claimants. Recovery funds compensate qualified subcontractors and suppliers who have not been paid. Reimbursement funds repay owners who otherwise would have to pay twice.

Lien Reimbursement Fund

Unpaid liens or lienable claims would be compensable from a fund administered by a state agency, financed by some type of assessment on contracts or contractors. A recovery or reimbursement fund also necessarily entails the cost and delays inherent in any bureaucratic solution. A fund approach was proposed in bills introduced by Assembly Member Honda in the 1999-2000 session.[47]

Crucial factors in setting up a recovery or reimbursement fund include the determination of who should pay into it and the amount of the assessments needed to make the fund self-supporting. A $200 annual fee from each home improvement contractor was set out in AB 2113 in the 1999-2000 session. The Contractors' State License Board estimated that this would generate a $50 million fund. Directly related to the

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47. See AB 742, in Mem. 2000-9, Hunt Report Pt. 2, Ex. pp. 3-5; *id*. pp. 6-17 (Assembly Judiciary Committee analysis of AB 742); *id*. pp. 19-22 (CSLB staff analysis); Mem. 2000-9, Ex. pp. 1-14 (supporting documents on AB 742); AB 2113 in Mem. 2000-26, Ex. pp. 7-16.

issue of assessments is the question of who would be able to make claims against the fund and the standard for qualifying.

A fund can protect victimized homeowners and subcontractors and suppliers without drastically revising the mechanic's lien law or imposing new requirements on the parties. A $200 annual fee assessed from contractors would be nominal. Although costs would presumably be passed on to homeowners, any individual owner's share of the annual fee would be nominal. The assessment would have to be large enough to compensate the intended beneficiaries, but in addition, would have to be sufficient to maintain the bureaucracy necessary to administer the fund. Studies of funds in other states suggest that they are not financially sound or that they do not pay out sufficient claims.[48]

Some commentators have objected that the fund approach is inherently unfair because all contractors would have to pay to indemnify lien claimants and homeowners for the irresponsibility of a few. The assessment, paid only by licensed contractors, would also benefit suppliers who would not pay into the fund. A fund approach would not make prime contractors more responsible. In fact, a fund might foster more abuse, since the fund would be another source of compensation for unpaid subcontractors and suppliers.

The Commission concluded there were too many obstacles to establishing a lien reimbursement fund in California. In light of the 1999-2000 legislative experience with a fund proposal, the Commission did not believe that further work on this approach would be productive.

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48. See, e.g., Mem. 2000-9, Hunt Report Pt. 2, Ex. pp. 19-22 (CSLB staff analysis); Mem. 2000-9 Supp. 2, Ex. p. 4 (Gallagher); Mem. 2000-9 Supp. 2, Ex. p. 18 (Acret); Mem. 2000-26 pp. 11-12. See also CSLB, *Analysis of State Recovery Funds*, (July 1999, 98 pp., rec'd Feb. 7, 2000, Commission file H-820).

Homeowner's Relief Recovery Act

The objection to assessing contractors to support a lien reimbursement fund can be addressed by basing the fund on a percentage assessment on building permits. This approach was proposed by Prof. J. Clark Kelso and the Institute for Legislative Practice.[49] The appropriate percentage assessment should be fairly low and, as a proportional fee, would avoid the pitfalls inherent in a fund based on an annual flat fee.

The Commission is reluctant to propose any scheme based on establishing a new adjudicatory bureaucracy to process claims, regardless of the funding mechanism. Furthermore, homeowner representatives reacted negatively to an assessment on building permits.

(4) Payment Bonds

Commission discussions of bonds have been limited to payment bonds covering the cost of labor and materials already supplied, not performance bonds covering the cost of completion of the project.[50] A payment bond would substitute for the lien against the owner's property. Focusing on payment bonds, as opposed to performance bonds, would limit the cost of any mandatory bonding requirement.

