

Second Supplement to Memorandum 2000-26

Mechanic’s Liens (Materials Submitted at April 2000 Meeting)

The attached materials were submitted to the Commission at the April 13, 2000, meeting:

	<i>Exhibit p.</i>
1. Keith Honda, Office of Assemblyman Mike Honda, Response to Gordon Hunt Comments of April 10 (April 11, 2000)	1
2. Letter from Ellen Gallagher, Staff Counsel, Contractors State License Board (April 12, 2000)	4

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary



Assembly California Legislature

MEMBER
EDUCATION
PUBLIC EMPLOYEES RETIREMENT
AND SOCIAL SECURITY
REVENUE AND TAXATION

MIKE HONDA

ASSEMBLYMEMBER, TWENTY-THIRD DISTRICT

Memorandum

Date: April 11, 2000

To: California Law Revision Commission

From: Keith Honda, Office of Assemblymember Mike Honda

RE: **Response to Gordon Hunt Comments (dated April 10, 2000)**

This memorandum is a response to Mr. Gordon Hunt's comments (dated 04.10.2000).

Response to Section I: The Acret proposal does not eliminate mechanics' liens.

Mr. Hunt's memo inaccurately states that our office advocates the "elimination" of the constitutionally established lien right [page 1 of Hunt Comments dated 04.10.2000]. Neither our office nor Mr. Acret recommends that mechanics' liens be eliminated on single family owner-occupied dwellings. We agree that mechanics' liens serve an essential purpose by securing payment from homeowners for works of improvement.

However, the mechanic's lien law does not operate fairly and equitably in every situation. As Mr. Hunt notes in his comments, the legislature has exercised its authority in a number of these circumstances to balance the rights of lien claimants against the broader public interest.

Response to Section II: The cases cited do not prohibit the legislature from protecting homeowners.

The cases cited in Mr. Hunts comments reiterate the importance of the mechanic's lien laws in our state. We agree that that mechanic's liens are important. However, none of these cases have considered the specific question that is at issue: Can the rights of lien claimants be limited with respect to home improvement transactions?

None of the cases cited prohibit the legislature from providing additional protection for innocent homeowners. For example, the 1997 Clarke Case involved homeowners who did not pay the prime or general contractor. We agree with the holding of the court in this case. Prime contractors should not be allowed to require subcontractors to waive their lien rights. As stated earlier, where homeowners have not paid, we agree that mechanics' liens are an appropriate remedy.

Response to Section III: Existing law is consistent with the Acret Proposal.

1. Mr. Hunt concedes that rights of lien claimants are not absolute.

Mr. Hunt states that in some situations the legislature may recognize and provide "balance" against the constitutionally protected rights of lien claimants [page 6 of Hunt Comments]. Therefore, though the court cases have granted great deference to the right of a lien claimant, Mr. Hunt agrees that this right is not absolute.

2. Existing statutes substantially limit the constitutional rights of lien claimants.

Civil Code Section 3094 provides a defense to a lien where it would otherwise be unfair to strictly apply the lien law, because the owner is a "non-contracting" party. Mr. Hunt artfully argues that the lien right is not lost, but the fact remains that the owner avoids lien claims by exempting his or her property through the recording and posting of a notice of non-responsibility. [Los Banos Gravel Co. v. Freeman (1976) 130 Cal.Rptr. 180.]

Civil Code Section 3109, and 3156 provide that property owned by the public is not subject to mechanics' liens. Again, Mr. Hunt skillfully argues that lien rights are not lost, but substituted for by the alternative remedies of the stop notice and right to recover on the payment bond. However, the fact remains that public property is not subject to any liens. Home improvement contractors presently have access to the stop notice remedy, may recover on the license bond (or payment bond), AND in addition retain the right to lien the homeowner's property.

Mr. Hunt states that Business and Professions Code Section 7031 represents a "strong public" policy that all contractors and subcontractors be licensed. By establishing the requirement that all lien claimants be licensed, the legislature revoked a constitutional right from an entire class of lien claimants: those who are unlicensed. Since the constitution does not distinguish between licensed and unlicensed (it speaks broadly "of every class" of mechanic), under Mr. Hunt's reasoning, Section 7031 should be declared unconstitutional.

Conclusion: The Acret Proposal is constitutional.

Mr. Hunt's response underscores the fact that constitutional rights are not absolute and are subject to reasonable regulation by statute. The provision of a statutory defense for homeowners is no more unconstitutional than the well accepted laws that currently govern construction transactions. In each of these cases, an important public policy balances the rights of the claimants against the rights of property owners.

