

Memorandum 2007-8

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

This supplement continues the staff's analysis of public comments on the private works portion of the Commission's tentative recommendation on *Mechanics Lien Law* (June 2006). This memorandum will address comments received relating to the stop payment notice remedy in a private work of improvement.

The comments analyzed in this memorandum are attached as an Exhibit to CLRC Memorandum 2006-39, which was presented at the October 2006 meeting.

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

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

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

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

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

STOP PAYMENT NOTICE ISSUES

A stop payment notice (known as a “stop notice” under existing law) is one of three primary mechanics lien remedies, along with a mechanics lien claim and a claim against a payment bond.

A stop payment notice is a notice given by a claimant to the holder of a construction fund (usually a construction lender, occasionally an owner), demanding that funds corresponding to work provided by the claimant be withheld from distribution. The notice serves to reserve a portion of the construction fund as compensation for the claimant, in the event the claimant is not otherwise paid.

Who May Give a Stop Payment Notice

Provisions in the proposed law relating to who may give a stop payment notice provide as follows:

§ 7500. Stop payment notice exclusive remedy to reach construction funds

7500. (a) A person may not assert a legal or equitable right in a fund for payment of construction costs, other than a right created by direct written contract between the person and the holder of the fund, except as provided in this chapter.

(b) This chapter provides the exclusive remedy of a person that provides work against a fund for payment of construction costs.

Comment. Section 7500 restates former Section 3264, but is limited to a private work.

....

§ 7520. Stop payment notice to owner

7520. (a) A person that has a lien right under Chapter 4 (commencing with Section 7400), other than a direct contractor, may give the owner a stop payment notice.

(b)

Comment. Section 7520 restates former Section 3158.

....

§ 7530. Stop payment notice to construction lender

7530. (a) A person that has a lien right under Chapter 4 (commencing with Section 7400) may give a construction lender a stop payment notice.

(b)

Comment. Subdivision (a) of Section 7530 restates a portion of the first sentence of former Section 3159 without substantive change.

....

Authorizing Surety to Give Stop Payment Notice

The American Insurance Association, National Association of Surety Bond Producers, and Surety & Fidelity Association of America (hereinafter “joint surety commenters”) correctly read these sections as providing that only a claimant (i.e., a person that has provided work on a work of improvement) may give a stop payment notice.

The joint surety commenters then urge that a surety on a payment bond that has been recorded on a construction project — who thus becomes responsible for the payment obligations of a contractor on a job — should also be authorized to give a stop payment notice. Exhibit to CLRC Memorandum 2006-39, p. 98.

A surety on a payment bond recorded on a project has a reasonable interest in making certain that construction funds are disbursed in a manner assuring payment to all claimants. Otherwise, the chance that the surety will have to pay claims against the payment bond increases.

However, the change the joint surety commenters advocate would be a significant change in existing law. See Sections 3158, 3159. If sureties were granted blanket authority to give a stop payment notice, such notices might become routine. A surety might use the remedy in order to have a hand in managing the distribution of construction funds. Since a surety does not provide work on a project, what dollar amount would be permitted in the surety’s stop payment notice? For whose benefit would the funds be held? It is unclear how the proposed change would be implemented or how it would effect existing practice.

While the staff recognizes a legitimate desire on the part of sureties to protect against unnecessary claims against a payment bond, **the staff does not recommend that a surety be given the authority to give a stop payment.** The change is too substantive a deviation from existing law to make in this study.

Interference with Other Surety Rights

The joint surety commenters also assert that, at minimum, Section 7500 should not prevent a surety from exercising any right it may have to compel

funds to be held in order to pay contract obligations. Exhibit to CLRC Memorandum 2006-39, pp. 98-99.

Under both existing law and proposed Section 7500(a), a surety is expressly *not* prevented from exercising any contractual right it may have relating to a construction fund, to the extent it has been able to secure such right pursuant to a direct contract with the fund holder. Beyond such contractual rights, it is not clear what other right the joint surety commenters seek to protect, or whether the exercise of any such right would be precluded by Section 7500.

The staff has requested clarification of the group's comment, and will further analyze the comment in a supplemental memorandum.

Content of Stop Payment Notice

Proposed Section 7502 sets forth what may be included in a stop payment notice:

7502. (a) A stop payment notice shall comply with the requirements of Section 7102, and shall be signed and verified by the claimant.

(b) The claimant may include in a stop payment notice an amount due as a result of rescission, abandonment, or breach of the contract. If there is a rescission, abandonment, or breach of the contract, the amount of the stop payment notice may not exceed the reasonable value of the work provided by the claimant.

Comment. Subdivision (a) supersedes subdivisions (a)-(d) of former Section 3103. This section does not preclude the claimant from including in a stop payment notice an amount due for work provided pursuant to a contract change. See Section 7006 ("contract" defined).

Subdivision (b) applies provisions applicable to a claim of lien to the stop payment notice. Cf. Section 7430 (amount of lien).

....

The Association of California Surety Companies objects to subdivision (b) of this section, to the extent it allows a stop payment notice to include traditional contract damages. Exhibit to CLRC Memorandum 2006-39, p. 119. California State University (hereinafter "CSU") concurs in this objection. Exhibit to CLRC Memorandum 2006-39, p. 102.

The Commission has already considered and resolved the same issue as raised in a parallel context (proposed Section 7430, relating to the content of a mechanics lien). See discussion in CLRC Memorandum 2006-48, pp. 60-61.