Several types of bonding options exist under current law and practice, including performance bonds, payment bonds, and release bonds. A contractor can get a payment bond to cover payments to subcontractors, for example. Subcontractors can get a bond to guarantee payment to sub-subcontractors and material suppliers. An owner can seek a bond to substitute for the mechanic's lien remedy. Civil Code Sec-

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49. See Mem. 2001-18 Supp. 1. Prior drafts were included in Mem. 2000-47 Supp. 1, Ex. pp. 1-10, and Mem. 2000-78 Supps. 2 & 3. See also Mem. 2000-78 Supp. 5 pp. 1-2 (CAR).

50. See Mem. 2000-9, Hunt Report Pt. 2, pp. 6-10; Mem. 2000-9, Ex. 9-11 (Honda); Mem. 2000-26 pp. 8-10; Mem. 2000-78 Supp. 1, Ex. p. 1 (Wayson).

tions 3235-3236 provide protection against lien claimants where a bond in the amount of 50% of the contract price is recorded, along with the contract, before work commences. But on small projects and in the home improvement area, bonds are not a practical option. The cost of a bond can be 1% to 5%, some subcontractors may have difficulty qualifying, and human nature is to avoid the trouble and expense of a bond until it is too late. Mandating payment bonds would add to the paperwork and expense of home improvement contracts.

As to payment bonds, Prof. George Lefcoe points out:

> Bonding is needed most when it is least likely to be available. Small and undercapitalized contractors do modest-sized jobs for individual property owners on tight budgets. In these situations, few contractors have the credit necessary to get a bond. The costs of such bonds as are available will be prohibitive to the owner and the contractor.[51]

He believes that the recorded bonded contract option under Civil Code Section 3235 "offers the best protection for the owner, but is the least often used because few owners know about it and, in any event, bonding is a costly and bureaucratic exercise for the novice."[52]

The Nolo Guide on mechanic's liens gives little attention to payment bonds, since they are "not a viable option for most small property owners." As to the recorded contract and bond under Section 3235, the Nolo Guide advises:

> Although this approach to reducing mechanics lien risk may seem like a good idea, most general contractors will not qualify for a payment bond equal to 50% of the overall project cost.… [In a $100,000 project example] the cost of

51. G. Lefcoe, *Mechanics Liens*, in Thompson on Real Property § 102.02(a)(2)(i), at 560 (Thomas ed. 1994).

52. *Id*. § 102.02(a)(2)(iv), at 562.

> the bond would be somewhere in the neighborhood of $10,000, which would be economically unfeasible as well. As a general rule, this owner protection is seldom used except on extremely large projects involving highly bondable general contractors and price tags that allow the cost of the bond to be absorbed in the larger project.[53]

Mandatory Full Payment Bond

Prime contractors could be required to obtain payment bonds in the full amount of the contract price as a condition to engaging in the home improvement business. Recovery against the bond would substitute for the lien. Bonds of this amount would set a high standard for contractors because they are underwritten by surety companies, which conduct a careful review of the financial soundness, capacity, and character of the contractor before issuing a bond. A cap on the principal amount of the bond could be set to make the bonds more affordable and to save costs for homeowners. Capping the bond at a level such as $25,000 or $50,000 would also scale the remedy to cover smaller home improvement contracts where consumer protection is needed most.

Bonding only small jobs would, however, turn the usual bonding scheme on its head. Bonds are routine in public works in California, but are required for jobs *exceeding* a certain level.[54] Past proposals for mandatory bonding have always *excluded* smaller contracts.[55]

While bond premiums should go down if the volume of business for sureties increases through a mandatory bonding requirement, it is still unknown how the surety industry would

53. S. Elias, Contractors' and Homeowners' Guide to Mechanics' Liens 9/12-9/13 (Nolo Press 1998).

54. Civ. Code § 3247(a) ($25,000 for non-state entities); Pub. Cont. Code § 7103 ($5,000 for "state entities").

55. See, e.g., Hunt, *California Mechanics' Lien Law: Need for Improvement*, 9 Santa Clara Law. 101, 106 (1968); Comment (Nock), *The "Forgotten Man" of Mechanics' Lien Laws — The Homeowner*, 16 Hastings L.J. 198, 201 (1964).

respond to the massive demand that would be created by this type of proposal. Bond premiums could add significantly to the cost of the project, particularly in the smaller home improvement market. Mandatory bonding would be hard to police, because the rogue contractor who is most likely to need the bond is also most likely to ignore the bond requirement. In addition, some percentage of responsible but fiscally unproven contractors would not be able to qualify for the bond. The unbondable contractor problem could be addressed by providing for retention of a percentage of the contract price as an alternative to the bond, but development of this type of scheme just adds another layer of complexity to the statute and creates the potential for confusing the owner and other parties to a small home improvement contract.