The legislative proposal authored by Mr. Acret is clearly within the scope of existing statutory limitations imposed on the rights of lien claimants. The legislature may enact laws to balance the rights of homeowners against the rights of lien claimants without running afoul of the constitution. Mr. Acret's proposal provides for homeowners in the same way that Civil Code Section 3109 and 3156 provide for publicly owned property. In both instances, lien claimants retain the alternative remedies of stop notices and actions against bonds.



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April 12, 2000

Mr. Stan Ulrich
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road
Room D-1
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Dear Mr. Ulrich:

Re: **Mechanics' Liens**

The Contractors State License Board (CSLB) has not yet met to discuss mechanics' liens and Assemblyman Honda's proposed recovery fund. However, CSLB staff wanted to include this proposal in the overall discussion of mechanics' liens to get feedback from interested parties. As you know, CSLB staff has been reviewing this area of law for some time. We have paid particular attention to the circumstances that cause liens and the way homeowners respond to them.

Introduction

When asked how to prevent liens, one of CSLB's Enforcement Deputies suggests paying subcontractors and material suppliers direct. Why not? A plan called Direct Pay is described below.

Background

Home Improvement Law

The law governing home improvement contracts is based on the idea that the homeowner should not pay until various phases of the work are satisfactorily completed. Except for the down-payment, it is illegal for a contractor to collect money up-front to pay for goods and services. The payment for progress scheme was adopted to reduce fraud and abandonment in the home improvement arena and to encourage homeowners to have control over their projects.

When a homeowner fails to pay a contractor for goods and services rendered under a home improvement contract, the contractor has two options. The contractor can sue the homeowner in civil court based on the property owner's breach of contract or the contractor can file a mechanics' lien.

When a contractor fails to pay a subcontractor or material supplier (hereinafter, subcontractor only), the subcontractor has two options. The subcontractor can sue the contractor in civil court based on the contractor's breach of contract, or the subcontractor can file a mechanics' lien on the homeowner's property.

There are a number of reasons a contractor might fail to pay the subcontractor.

The contractor may not have been paid by the homeowner. This is the situation where it makes sense to allow the subcontractor or material supplier to go directly against the homeowner by pursuing lien rights.

There may be a dispute about the work or material-- the work or material was defective in some way.

There may be a dispute between the contractor and the subcontractor about another job. Perhaps the contractor has already paid the subcontractor for a previous job but later decides to dispute its quality. Another variation of this occurs when a contractor is carrying an open account with a subcontractor. When the contractor pays, the payment is credited to other debt, leaving the debt that is the basis of the lien unpaid. Although these liens are removable, the homeowner still has to deal with them.

More often, however, the contractor does not pay because he or she doesn't have the money. The contractor has gotten too far ahead financially. Instead of paying the subcontractor for this job, the contractor uses the money to pay some other subcontractor or material supplier owed from a previous job. If a contractor gets too far ahead for too long, he or she will ultimately go bankrupt. CSLB's experience with contractors who go bankrupt is that long before the bankruptcy, the contractor's performance deteriorates in quality and timeliness. Delays, abandonment, poor workmanship, all accompany the contractor on the way to bankruptcy.

Direct Pay

Under a Direct Pay plan, the subcontractor and material supplier would decide whether to extend credit to the contractor. In making this decision, a subcontractor could look to his or her own records for credit information. The subcontractor could also use any one of the available credit check sources. The Internet has made this kind of information readily available.

If the subcontractor decides the contractor is not credit worthy, the subcontractor would ask for Direct Pay. Instead of providing a traditional Preliminary Notice, the subcontractor would send a Direct Pay Notice to the homeowner. The Direct Pay Notice would say something like --

Don't pay the contractor. When the contractor informs you it is time to pay for the services/material I have provided for your project, Pay Me Directly instead.

If you pay the contractor, instead of me, and the contractor fails to pay me, I will place a lien on your house. (This is modeled after the Texas lien notice statutes).

If the subcontractor has confidence in the contractor, the subcontractor could send a modified Preliminary Notice informing the homeowner that, if the contractor is not paid, the subcontractor will file a lien.

Responsibility Shifted

Right now, the homeowner's money, credit rating and, perhaps, the home itself are in the hands of the contractor and subcontractor. Direct Pay shifts responsibility out of possibly irresponsible hands and places it where it belongs. The subcontractor is responsible for the decision to extend credit. If the contractor does not have sufficient credit, the homeowner would be asked to pay direct. The homeowner is responsible for making payments directly.

The plan substitutes the complicated preliminary notice scheme with the relatively simple direct payment. The plan does not affect lien rights, constitutional or otherwise. If the contractor fails to pay the subcontractor because the homeowner fails to pay the contractor, the lien rights are still viable.