In both sections, the language is not intended to allow a claimant to include traditional contract damages, such as consequential or delay damages. Rather, the language is intended only to protect a claimant's right with respect to additional *work provided* as the result of a rescission, abandonment, or breach of a contract (as distinguished from work provided under the terms of the contract). See *Basic Modular Facilities, Inc. v. Ehsanipour*, 70 Cal. App. 4th 1480, 83 Cal. Rptr. 2d 462 (1999). An example might be costs incurred to winterize a construction site due to delays resulting from a breach of contract.

The staff recommends **that Section 7502 be revised in the same manner as Section 7430:**

7502. (a) A stop payment notice shall comply with the requirements of Section 7102, and shall be signed and verified by the claimant.

(b) The claimant may include in a stop payment notice an amount due for work performed as a result of rescission, abandonment, or breach of the contract. If there is a rescission, abandonment, or breach of the contract, the amount of the stop payment notice may not exceed the reasonable value of the work provided by the claimant.

Stop Payment Notice to Construction Lender

Proposed Section 7506(b) provides a specific rule for how a stop payment notice must be given to a construction lender:

7506. (a)

(b) A stop payment notice to a construction lender holding construction funds shall be given to the manager or other responsible officer or person at the office or branch of the lender administering or holding the construction funds.

....

Comment. Subdivisions (a) and (b) of Section 7506 restate a portion of the second paragraph of former Section 3103 and the last two sentences of former Section 3083.

....

The Association of California Surety Companies objects to subdivision (b) of this section, for two reasons. Exhibit to CLRC Memorandum 2006-39, p. 119.

First, the Association contends that most national banks that serve as construction lenders administer construction funds from an out-of-state office "somewhere in the bowels of the bank," not open to the general public. As a practical matter, it may be difficult to find the name and address of that person.

Consequently, the Association argues that the voiding of a stop payment notice due to noncompliance with subdivision (b) would be “draconian.”

However, subdivision (b) is existing law and may be important in practice. Time is of the essence when a stop payment notice is given. Not only could a failure to timely withhold funds potentially expose a lender to liability, but a claimant is permitted to commence litigation to enforce a stop payment notice within 10 days of its mailing. See proposed Sections 7104, 7550.

It may be that we can find a compromise that would improve the law for all of the parties, but we should not make any change without knowing how it would affect construction lenders. The staff has asked the California Bankers Association for input on the issue, but has not yet received a response.

The Association also argues that subdivision (b) is inconsistent with a provision in proposed Section 7106, one of the proposed law’s general notice provisions. Section 7106 provides that notice to a construction lender may be given at the lender’s home or business address, or at the address shown on the construction loan agreement or construction trust deed.

Section 7106 is a default provision. It should not control over other specific notice requirements. **The staff will revise Section 7106 to make that clear.**

Stop Notice Release Bonds

Proposed Section 7510 allows a person to release funds that are withheld pursuant to a stop payment notice, on providing a release bond:

7510. (a) A person may obtain release of funds withheld pursuant to a stop payment notice by giving the person withholding the funds a release bond.

(b) A release bond shall be given by an admitted surety insurer and shall be conditioned for payment of any amount the claimant recovers on the claim, together with costs of suit awarded in the action. The bond shall be in an amount equal to 125 percent of the amount claimed in the stop payment notice.

(c) On receipt of a release bond, the person withholding funds pursuant to the stop payment notice shall release them.

Comment. Section 7510 restates former Section 3171 but eliminates the restrictions on the persons and the conditions under which a release bond may be given.

The Association of California Surety Companies points out that certain language in existing law (noted below in bold) has been omitted from Section 7510, and urges its reinsertion. Exhibit to CLRC Memorandum 2006-39, p. 120.

Civil Code Section 3171, the source of proposed Section 7510, provides:

3171. If the owner, construction lender or any original contractor or subcontractor disputes the correctness or validity of any stop notice or bonded stop notice, he may file with the person upon whom such notice was served a bond executed by good and sufficient sureties in a penal sum equal to 1 1/4 times the amount stated in such notice, conditioned for the payment of any sum **not exceeding the penal obligation of the bond** which the claimant may recover on the claim, together with his costs of suit in the action, if he recovers therein.

A further word about stop payment notice enforcement procedure may be helpful here. After a claimant gives a stop payment notice, the claimant will normally either be paid by the claimant's customer and will release the notice, or the claimant will bring an enforcement action against the holder of the fund, seeking an order compelling payment from the fund. However, if after a stop payment notice is given another person posts a stop payment release bond, a recovery in the enforcement action would then normally be ordered against the surety and principal on the furnished release bond.

The language the Association wants reinserted in Section 7510 limits a claimant's recovery on the bond in this latter situation to the "penal obligation" of the posted release bond (i.e., the bond amount). If this language is not included in Section 7510 (particularly given that the language would have been deleted from existing law), an argument might be made that in this enforcement action the surety and principal would be personally liable for the full amount of the claimant's recovery, even if the recovery exceeded the penal amount of the release bond.

Both existing law and proposed Section 7510 require the penal amount of the bond to be 125 percent of the amount stated in the claimant's stop payment notice. Thus, in most cases a claimant's recovery in an enforcement action would be less than the amount of the bond, and the omitted language would be superfluous.