These complexities and costs make full payment bonding impracticable. Neither owners nor contractors want to incur the expense or handle the paperwork created in such a scheme.

Blanket Payment Bond

Another option would be to require home improvement contractors to provide a blanket payment bond (not a performance bond) of $50,000 or some other amount as an adjunct to the license bond, to provide a degree of protection against double payment liability by homeowners. This would not be a bond on each project, but a single payment bond, similar in concept to the license bond, but covering all projects the licensed contractor undertakes. Failure to maintain this bond would be equivalent to failing to satisfy licensing requirements.[56] The blanket payment bond could also be stepped up depending on how much business the contractor does in a year.

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56. See Mem. 2000-37 p. 7 & Ex. p. 7.

Blanket bonding in a relatively modest amount should not be too expensive. If mandated in the home improvement industry, the cost and threshold qualifications should drop as a result of economies of scale. Raising standards for home improvement contractors might also help weed out the more irresponsible and financially precarious contractors.

As with all significant improvements in bonding protection, however, bonds in this amount would have to be underwritten and would not be issued by surety companies on a routine basis. Underwriting increases the bond premium and may strain the capacity of the surety industry to respond to demand. It also raises the cost of doing business for all prime contractors and would create barriers to entry into the business of contracting.

Lien Bond Between Contractor and Subcontractors-Suppliers

A "line of credit" form of bond could be created to protect payment to the subcontractors and suppliers where the prime contractor is paid but fails to pay subcontractors and suppliers. The premium on this type of bond should be inexpensive because of its limited nature and small risk to the surety.[57] This lien bond would not be mandatory, to avoid driving responsible but unbondable contractors out of the construction business or underground.

The voluntary lien bond would be coupled with a direct payment feature.[58] This would provide subcontractors and suppliers with a remedy where they are unwilling to extend credit to a prime contractor who has not obtained the lien bond. Generally, lien rights would be enforceable against the bond, but if there is no bond claims would be enforceable against the owner's property after giving a direct payment notice for amounts not yet paid by the homeowner. This

57. See Mem. 2000-78 pp. 9-10; *id.* Ex. pp. 9-13 (Gallagher).

58. See discussion of "Direct Payment" *supra*.

implementation of the direct payment approach would also make it unnecessary for subcontractors and suppliers to give preliminary 20-day notices to preserve lien rights.

While this scheme has some appeal in outline form, the Commission did not pursue it because it involved two new features: a new type of bond and a direct payment procedure. Any new bonding scheme would have to be fleshed out by the surety industry, which would also need to have the capacity to respond to demand, whether created under a voluntary bonding system or a mandatory scheme. As discussed above, the direct payment option is an intriguing, but unproven procedure. Combining these two features might entail a level of complexity that would be self-defeating. In addition, the voluntary bonding feature leaves the homeowner's protection up to market choices made by other parties whose motivations would not likely be consistent with the need for consumer protection. Existing law already permits subcontractors and suppliers to voluntarily seek bonds covering failure of the prime contractor, as well as direct payment from the owner, although these options are not widely used.

Mandatory 50% Payment Bond

A less expensive alternative to mandatory bonding for the full contract price would be to require prime contractors to obtain payment bonds in the amount of 50% of the contract price for contracts under $25,000 (or some other appropriate level). As with full bonding, the 50% bond would substitute for the lien and would provide adequate protection in almost all cases, but without the greater expense of a full bond. The 50% bond is an option under existing law, but appears to be little known and rarely used in home improvement contracts.[59] The threshold amount would be set to cover the bulk

59. See discussion in Mem. 2000-63 pp. 1-12 & Ex. pp. 1-3; Mem. 2000-63 Supp. 1 pp. 3-4 (Hunt).

of cases where experience shows there have been the most double payment problems.