Discussion

No one will like this, at first. It is a change and, in the construction industry, change is bad. Once the transition is over, however, it may work out very well for everyone who is financially competent.

Contractors

Contractors who do a good job and have good credit will continue to be paid and to pay the people who work for them. Contractors who are working beyond their credit capacity will be restrained.¹ Contractors with bad credit will have to improve their credit if they want to take on more work. This would be good for the whole industry. In the meantime, subcontractors and material suppliers would ask to be paid directly.

Another reason contractors with poor credit won't like it is the new notice will tell the homeowner exactly the amount due to the subcontractor, exposing the mark-up attached to the subcontractor's work (and material supplier's supplies). This situation may provide a powerful incentive to quickly acquire a good credit rating.

¹The Nevada Board's step-bonding program rests on this same principle. Contractors should not take on larger jobs than their financial status can support.

Subcontractors

Subcontractors may not like it to start with. They have to take responsibility for their credit choices. If they opt for direct pay, they may risk the wrath of contractors who may prefer other subcontractors who do not assert direct pay rights. Contractors may attempt to place pressure on subcontractors not to seek direct pay. But pressure not to file mechanics' liens has already been addressed by law, surely pressure not to assert direct pay rights could be addressed as well.

Pressure on subcontractors notwithstanding, here is where the public policy comes in. When subcontractors extend unwarranted credit to a contractor, they are not risking their own money, they are risking the homeowner's money, credit and home. Subjecting homeowners to liens based on the subcontractor's poor credit decision is unfair to homeowners, particularly when the ways to prevent liens are inexplicable at best.

Homeowners

One criticism of Direct Pay is that it is too complicated for homeowners. Granted, compared to the present situation where an unwary homeowner *fails to take any steps at all* to prevent liens, Direct Pay is more complicated. The Direct Pay procedure draws the homeowner into the relationship between the subcontractor and the contractor. While the homeowner may not want this, as long as lien law exists, the homeowner will be drawn in. The question is- will we involve the homeowner *before* a lien is filed or *after*?

Of course, the homeowner is drawn in only when the contractor does not have sufficient credit.

On the other hand, if a homeowner is following the suggestions offered by law on how to prevent liens, Direct Pay is much less complicated. The following discussion of liens illustrates the complications of the present system.

Notice to Owner

The law presently requires contractors to present homeowners with a notice called the Notice to Owner. The first problem is that contractors routinely fail to present homeowner with the Notice. (One of the provisions of CSLB's Home Improvement Protection Plan (HIPP) was to attempt to strengthen penalties for failure to provide notices).

The Notice to Owner is designed to provide homeowners with information about mechanics' liens and to suggest certain ways to prevent them. The second problem is the Notice is extremely confusing and difficult to read. CSLB's HIPP proposal includes a more user friendly version of this notice, called Mechanics' Lien Warning. CSLB staff acknowledge, however, that the user friendly version is still awfully complicated. The Notice describes four approaches to lien prevention-- signed releases, joint control accounts, joint checks and payment and performance bonds. Frankly speaking, the Notice is so intimidating that it is this author's belief that the few homeowners who actually read the Notice are not illumined by it.

Signed Release

The Notice suggests that consumers should protect themselves from mechanic's liens by getting signed releases. The Preliminary Notice (the notice designed to inform the property owner of the possibility of liens) (not the Notice to Owner or the Notice to Property Owner) also stresses this approach.

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

- The homeowner must make clear to the contractor that he or she will not pay unless releases are provided. Business people working in the commercial trades do not hesitate to request releases. However, the few homeowners who know about mechanics' liens are reluctant assert their right to lien releases. Contractors, subtly and not so subtly, lead homeowners to believe among other things that releases will hold up the job, are not really necessary and signal that the homeowner doesn't trust the contractor. The homeowner fears the contractor will "take it personally." A homeowner's reluctance to challenge the contractor is understandable. Bluntly put, "When the house is tore up and you're already behind schedule, the last thing you want is your contractor mad at you."
- The releases work as follows: When the contractor presents the homeowner with a bill for a scheduled payment that includes the work of the subcontractor, the contractor must also provide a release signed by the subcontractor. Unfortunately, this release is really a conditional release. It is not effective unless the subcontractor is, in fact, paid. Once the subcontractor is paid, the subcontractor is supposed to provide the contractor with an unconditional release². The unconditional release is rarely supplied even when the contractor is routinely paying the subcontractors.
- There are a number of pitfalls for homeowners that arise out of the way lien notice law has been formulated. First, the Preliminary Notice describes a release but does not distinguish a conditional from an unconditional release. Second, the Preliminary Notice simply refers to a release, not a release by a subcontractor or material supplier. This misleads homeowners into thinking that a release by the contractor is sufficient. Third, business people working in commercial construction understand that there is only one Preliminary Notice no matter how many services are provided or goods delivered. Homeowners don't understand this. Homeowners do not understand that a release through January 1, 200X does not cover work done or services provided after January 1, 200X, although there will be no additional Preliminary Notice. Finally, the Preliminary Notice can be presented to the homeowner after the work is done and the contractor has already been paid. Other than that, it works pretty good.