However, under both existing and proposed law, recovery in the enforcement action is allowed for certain items over and above the amount stated in the stop payment notice. These items include litigation costs, attorney's fees, and interest. See Sections 3171, 3176, 3176.5 (proposed Sections 7510, 7558, 7560). With those amounts included, the total recovery might exceed 125% of the amount claimed

in the notice. Without the penal obligation limitation language, that could arguably result in liability for the surety beyond the amount of the bond.

It wasn't our intention to make a substantive change to that effect. The staff recommends that **Section 7510 be revised to reinsert the language omitted from existing law:**

§ 7510. Release bond

7510.

(b) A release bond shall be given by an admitted surety insurer and shall be conditioned for payment of any amount not exceeding the penal obligation of the bond that the claimant recovers on the claim, together with costs of suit awarded in the action. The bond shall be in an amount equal to 125 percent of the amount claimed in the stop payment notice.

....

Stop Payment Notice to Owner

Proposed Section 7520 relates to a stop payment notice given to an owner:

7520. (a) A person that has a lien right under Chapter 4 (commencing with Section 7400), other than a direct contractor, may give the owner a stop payment notice.

(b) The owner may give notice demanding that a person that has a lien right under Chapter 4 (commencing with Section 7400) give the owner a stop payment notice. The notice given by the owner shall comply with the requirements of Article 4 (commencing with Section 7100). If the person fails to give the owner a bonded or unbonded stop payment notice, the person forfeits the right to a lien under Chapter 4 (commencing with Section 7400).

....

Comment. Section 7520 restates former Section 3158.

....

There are three issues relating to subdivision (b).

Utility of Provision

Mr. Howard Brown, an attorney from Manhattan Beach with extensive mechanics lien law experience, does not see the need for subdivision (b) of this section, which allows an owner to proactively *demand* a stop payment notice. Exhibit to CLRC Memorandum 2006-39, p. 42. He agrees that the provision is part of existing law, but is not aware of it ever being used.

Mr. Brown may be correct that the provision is little used. However, the staff can see a useful purpose for the provision. It provides an owner a reasonable opportunity to identify and head off a potential lien claim, by demanding that a claimant identify the amount due for respective work while there are still funds available to pay for it.

Unless the provision is causing problems, **the staff would preserve it.**

Application to Direct Contractor

There may be an inconsistency between subdivisions (a) and (b) of this section, or at least a basis for confusion.

Subdivision (a) provides that a claimant that is a direct contractor may not give an owner a stop payment notice. However, subdivision (b) provides that an owner may affirmatively demand that any claimant give the owner a stop payment notice, or forfeit lien rights. If an owner demands that a direct contractor give a notice under subdivision (b), does that demand supersede the bar of subdivision (a)? Can an owner give a direct contractor a demand for a notice under subdivision (b)? The same questions arise under existing law.

One treatise indicates that a direct contractor must comply with an owner's demand under subdivision (b), but no supporting authority is cited. See Hunt, California Mechanics' Liens and Related Construction Remedies § 7.37, at 498-499 (3d ed. 2006).

The staff **solicits input on this issue from practitioners.** Considering that failure to provide the stop payment notice on demand results in forfeiture of lien rights, the meaning of the provision should be made clearer.

The provision could be revised in accord with Mr. Hunt's reading of the existing law, as follows:

7520. (a) A person that has a lien right under Chapter 4 (commencing with Section 7400), other than a direct contractor, may give the owner a stop payment notice.

(b) The owner may give notice demanding that a person that has a lien right under Chapter 4 (commencing with Section 7400), including a direct contractor, give the owner a stop payment notice. The notice given by the owner shall comply with the requirements of Article 4 (commencing with Section 7100). If the person fails to give the owner a bonded or unbonded stop payment notice, the person forfeits the right to a lien under Chapter 4 (commencing with Section 7400).

Timing

Sam K. Abdulaziz, an attorney with Abdulaziz, Grossbart & Rudman in North Hollywood, inquires as to the time frame in which a claimant may give a stop payment notice. Exhibit to CLRC Memorandum 2006-39, p. 18.

Proposed Section 7508 is the only section in the proposed law that addresses the timing issue:

§ 7508. Requirements for valid stop payment notice

7508. A stop payment notice is not valid unless both of the following conditions are satisfied:

- (a) The claimant gave preliminary notice to the extent required by Chapter 2 (commencing with Section 7200).
- (b) The claimant gave the stop payment notice before expiration of the time within which a claim of lien must be recorded under Chapter 4 (commencing with Section 7400).

Comment. Section 7508 restates former Section 3160 and a portion of the first sentence of former Section 3159 without substantive change.

Subdivision (b) clearly specifies the *last* date that a claimant may give a stop payment notice, but does not expressly limit the *first* date that the notice may be given. The staff is informed that practitioners do not all agree on whether such a limit exists.

In light of this absence of consensus, the staff recommends that **the proposed law simply continue the relevant provisions of existing law, and add no new provision relating to when a stop payment notice may first be given.**

Stop Payment Notice to Construction Lender

Proposed Section 7530 relates to a stop payment notice given to a construction lender:

7530. (a) A person that has a lien right under Chapter 4 (commencing with Section 7400) may give a construction lender a stop payment notice.

(b) If the person that gives a construction lender a stop payment notice is a claimant other than a direct contractor, the notice may only be given for work provided by the claimant.