By mid-2001, it appeared to the Commission that the 50% bond would be the most acceptable reform to subcontractors, suppliers, and homeowners. In September 2001, the Commission issued a tentative recommendation[60] proposing limited mandatory bonding, coupled with protection for good-faith payments, as the best balance between the interests of homeowners, subcontractors, and suppliers and the cost of the protections. This proposal required that prime contractors on home improvement contracts obtain a payment bond from a surety insurer in the amount of 50% of the contract price. The bond would protect unpaid subcontractors and suppliers, thereby relieving the homeowner from double liability. The home improvement contract would be filed with the county recorder and the payment bond would be recorded before the home improvement job commences. In essence, this proposal would make the optional procedure in Civil Code Section 3235 mandatory for home improvement contracts.

The mandatory 50% bond would not be required for contracts under $10,000, in view of the inefficiency of bonding on smaller jobs, but blanket payment bonds would be available in the smaller cases. Under the $10,000 contract level, and in any case where the prime contractor fails to obtain the required bond, the homeowner would be protected from double liability to the extent that payments were made in good faith under the contract. Subcontractors and suppliers should easily be able to determine whether the job is bonded by reference to the recorder's files or by checking with the surety company noted on the contract form.

The mechanic's lien and stop notice rights of subcontractors and suppliers would not be affected to the extent that the

60. See Tentative Recommendation on *The Double Payment Problem in Home Improvement Contracts* (Sept. 2001).

homeowner did not pay for labor, supplies, equipment, and materials. If a bond was provided, subcontractors and suppliers would also have the additional remedy of enforcement against the bond.

The Commission received extensive commentary on the tentative recommendation, most of it negative.[61] Commentators found the proposal complicated, unworkable, unfair, and costly. The anticipated consensus broke down over some of the details in the proposal that were intended to make it self-enforcing. If the mandatory 50% bond could be evaded, the intended benefit of the new scheme would be lost. In addition, there was concern about the cost of the bond, the difficulty of obtaining bonds, and the capacity of the surety industry to respond to demand — in short, all of the usual objections to mandatory bond proposals.

In view of the lack of support for this approach, and the apparent lack of any consensus on how to salvage any mandatory bond approach, the Commission abandoned efforts to perfect revisions based on bonding.

(5) Escrows and Withholding

Joint Control

The services of a joint control company are available under existing law. Contractors engaged in home improvement projects could be required to use joint control (escrow) accounts to process payments and releases. The Commission considered joint control in some detail because initially it appeared to be a promising approach. A joint control scheme should have the following features:[62]

- *Mandatory*. Use of the joint control account would have to be mandatory, or very difficult to waive, if it

61. See Mem. 2001-99 & Supp. 2.

62. For more detail, see Mem. 2000-78 pp. 3-5.

is to have its intended effect of protecting consumers. Sufficiently bonding a job (at least 50% of contract price), however, would provide a sufficient substitute remedy.

- *Threshold*. Contracts below a certain amount would not be subject to the joint control requirement because the protection would be too costly in light of the risk. A minimum contract amount such as $5,000 or $10,000 seems appropriate.
- *Prime contractor responsibility*. The prime contractor would be required to set up the joint control account with a licensed joint control agent, and would be responsible for informing subcontractors and suppliers dealing directly with the prime contractor of the joint control account. The prime contractor would also be required to inform the joint control agent of all parties contracting with the prime.
- *Subcontractor and supplier responsibility*. Parties in privity with the prime contractor would need to make sure that there is a joint control account in place. A mechanism would need to be set up so that sub-subcontractors and suppliers furnishing to subcontractors get information on the joint control account, since they would submit claims to the joint control agent.
- *Homeowner responsibility*. A joint control system would relieve much of the burden on homeowners. Payments would need to be made in a timely fashion to the joint control agent, but no other special action would be needed unless the homeowner wanted to use some other approved substitute remedy such as a bond.
- *Enforcement*. As under existing law, the duties of licensed contractors would be enforceable by CSLB, and joint control companies would be subject to regulation by the Commissioner of Corporations. But the major enforcement mechanism would be that parties wishing to be paid expeditiously would try to ensure that the joint control is in effect, and owners wishing to avoid mechanic's liens would demand assurance that payments were properly made.