There are three other suggested approaches: Joint Control Accounts, Payment and Performance Bonds, and Joint Checks.

²There is some messiness concerning when an unconditional release is actually only a conditional release that are addressed by lien experts contributing to this dialogue. This will not be addressed here.

Joint Control Accounts

Under a joint control account, a third party is hired to make appropriate payments as the work progresses. The joint control agent may pay the subcontractors and material suppliers directly or may track payments by the contractor through the conditional/ unconditional release format. The cost to the homeowner for using this service is said to be between 3% and 5% of the contract.

This option is selected when a bank is specifically financing a home improvement project. Under this scheme, the home improvement is financed in line with the home's equity *after* the remodel is complete. To make sure the bank is not left with a loan exceeding the home's value, the bank insists that a joint control account be used. The bank charges the homeowner for the cost of the joint control.

This option is almost never chosen by homeowners. A homeowner with sufficient sophistication to understand the risks of liens, often believes he or she is sophisticated enough to personally keep track of the project by making sure all subcontractors and material suppliers are paid.

Payment and Performance Bonds

These bonds cover both the risk of liens through non-payment and the dangers of poor performance. Except for blanket bonds available to the very large contractors like Home Depot and Sears, these bonds are rarely available to contractors working in the home improvement sector.

Even if the bond was restricted to guaranteeing payment, industry maintains that most contractors would fail to qualify.

Thus, unless some kind of step bonding approach was devised, requiring these bonds would probably result in closing the home improvement market to small contractors.

In some ways, Direct Pay addresses the same issues as a payment bond. However, instead of allowing the contractor to be given control of the homeowner's money and using a bond to cover the situation where the contractor fails to pay, the homeowner holds the money and pays direct.

Joint Checks

Of the solutions presently suggested, joint checks is by far the simplest. When the contractor presents a bill for the subcontractor's work, the homeowner writes a joint check. There are a number of problems with this approach. First, like all the other suggestions, the homeowner rarely knows about the problem. Contractors fail to give the notice. If the notice is given it is in with all the contract gobbledegook and homeowners don't read it. If they read the notice, it provides so many suggestions that it is hard to wade through. If the homeowner focuses on joint checks, the problems of intimidation described above start in with special emphasis on the idea that the joint check will just hold things up.

Direct Pay Loose Ends

While Direct Pay is considerably less complicated than the conditional/unconditional procedures suggested by the present Notice to Owner, homeowners still must pay attention. If the homeowner gets a direct pay notice, he or she must directly pay or risk a lien if the contractor fails to pay. The plus for homeowners is that this plan is much more understandable than present lien notices. It says: Wait. Don't pay the contractor. When the contractor presents the bill for my services, pay me directly.

Direct Pay also keeps the homeowner out of situations where the homeowner has paid but the contractor has a dispute about some other job with the subcontractor. On the other side of the spectrum, Direct Pay also keeps the homeowner out of situations where the subcontractor files a lien based on a dispute with the contractor about some other job. While these liens are not difficult to remove, they are frustrating and scary for homeowners, and often require the services of an attorney.

There is incidental plus. The Direct Pay plan focuses the homeowner on what has been done and when. It forces everyone to look at the schedule of payments and follow the strategy built into the home improvement law -- *Do not let the money get ahead of the work. Make sure the subcontractors and suppliers are paid.* Keeping performance ahead of money greatly decreases loss from contractor bankruptcy and abandonment as well as liens.

Secondary Subcontractor

The situation is a little less straight forward when a subcontractor hires another subcontractor or material supplier. The best solution is to adopt the same strategy. The secondary subcontractor or material supplier decides the hiring subcontractor is good for the money or sends the direct pay notice.

Timing

We should also include a provision that prohibits a contractor from taking payment before 21 days (the days needed for a homeowner to receive a direct pay notice).

I know this description is very rough. I present it only to round out the mechanics' lien discussion. Thank you for the opportunity to participate in this process. If you have any questions, please call me at 916-255-4116.

Sincerely yours,



Ellen Gallagher, Staff Counsel
Contractors State License Board