Comment. Subdivision (a) of Section 7530 restates a portion of the first sentence of former Section 3159 without substantive change. See also Sections 7042 ("stop payment notice" defined), 7508 (requirements for valid stop payment notice).

For provisions governing the amount withheld where the person giving a stop payment notice is a direct contractor or subcontractor and there is a claim of another subcontractor or material supplier, see Section 7542 (amount withheld).

See also Sections 7002 ("claimant" defined), 7004 ("construction lender" defined), 7012 ("direct contractor" defined), 7024 ("lien" defined), 7032 ("person" defined), Section 7045 ("work" defined).

There are two issues that relate to the language in subdivision (b). They are discussed below.

Non-Work Claims

Mr. Brown believes that Section 7530(b) could be read to imply that a stop payment notice given by a direct contractor can include claims for things *other* than work provided (such as breach of contract damages, delay damages, etc.). Exhibit to CLRC Memorandum 2006-39, p. 42.

Such a reading of section 7530 would be a significant change from existing law, and was not intended by the Commission. Existing Section 3159(a)(3) provides that a stop payment notice given to a construction lender "may only be given for materials, equipment, or services furnished, or labor performed."

The staff is not certain of the origin of the clause in subdivision (b) distinguishing between a direct contractor's stop payment notice and all others, or what purpose the clause serves. The staff will look into this issue further, and will update the Commission if it learns more.

The staff also notes that the proposed law currently contains no provision limiting a stop payment notice given to an *owner* to work provided by the claimant (as contrasted with contractual or other damages). Although existing law does not expressly state that limitation, authorities seem to suggest that is existing law.

Assuming that existing law limits *any* stop payment notice to work provided, whether the notice is given to a lender or an owner, the limitation would be better placed in an introductory section relating to stop payment notices in general. **Such a provision could be added to Section 7502, resulting in the following revision to Sections 7502 and 7530:**

§ 7502. Contents of stop payment notice

7502. (a) A stop payment notice shall comply with the requirements of Section 7102, and shall be signed and verified by the claimant.

(b) The notice may only be given for the amount due the claimant for work provided.
(c)

§ 7530 (Stop payment notice to construction lender)

7530. (a) A person that has a lien right under Chapter 4 (commencing with Section 7400) may give a construction lender a stop payment notice.

~~(b) If the person that gives a construction lender a stop payment notice is a claimant other than a direct contractor, the notice may only be given for work provided by the claimant.~~

 **Future Work Under Contract**

This proposed revision would not resolve another more significant issue that apparently has not yet been considered by the Commission. Existing law is unclear on whether the claim included in a stop payment notice is limited to work *already provided* by a claimant, or whether it may also include work that is *to be provided* pursuant to contract.

Existing Section 3103 requires that a stop payment notice state the work "furnished" or "*agreed to be furnished*":

3103. "Stop notice" means a written notice, signed and verified by the claimant or his or her agent, stating in general terms all of the following:

- (a) The kind of labor, services, equipment, or materials furnished or **agreed to be furnished** by such claimant.
- (b) The name of the person to or for whom the same was done or furnished.
- (c) The amount in value, as near as may be, of that already done or furnished and **of the whole agreed to be done or furnished**.
- (d) The name and address of the claimant.

....

On the other hand, Section 3159 contains the statement "The notice may only be given for materials, equipment, or services furnished, or labor performed." Section 3159(a)(3).

Section 3159 is a lengthy section addressing several subjects relating to the duties of a construction lender upon receipt of a stop payment notice. Due to the section's length, the contextual meaning of the statement above — if different from the plain meaning of the words used — is difficult to determine, as the statement appears in Section 3159 at the end of a subdivision relating to an entirely different subject.

The language from Section 3159 that is quoted above was cited, in dicta, in *Romak Iron Works v. Prudential Ins. Co.*, 104 Cal. App. 3d 767, 778, 163 Cal.Rptr. 869 (1980) as authority for the proposition that a stop payment notice may only be given for work *already* performed. The *Romak* court did not address or analyze the apparently inconsistent language in Section 3103. Nor did it discuss whether Section 3159 governs notice given to an owner (as opposed to a construction lender).

The staff does not know if a consensus exists among practitioners as to whether a stop payment notice may include a claim for future work. **The staff solicits input on the point from practitioners.** It may be that there is no consensus on the issue. The stop notice remedy is apparently rarely used and an intention to include future work in a claim may be rarer still.

If there is no clear industry practice on the issue, we will need to decide the matter based on questions of policy. We cannot defer resolving the issue by simply continuing existing law, because existing law appears to be contradictory.

There are good reasons to allow a stop payment notice to include future work. A claimant who has been unpaid for already completed work may reasonably expect that future work might also be unpaid. If a stop notice can only include completed work, the claimant must decide whether to keep working in the hopes of getting paid for future work. Without a way to protect against future unpaid work, the claimant may decide to leave the job.

If the claimant continues to work, the claimant could continue to give periodic stop payment notices, as various bits of work are completed. However, at some point there may be no funds left, at which point the notice will have no effect. See discussion and cases cited in 5 Miller & Starr, California Real Estate § 28:85, at 270-271 (3d ed. 2001, supplemented in 2006). If the stop payment notice can include future work, then only a single notice need be given, and the claimant can continue working with confidence that payment will eventually be made.

On the other hand, a stop payment notice is a fairly disruptive remedy, as it freezes funds that are required to make progress on the job. If the scope of work that can be claimed in the notice is expanded to include future work, it is more likely that stop payment notices might create operational problems (by locking up a larger share of the fund than would otherwise be the case).