Joint control agencies exist now and are used in large projects, but not in small projects. The fees should be lower if there is more volume of business. Use of escrow in real estate transactions and refinancing is presumed; it is not too big a step to apply a simple escrow system to home improvement contracts. Joint control companies are bonded, providing additional protection. The mechanism would benefit subcontractors and suppliers by making sure they get timely payment. Properly implemented, a joint control scheme would cut down on paperwork for everyone concerned.

However, all of the benefits would come at a cost that would be unattractive for jobs under $10,000-20,000, because of the threshold costs. Furthermore, it is difficult to predict how the market would respond, so fees could be higher than envisioned. There would also be enforcement issues, since contractors and owners would have an incentive to cut costs and agree to ignore the requirement. These difficulties ultimately appeared insurmountable and the Commission abandoned further consideration of joint control as an approach to addressing problems with small home improvement contracts.

Check-Writing Services

Check writing services could serve as a simplified and cheaper alternative to joint control. The idea would be to use the services of a neutral party to match releases with payments. One commentator described the concept as follows:[63]

> We would suggest a new procedure that would not require a bonded joint control company but merely a check writing service of some sort. That procedure would be to assure, to the extent possible, that there are no liens on the project. The company proposed would not need to be a joint control company. It would not need to actually hold any of the funds. What it would do is obtain appropriate

63. See Mem. 2000-37 p. 7 & Ex. p. 7 (Abdulaziz proposal).

> releases from everyone who had given preliminary notices, and before allowing an owner to make any payment, the proposed company would secure a release executed. The release would then be held by the service and a check prepared by this service would be written which would be signed by the owner. With our present state of computer technology, we believe that this type of service would be nominal in cost.

Presumably, this type of service is available now and may be available through the Internet. Check writing services should be cheaper than full-service joint control agencies, because they would not need to be bonded and would not make inspections to determine whether payment was due.

Unfortunately, if check writing services are not bonded, there is a risk that they would not be financially reliable and could abscond with the owner's money. Trying to find a cheaper substitute for responsible joint control agencies is probably a self-defeating exercise. If a new statutory procedure is to be mandated, it should significantly reduce or eliminate the risk of double liability for homeowners, as well as the parallel problem faced by subcontractors and suppliers who are not paid by defaulting prime contractors. But the cost of a service goes up as responsibility and reliability are increased and the risk is transferred.

Retainage

The retainage approach would delay payment of a percentage of the contract price (e.g. 10% or 25%) for a period such as 30 or 60 days to clear lien claims. Retention may be based on a percentage of each payment or the last 10% or so of the entire contract amount. The prime contractor would have the option of bonding as a substitute for the retainage, and thus accelerate final payment or permit full payment of all progress payments when due.[64] California has detailed statutes on "retention proceeds," progress payments, and prompt payment that would have to be revised.[65] Unless retainage were mandated, it would not address the double payment problem, which by definition arises where the owner has not retained payments. For example, in Texas, the owner is required to retain 10% of the contract price of improvements until 30 days after completion.[66] The lien claimant has a lien on the retainage by sending proper notice and filing an affidavit within 30 days after completion.[67] Early California law required 25% of the contract price to be retained.[68]

Retainage would be simple to administer from the owner's perspective (as well as that of the lender). Holding 25% of the contract price for a short period would cover many potential double payments, though not major contractor failures. Contractors who wanted to be paid in full before the retainage period expired would be able to substitute a bond or avoid retainage by setting up joint control, which would continue the protection afforded the owner. Contractors would have an incentive to make sure subcontractors and suppliers were paid so that they could get complete payment promptly.

Prime contractors object, however, that even a 10% retainage requirement would withhold an amount greater than their net profits, which are often less than 5%. This, in turn, would force them to provide credit (or defer paying subcon-

64. See Mem. 2000-26 p. 11.

65. See Civ. Code § 3060 *et seq*.; see also Bus. & Prof. Code § 7159 (home improvement contracts).

66. Tex. Prop. Code § 53.101 (Westlaw 2000).

67. *Id*. §§ 53.102, 53.103.

68. See Mem. 2000-36 p. 12.

tractors and suppliers) until final payment.[69] In other words, prime contractors would become involuntary financiers of an unacceptable portion of the project. This would force them to use bonding or joint controls, with the attendant cost to the homeowner. Retainage would also be difficult to enforce, because it involves payments the homeowner makes to the contractor, and the homeowner may not understand what to do. Homeowners could be influenced to save money by paying without the retention. In view of the enforcement difficulties and the likely objections from significant stakeholder interests, the Commission has not pursued this option as the centerpiece of a remedial scheme.

(6) Other Approaches

Consent to Lien

Since it is the homeowner's property that becomes subject to the mechanic's lien, the law could require specific consent to imposition of a mechanic's lien. Without consent, the subcontractor or supplier would not have a direct lien against the home and payment to the prime contractor would protect the homeowner.[70] This type of procedure would be more like other real property transactions, where the owner voluntarily agrees to a lien to secure a loan.

The Missouri mechanic's lien statute adopts a consent requirement for certain residential improvement contracts,[71] but it appears that one blanket consent can be obtained by the prime contractor covering all subcontractors and suppliers. An alternative would be to require each potential lien claimant to obtain a consent in response to a preliminary

69. See, e.g., Kirksey & Maute, *Moneymoneymoney: Legal and Ethical Dilemmas in the Construction Payment Process*, 16 Construction Law. 3, 4 (January 1996).

70. See Mem. 2000-26, Ex. p. 3 (Loumber).

71. Mo. Ann. Stat. § 429.013 (Westlaw 2001).

notice or other form of paper given to the homeowner by subcontractors and suppliers.

Requiring explicit consent to lien rights would potentially provide a type of privity and would help focus the homeowner's attention on the potential for double payment liability. Assuming that a blanket consent could not be used to satisfy the requirement, the consent would have some of the same potential benefits as other proposals that would encourage subcontractors and suppliers to assess their real risk and consider the creditworthiness of their customer. It would not have the disruptive potential some see in the direct payment proposal, since the flow of payments would still be through the prime contractor (unless direct payment has been arranged).

While consent requirements would work well in some cases, the Commission concluded that the consent form would often just be another piece of paper the homeowner signs without knowing its significance. For the idea to work, the relatively unsophisticated owner would need to know whether to give consent or work out some other arrangement. In addition, consent would be requested early in the process, before it could be known whether the prime contractor will make timely payments. Finally, requiring consent would add another burden on subcontractors and suppliers to get the signature of the owner and maintain another paper in the files.

Criminal Sanctions — Lien Fraud

The prime contractor's failure to pay subcontractors and suppliers, as well as the subcontractor's failure to pay sub-subcontractors and suppliers, could be criminalized.[72] It is generally recognized, however, that most cases of double payment do not involve criminal conduct, but incompetence,

72. See Mem. 2000-26, Ex. p. 4 (Loumber); Mem. 2000-78 Supp. 1, Ex. p. 3 (McSweeny).

carelessness, overextension, and other factors that lead to insolvency. Unless the criminal sanction would act as a significant deterrent, it would do nothing to aid homeowners faced with double liability where a contractor defaults.

CONCLUSION

As noted above, the Commission's proposal for addressing the double liability problem is set out in the separate Recommendation on *The Double Liability Problem in Home Improvement Contracts*.[73] Work on the remainder of the mechanic's lien law revision project will continue as Commission resources permit.

73. 31 Cal. L. Revision Comm'n Reports 281 (2001).