What's more, the value of future work is necessarily speculative. Claims for future work may be inflated, increasing the risk that stop payment notices will tie up project funds to a problematic extent.

Once the Commission has heard from practitioners, and determined whether there is a prevailing practice, it should decide whether a stop payment notice may or may not include future work to be performed pursuant to contract. The staff will revise the proposed law accordingly.



Bonded Stop Payment Notice

A stop payment notice given to a construction lender may be accompanied by a bond. If the notice is not bonded, the lender is not obligated to withhold the amount specified in the notice. Proposed Section 7536.

The requirements for the bond are set forth in proposed Section 7532:

7532. A claimant may give a construction lender a stop payment notice accompanied by a bond in an amount equal to 125 percent of the amount of the claim. The bond shall be conditioned that if the defendant recovers judgment in an action to enforce payment of the claim stated in the stop payment notice or to enforce a claim of lien recorded by the claimant, the claimant will pay all costs that are awarded the owner, direct contractor, or construction lender, and all damages to the owner, direct contractor, or construction lender that result from the stop payment notice or recordation of the claim of lien, not exceeding the amount of the bond.

Comment. Section 7532 restates the first sentence of former Section 3083 without substantive change.

....

The joint surety commenters would like it to be clearer that "the bond will never be responsible for an amount greater than the penal limit listed on the bond." Exhibit to CLRC Memorandum 2006-39, p. 99.

The staff believes that is the intent of Section 7532, which restates the substance of existing Section 3083.

However, before recommending a possible revision to Section 7532, **the staff seeks clarification from practitioners as to another aspect of Section 3083, which provides as follows:**

3083. "Bonded stop notice" means a stop notice, given to any construction lender, accompanied by a bond with good and sufficient sureties in a penal sum equal to 1 1/4 times the amount of such claim conditioned that if the defendant recovers judgment in an action brought on such verified claim or on the lien filed by

the claimant, the claimant will pay all costs that may be awarded against the owner, original contractor, construction lender, or any of them, and all damages that such owner, original contractor, or construction lender may sustain by reason of the equitable garnishment effected by the claim or by reason of the lien, not exceeding the sum specified in the bond.

Is this section intended to operate — or has it been interpreted to operate — as a limitation only on the amount that may be recovered by a defendant *on the bond* (i.e., a limitation on the surety's exposure), or as a limitation on the *claimant's* exposure? In other words, if a defendant's costs and damages in an action defending against a stop payment notice claim exceed the amount of the bond posted by the claimant, is the claimant personally liable for the excess?

The staff will revisit this issue at a future time, once this question is resolved.

Construction Lender's Objection to Bond

Proposed Section 7534 provides that a construction lender can object to the surety on the bond that accompanies a bonded stop payment notice:

7534. (a) A construction lender that objects to the sufficiency of sureties on the bond given with a bonded stop payment notice shall give notice to the claimant of the objection within 20 days after the bonded stop payment notice is given. The notice shall comply with the requirements of Article 4 (commencing with Section 7100).

(b) The claimant may within 10 days after notice of the objection is given substitute for the initial bond a bond executed by an admitted surety insurer. If the claimant does not substitute a bond executed by an admitted surety insurer, the construction lender may disregard the bonded stop payment notice and release all funds withheld in response to that notice.

Comment. Section 7534 restates former Section 3163 without substantive change. Cf. Section 7100 (written notice); Code Civ. Proc. § 995.120 ("admitted surety insurer" defined).

....

This section implies that, in the absence of an objection by the construction lender, a bond accompanying a bonded stop payment notice may be obtained from a surety that is *not* an "admitted surety insurer." (An "admitted surety insurer" is a surety issued a certificate of authority by the Insurance Commissioner. See Code Civ. Proc. § 995.120.)

The joint surety commenters suggest that the proposed law should require all bonds referenced in the proposed law, including the bond accompanying a stop

payment notice, to be obtained from an admitted surety insurer. Exhibit to CLRC Memorandum 2006-39, pp. 88-89. They note that bonds on all public projects must be obtained from admitted surety insurers (Code Civ. Proc. § 995.311) and argue that “regulatory oversight of sureties is sound public policy and protective of public owner and taxpayer interests.”

The joint surety commenters’ rationale for their suggested change has some merit. However, the change proposed would be a substantial one, as existing law provides for several bonds that need not be obtained from an admitted surety insurer.

The suggested change could also have significant unintended consequences. For example, an admitted surety insurer is likely to charge a higher premium than a non-admitted insurer for a bond of the same bond amount. That increased cost might make the bonded stop payment remedy impractical for some claimants who could afford the remedy under using an unadmitted surety.

The staff seeks input from practitioners as to the effect and advisability of the suggested change. In the absence of a consensus support for the change, however, **the staff does not recommend adopting the change in the context of this study.**

Mr. Brown notes that Section 7534 does not specify any procedure for resolving an objection by the lender to the sufficiency of the sureties on the bond. Exhibit to CLRC Memorandum 2006-39, pp. 42-43. He suggests that the section specify a particular method by which a lender can object.

The staff does not read the section as requiring a “resolution” of the lender’s objection to the surety. Rather, the section appears to give the lender a unilateral right to reject any surety that is not an admitted surety insurer, simply by giving the claimant notice of an objection. Further, the Commission’s recent addition to this section, referencing the general notice provisions of the proposed law, would appear to sufficiently identify the manner in which the lender must object.