APPENDIX OF SOURCE MATERIALS

COMMISSION STAFF MEMORANDUMS

The following is a list of mechanic's lien memorandums (Study H-820) to date prepared by the Commission staff, some of which have been cited in this Report:[74]

Memo	*Supp*	*Title*	*Date*
99-85		Mechanic's Liens: Commencement of Study	11/16/99
99-85	1st	Mechanic's Liens: Commencement of Study (Additional Material)	11/29/99
2000-9		Mechanic's Liens	1/31/00
2000-9	1st	Mechanic's Liens: Update on HIPP Project	1/31/00
2000-9	2d	Mechanic's Liens (Materials Submitted at February 2000 Meeting)	2/11/00
2000-26		Mechanic's Liens: Issues and Other Approaches	4/04/00
2000-26	1st	Mechanic's Liens (Comments of Gordon Hunt)	4/10/00
2000-26	2d	Mechanic's Liens (Materials Submitted at April 2000 Meeting)	4/13/00
2000-36		Mechanic's Liens: Constitutional Issues	6/02/00
2000-36	1st	Mechanic's Liens: Constitutional Issues (Abdulaziz Letter)	6/15/00
2000-37		Mechanic's Liens: Draft Proposals	6/13/00
2000-37	1st	Mechanic's Liens (Letters)	6/16/00
2000-37	2d	Mechanic's Liens (Materials Submitted at June 2000 Meeting)	6/22/00
2000-47		Mechanic's Liens: Full Pay and Direct Pay Drafts	7/14/00
2000-47	1st	Mechanic's Liens (Additional Comments)	7/18/00
2000-63		Mechanic's Liens: Home Improvement Payment Bond	9/29/00
2000-63	1st	Mechanic's Liens (Commentary from Consultants)	10/02/00
2000-63	2d	Mechanic's Liens (Additional Commentary)	10/03/00
2000-78		Mechanic's Liens: Reform Proposals	12/06/00
2000-78	1st	Mechanic's Liens (General Comment Letters)	12/06/00

74. These materials are available from the Commission's website at <http://www.clrc.ca.gov/pub/Study-H-RealProperty/H820-MechanicsLiens/>.

2000-78	2d	Mechanic's Liens (Homeowner's Recovery Fund)	12/08/00
2000-78	3d	Mechanic's Liens: Homeowner's Relief Recovery Act (New Draft)	12/08/00
2000-78	4th	Mechanic's Liens (More Comment Letters)	12/13/00
2000-78	5th	Mechanic's Liens (More Comment Letters)	12/14/00
2001-18		Mechanic's Liens: Overview of Reform Proposals	1/24/01
2001-18	1st	Mechanic's Liens: Homeowner Relief Recovery Fund	1/24/01
2001-18	2d	Mechanic's Liens (Comment Letters)	1/30/01
2001-41		Mechanic's Liens: General Revision	5/10/01
2001-41	1st	Mechanic's Liens: General Revision (Comments of Gordon Hunt)	5/11/01
2001-41	2d	Mechanic's Liens: General Revision (Comments of Sam Abdulaziz & James Acret)	5/16/01
2001-52		Mechanic's Liens: Double Payment Issue	6/19/01
2001-52	1st	Mechanic's Liens: Double Payment Issue (Commentary)	6/26/01
2001-52	2d	Mechanic's Liens: Double Payment Issue (Commentary)	6/28/01
2001-53		Mechanic's Liens: General Statutory Revision	6/21/01
2001-53	1st	Mechanic's Liens: General Statutory Revision (Commentary)	6/26/01
2001-70		Mechanic's Liens: Double Payment Issue (Draft Tentative Recommendation)	9/11/01
2001-70	1st	Mechanic's Liens: Double Payment Issue (Commentary)	9/19/01
2001-71		Mechanic's Liens: General Revision	9/17/01
2001-92		Mechanic's Liens: General Revision	11/07/01
2001-92	1st	Mechanic's Liens: General Revision (Abdulaziz Comments)	11/13/01
2001-99		Mechanic's Liens: Double Payment (Comments on Tentative Recommendation)	11/21/01
2001-99	1st	Mechanic's Liens: Double Payment (CSLB Bond Report)	11/26/01
2001-99	2d	Mechanic's Liens: Double Payment (Additional Commentary)	11/29/01
2002-7		Mechanic's Liens: Double Payment Issue (Comments on Discussion Draft)	1/14/02
2002-7	1st	Mechanic's Liens: Double Payment Issue (Comments on Discussion Draft)	1/16/02

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