The staff does not recommend any further revision to Section 7534 in response to Mr. Brown’s comment.



Duty of Construction Lender

Proposed Section 7536 provides (with emphasis added):

7536. (a) Except as provided in subdivision (b), on receipt of a stop payment notice a construction lender shall withhold from the borrower or other person to which the lender or the owner is

obligated to make payments or advancement out of the construction fund sufficient funds to pay the claim.

(b) The construction lender may, at its option, elect not to withhold funds in any of the following circumstances:

(1) The stop payment notice is unbonded.

(2) A payment bond is recorded before the lender is given the first stop payment notice. **This paragraph does not apply to a bonded stop payment notice given by a direct contractor.**

Comment. Section 7536 restates paragraphs (1) and (2) of subdivision (a) of former Section 3159, and subdivision (a)(1)-(2) of former Section 3162.

Mr. Abdulaziz finds subdivision (b)(2) to be confusing. Exhibit to CLRC Memorandum 2006-39, p. 18. He suggests the last sentence of the subdivision should instead read, "However, regardless of the recording of a payment bond, the construction lender shall withhold sufficient funds to pay the claim of a direct contractor who serves the construction lender with a bonded stop notice."

If the Commission agrees that subdivision (b) is unclear, the staff recommends the following clarifying changes:

7536. (a) Except as provided in subdivision (b), on receipt of a stop payment notice a construction lender shall withhold from the borrower or other person to which the lender or the owner is obligated to make payments or advancement out of the construction fund sufficient funds to pay the claim.

(b) The construction lender may, at its option, elect not to withhold funds in any of the following circumstances:

(1) The stop payment notice is unbonded.

(2) A The stop payment notice is given, by a claimant other than a direct contractor, and a payment bond is recorded before the lender is given the first any stop payment notice. This paragraph does not apply to a bonded stop payment notice given by a direct contractor.

The staff also questions whether any valid purpose is served by limiting the exception in subdivision (b)(2) to cases where the bond is received before any stop payment notice is given. If the policy of the section is to encourage owners to obtain a payment bond (thereby providing claimants with an alternative source of payment), why not allow the owner to provide this alternative remedy at any time?

Mr. Brown questions whether a borrower would have standing under the proposed law to object to a lender's election to withhold under subdivision (b). Exhibit to CLRC Memorandum 2006-39, p. 43. Consistent with existing law, the proposed law does not provide such a remedy.

Distribution of Funds Withheld

Proposed Section 7540 specifies how funds withheld pursuant to multiple stop payment notices are to eventually be distributed:

7540. (a) Funds withheld pursuant to a stop payment notice shall be distributed in the following order of priority:

(1) First, to pay claims of persons that have given a bonded stop payment notice. If funds are insufficient to pay the claims of those persons in full, the funds shall be distributed pro rata among the claimants in the ratio that the claim of each bears to the aggregate of all claims for which a bonded stop payment notice is given.

(2) Second, to pay claims of persons that have given an unbonded stop payment notice. If funds are insufficient to pay the claims of those persons in full, the funds shall be distributed among the claimants in the ratio that the claim of each bears to the aggregate of all claims for which an unbonded stop payment notice is given.

(b) Pro rata distribution under this section shall be made among the persons entitled to share in the distribution without regard to the order in which the person has given a stop payment notice or commenced an enforcement action.

Comment. Section 7540 restates former Section 3167 without substantive change. Only valid claims, as determined in an enforcement action, are entitled to participate in the distribution. *Cf. Idaho Lumber Co. v. Northwestern S. & L. Ass'n*, 265 Cal. App. 2d 490, 71 Cal. Rptr. 422 (1968). The amount of the claim for which payment is required is determined under Article 5 (commencing with Section 7550) (enforcement of stop payment notice).

...

Mr. Brown asks a number of questions about this section. Exhibit to CLRC Memorandum 2006-39, p. 43.

Application to Voluntarily Withheld Funds

Mr. Brown asks whether it is consistent to provide in subdivision (a)(2) for a distribution to claimants who have given an unbonded stop payment notice, when pursuant to Section 7536, construction lenders are not required to withhold based on an unbonded stop payment notice.

The staff does not believe an inconsistency exists. A construction lender is not required to withhold funds based on an unbonded stop payment notice, but may choose to do so anyway, for any number of reasons. For example, the lender may determine that a refusal to withhold may cause the claimant to stop working, which might cause a shutdown of the entire project.

Since a lender *may* choose to withhold funds based on certain unbonded stop payment notices, Section 7540 provides for an eventual secondary distribution of funds that have been withheld based on those notices.

Consistency with Provision Limiting Recovery to Net Amount Due

Mr. Brown questions whether Section 7540 is consistent with Section 7542 (which is discussed in more detail in the next part of this memorandum).

Section 7540 speaks generally of the payment of “claims.” Speaking generally, Section 7542 limits some contractor claims to the “net” amount due after deducting the amount of bonded stop payment notice claims given by those who provided work to the contractor. For example, Contractor gives a notice claiming \$1,000. Subcontractor who provided work to Contractor independently gives notice claiming \$250. The net amount due to Contractor is \$750.

It may not be clear enough that the term “claim” in Section 7540 means the net amount due pursuant to Section 7542 in those instances where Section 7542 applies. **The staff recommends that the Comment be revised to make that clearer:**

Comment. Section 7540 restates former Section 3167 without substantive change. Only valid claims, as determined in an enforcement action, are entitled to participate in the distribution. *Cf. Idaho Lumber Co. v. Northwestern S. & L. Ass’n*, 265 Cal. App. 2d 490, 71 Cal. Rptr. 422 (1968). The amount of the claim ~~for which payment is required is determined under Article 5 (commencing with Section 7550) (enforcement of stop payment notice) of a contractor is governed by Section 7542.~~

....

Payment Priority Not Clear Enough

Mr. Brown believes Section 7540 is not clear enough in providing that distribution to unbonded claimants is intended to occur only after distribution to bonded claimants. **The staff believes that the section is reasonably clear on that point and does not recommend any change.**

Funds Insufficient to Pay Bonded Claimants

Mr. Brown inquires what would happen if the total of all bonded stop payment notice claims exceeds the total amount of available funds. **The staff believes subdivision (a) is clear that a pro rata distribution of the available funds would be made.**

Amount Withheld or Recovered

Proposed Section 7542 limits the amount of a contractor's stop payment notice to the net amount due:

7542. Notwithstanding Section 7540:

(a) A direct contractor or a subcontractor may recover pursuant to a stop payment notice given to a construction lender only the net amount due the direct contractor or subcontractor after deducting the claims of all subcontractors and material suppliers that have given a bonded stop payment notice for work done on behalf of the direct contractor or subcontractor.

(b) In no event is the construction lender required to withhold, pursuant to a bonded stop payment notice, more than the net amount provided in subdivision (a). Notwithstanding any other provision of this chapter, a construction lender is not liable for failure to withhold more than that net amount on receipt of a bonded stop payment notice.

Comment. Section 7542 restates subdivisions (b) and (c) of former Sections 3159 and 3162.

See also Sections 7004 ("construction lender" defined), 7012 ("direct contractor" defined), 7026 ("material supplier" defined), 7042 ("stop payment notice" defined), 7044 ("subcontractor" defined).



Unbonded Notice

By its terms, Section 7542 primarily relates to a bonded stop payment notice. It is silent as to the amount that a construction lender must pay or withhold on an unbonded stop payment notice (*if* the construction lender elects to withhold funds).

Mr. Brown asks whether Section 7542 should also apply to an unbonded stop payment notice. He argues that a lender should be liable to *all* claimants, bonded or unbonded, to the extent of the amount that the lender actually withdraws.

This is a good point. There does seem to be a gap in the law as to what happens to funds that are voluntarily withheld by a construction lender pursuant to an unbonded stop payment notice.

It does not make sense that the funds withheld pursuant to a contractor's *bonded* notice would be reduced to reflect claims made by subordinate claimants, but the amount of money that a construction lender chooses to withhold pursuant to a contractor's *unbonded* notice would not be similarly reduced. Nor does it make sense that a contractor's claim is reduced only by the *bonded* claims of subordinate claimants. If money is *actually withheld* pursuant to an unbonded

notice given by a subordinate claimant, that amount should also be deducted from the contractor's net claim.

Although it would be a significant change in the law, **the Commission should consider generalizing Section 7542 as follows:**

7542. Notwithstanding Section 7540:

(a) If funds are withheld pursuant to a stop payment notice given to a construction lender by a direct contractor or subcontractor, the A direct contractor or a subcontractor may recover pursuant to a stop payment notice given to a construction lender only the net amount due the direct contractor or subcontractor after deducting any funds that are withheld by the construction lender pursuant to the claims of all subcontractors and material suppliers that have given a bonded stop payment notice for work done on behalf of the direct contractor or subcontractor.

(b) In no event is the construction lender required to withhold, pursuant to a bonded stop payment notice, more than the net amount provided in subdivision (a). Notwithstanding any other provision of this chapter, a construction lender is not liable for failure to withhold more than that net amount on receipt of a bonded stop payment notice.

Comment. Section 7542 restates subdivisions (b) and (c) of former Sections 3159 and 3162, except that the rules governing a bonded notice are generalized and also apply to funds that a construction lender actually withholds pursuant to an unbonded notice.

The staff believes that would be a sensible change, though it may be too controversial for this project.



Notice of Enforcement

Proposed Section 7550 provides time limits relating to the enforcement of a stop notice claim:

§ 7550. Time for enforcement of claim stated in stop payment notice

7550. (a) A claimant shall commence an action to enforce the claim stated in a stop payment notice not earlier than 10 days after the date the claimant gives the notice and not later than 90 days after expiration of the time within which a stop payment notice must be given. The action may not be brought to trial or judgment entered before expiration of the time prescribed in this subdivision.

(b) If a claimant does not commence an action to enforce payment of the claim stated in a stop payment notice within the time prescribed in subdivision (a), the notice ceases to be effective

and the person withholding funds pursuant to the notice shall release them.

(c) **Within five days after commencement of an action to enforce payment of the claim stated in a stop payment notice, the claimant shall give notice of commencement of the action** to the persons to which the stop payment notice was given.

Comment. Section 7550 restates former Section 3172 without substantive change.

....

Section 3172, the source of proposed Section 7550, also states that within five days after commencement of an action to enforce a stop payment notice, the claimant “shall” give notice of the commencement of the enforcement action. Nevertheless, in the context of a public works matter, the court in *Sunlight Elec. Supply Co. v. McKee*, 226 Cal. App. 2d 47, 37 Cal. Rptr. 782 (1964) arguably held that this provision was only directory, rather than mandatory.

The rationale of the *Sunlight Electric* court was that in a public work (in which a mechanics lien is not authorized), the stop payment notice substitutes for a mechanics lien. Therefore, the court reasoned, any provision relating to a stop payment notice should be construed liberally in favor of a claimant, just as provisions relating to a mechanics lien are construed liberally in the private work context.

However, although the next to last sentence of the *Sunlight Electric* opinion states its conclusion that “the [five day notice requirement] is not mandatory but merely directory,” the case actually turns on the appropriateness of applying a “substantial compliance” rule to the notice requirement. Most of the opinion is devoted to an examination of whether any detriment was caused by the claimant giving notice of the enforcement action 14 days after commencement, rather than five. The court concludes that as no such detriment was shown, there is no need to deprive the trial court of jurisdiction to hear the enforcement action.

Despite the court’s concluding language, its holding may not reach so far as to make the notice provision purely directory even in the public works context, such that non-compliance will *never* have a consequence. Rather, the opinion might instead be fairly read as providing that, if a claimant “substantially” complies with the notice provision, and no harm is caused by the technical non-compliance, the provision will not bar the enforcement action.

Whatever the holding of the *Sunlight Electric* court, it does not necessarily apply when a stop payment notice is given in a *private* work of improvement. In

a private work, the stop payment notice only augments and does not substitute for the mechanics lien remedy. Therefore, the liberal construction of rules relating to stop payment notices may not be indicated, and may in fact be contrary to the Legislature's intention.

In the tentative recommendation, the Commission sought input from practitioners as to whether the five day notice provision should be made explicitly mandatory, when a stop payment notice is given on a private work of improvement.

The Commission received a number of responses. Most commenters believe that the notice requirement is or should be directory, rather than mandatory:

- Mr. Moss, an attorney with Moss, Levitt and Mandell in Los Angeles, believes most practitioners currently view the notice provision as merely directory in both public and private projects. Exhibit to CLRC Memorandum 2006-39, p. 2. Mr. Moss is not in favor of changing existing law on the issue in the private works context.
- Mr. Last, an attorney in San Mateo, favors deleting the notice provision entirely, to eliminate the possibility that an appellate court will someday hold the notice mandatory. Exhibit to CLRC Memorandum 2006-39, p. 86.
- Gibbs, Giden, Locher & Turner LLP ("GGLT"), a law firm in Los Angeles, urges that the provision should be directory, consistent with a liberal construction of all mechanics lien provisions in favor of a claimant. Exhibit to CLRC Memorandum 2006-39, p. 156. Alternatively, the group urges that the provision should be deleted from the proposed law, or that the five day period should be extended to 10 days. Exhibit to CLRC Memorandum 2006-39, p. 133.
- The Association of California Surety Companies asserts the provision should be directory. Exhibit to CLRC Memorandum 2006-39, p. 120. The Association suggests the provision is intended to warn an owner or lender not to disburse the funds claimed in the stop payment notice, but urges that making the provision mandatory would be "draconian."

Mr. Abdulaziz does not express a view on whether the notice should be directory or mandatory, but believes that the five day period is far too short for a mandatory requirement. Exhibit to CLRC Memorandum 2006-39, pp. 13-14.

Mr. Brown is the only commenter who supports making the notice requirement expressly mandatory. He feels that lender or the borrower should be

advised of the enforcement action as soon as possible. Exhibit to CLRC Memorandum 2006-39, p. 43.

Regardless of how the Commission resolves the directory/mandatory issue, the staff believes that some revision of Section 7550 is needed. Continued use of the normally mandatory term “shall” could be confusing given the court’s more permissive interpretation of similar language in the public works context.

The staff does not recommend making the provision directory only. Such a provision would appear serve little purpose other than to authorize the giving of notice. The mechanics lien law statute does not include any other “permissive notice” provision. If the Commission feels the provision should be permissive, the staff recommends that **the Commission delete the provision entirely.**

If the Commission believes that the notice provision should be expressly mandatory, the staff recommends **extending the time period to 10 days, and adding language either in the Comment or even the statutory text expressly indicating that the provision is mandatory, notwithstanding the holding in *Sunlight Electric*.**

Dismissal of Enforcement Action for Lack of Prosecution

Section 7554 provides for a discretionary dismissal of an action to enforce a stop payment notice claim:

7554. Notwithstanding Section 583.420 of the Code of Civil Procedure, the court may dismiss an action to enforce payment of the claim stated in a stop payment notice that is not brought to trial within two years after commencement of the action.

Comment. Section 7554 restates former Section 3173 without substantive change. The cross-reference to the Code of Civil Procedure is added to make clear that this section modifies the general three-year period for discretionary dismissal. Cf. Section 7054 (rules of practice).

....

Mr. Brown suggests that two years is an insufficient time to allow a claimant to bring an action to trial, and that there exists no reason for this requirement. Exhibit to CLRC Memorandum 2006-39, p. 43.

Section 7554 continues existing Section 3173, the passage of which likely involved a legislative balance of competing interests. While Mr. Brown’s contention about the difficulty of proceeding to trial in two years may have

merit, the staff does not recommend altering the balance established under existing law.

Respectfully submitted,

Steve Cohen
Staff Counsel