

First Supplement to Memorandum 2007-8

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

The American Insurance Association, National Association of Surety Bond Producers, and Surety & Fidelity Association of America (hereinafter “joint surety commenters”) assert that proposed Civil Code Section 7500 should not be interpreted to prevent a surety from exercising “contractual, statutory or common law rights that otherwise exist to have contract funds held for use in paying contract obligations.” Exhibit to CLRC Memorandum 2006-39, pp. 98-99.

The staff asked the joint surety commenters to clarify its comment. The group’s response is attached to this supplement as an Exhibit.

Joint Surety Commenters’ Response

In summary, the joint surety commenters offer that under existing law a surety that pays a claimant on a payment bond has an equitable right of subrogation. This right of subrogation allows the surety to stand in the shoes of the paid claimant, and assert any right the claimant had to the compensation paid by the surety. (According to the joint surety commenters, the surety is also a subrogee of both the owner and the direct contractor.)

The joint surety commenters argue that under existing California law, a surety may rely on this generally recognized subrogation right to recover from a construction fund. The group is concerned that proposed Section 7500, which generally governs claims against a construction fund, could be interpreted as precluding a surety from recovering from a construction fund pursuant to this right of subrogation.

Analysis of Joint Surety Commenters’ Assertion

Proposed Section 7500 is based on and largely continues the language of existing Civil Code Section 3264. To analyze whether Section 7500 would inadvertently extinguish any right a surety currently has against a construction

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

fund, the staff attempted to determine what rights a surety has against a fund under existing Section 3264. Unfortunately, the answer proved less than clear.

Section 3264 clearly limits a *claimant* (i.e., a person contributing work) on a private work of improvement to the statutory stop payment notice remedy. Read literally, the section also seems to limit the right of any *non-claimant* (such as a surety) to recover from a fund, and preclude any non-claimant from asserting an equitable claim against the fund. However, that construction of the section is contested by the joint surety commenters.

Section 3264 provides as follows (with emphasis added):

3264. The rights of all persons furnishing labor, services, equipment, or materials for any work of improvement, with respect to any fund for payment of construction costs, are governed exclusively by Chapters 3 (commencing with Section 3156) and 4 (commencing with Section 3179) of this title, and **no person** may assert any legal or equitable right with respect to such fund, other than a right created by direct written contract between such person and the person holding the fund, except pursuant to the provisions of such chapters.

The joint surety commenters argue that the bolded phrase “no person” refers only to the “persons furnishing labor, services, equipment, or materials” referenced earlier in the section. Exhibit pp. 3-4. The group therefore argues that Section 3264 does not limit a surety’s rights against a fund at all, thereby freeing a surety to assert against the fund its equitable right of subrogation granted under common law.

While Section 7500 contains loosely the same language as Section 3264, the manner in which the proposed section is drafted makes the joint surety commenters’ “no person” argument virtually impossible to sustain:

§ 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.

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Surety's Right of Subrogation Against a Construction Fund

But have the joint surety commenters correctly construed Section 3264? Under existing law, may a surety assert an equitable subrogation right against a construction fund, or is the surety prohibited from doing so by Section 3264?

It appears undisputed that, as a general principle of law, a surety that pays a claimant pursuant to a defaulting direct contractor's payment bond at least acquires subrogation rights from the claimant. As a subrogee, the surety is then *generally* entitled to assert any claim the claimant had to recover the payment that was instead made by the surety. *Golden Eagle Ins. Co. v. First Nationwide Financial Corp.*, 26 Cal. App. 4th 160, 31 Cal. Rptr. 2d 815 (1994), *Commercial Standard Ins. Co. v. Bank of America*, 57 Cal. App. 3d 241, 129 Cal. Rptr. 91 (1976).

The joint surety commenters assert that existing law allows a surety to assert this equitable right of subrogation against a construction fund established for a work of improvement. At least one theory of recovery would be that the surety, standing in the shoes of the claimant, may assert a claim against any part of the fund that had been earned by the direct contractor (e.g., a retention fund). Since the claimant could have asserted a claim against those funds (pursuant to its contract with the defaulting direct contractor) had it not pursued a claim against the payment bond, the surety subrogee should be able to assert that same claim.

As authority for their assertion that a surety can pursue a subrogation claim against a construction fund, the joint surety commenters have cited the staff to several cases. Exhibit p. 2. However, most of the cited cases are from jurisdictions outside of California, and generally relate to public rather than private works of improvement. These cases stand for the proposition that, at least outside of California, a surety has subrogation rights against funds belonging to a direct contractor being held by a public entity.

The joint surety commenters also cite a recent unpublished decision from the 9th Circuit Court of Appeal, discussing what appears to have been a private work of improvement, in California. This brief opinion upheld a bankruptcy court's ruling that a surety had an equitable subrogation right to "settlement proceeds" of a direct contractor, which had been turned over to a bankruptcy trustee. However, the opinion does not mention Civil Code Section 3264, nor any other California law.

The staff has also located a California court of appeal decision upholding a subrogation claim of a surety against a direct contractor's retention proceeds, again in a situation in which funds had been withheld by a public entity in a

public work. *Leatherby Ins. Co. v. City of Tustin*, 76 Cal. App. 3d 678, 143 Cal. Rptr. 153 (1977). This opinion also does not mention Section 3264.

The cited cases make clear that a surety that pays a claimant under a payment bond has a right of subrogation, *in general*. However, the staff has located no case expressly addressing whether, when a surety attempts to assert that right against a construction fund, the subrogation right is curtailed by Section 3264. While the general policy underlying the equitable subrogation right might be applicable in such a situation, it may also be that Section 3264 is intended to address more specific (and perhaps more significant) countervailing considerations relating to the interests of construction lenders.

Appellate Constructions of Section 3264

The California appellate opinions that construe Section 3264 appear to address only the section's limitation on the rights of claimants. Typical are the following excerpts:

Section 3264 of California Civil Code was ... designed to protect investors in construction projects. Enacted as part of California's comprehensive Mechanics' Lien Law, Cal.Civ.Code § 3082 et seq., this section was drafted in response to mortgage lender protests against state court decisions holding that even after completion of construction, *a lien claimant* may have an equity interest in the building loan account that is prior and superior to the rights of both the lender and the builder. See M. Marsh, California Mechanics' Lien Law Handbook, § 5.27 at 182-83 (3d ed. 1979).

Sofias v. Bank of America, 172 Cal. App. 3d 583, 586, 218 Cal. Rptr. 388 (1985) (emphasis added).

It is evident from the language of section 3264 and judicial decisions interpreting it that the Legislature's central intent was to make unavailable *to unpaid subcontractors and materialmen* equitable lien and equitable trust fund remedies.

Cal-West Nat. Bank v. Superior Court, 185 Cal. App. 3d 96, 100, 229 Cal. Rptr. 431 (1986) (emphasis added).

In *Boyd & Lovesee Lumber Co. v. Western Pacific Financial Corp.* (1975) 44 Cal.App.3d 460, 465, 118 Cal.Rptr. 699, the court observed that under [Section 3264] “[a] fair line is drawn between the *contractors, subcontractors and materialmen* on the one hand and the construction lenders on the other. The former at least have remedies by mechanics lien against the property, unbonded stop

notice against the owner, and action upon the contract against the person or persons personally ordering the labor of material. The latter are relieved of the expense and risk of policing the ultimate distribution of construction funds and can concentrate on their primary duty of providing construction loans at lesser expense to the borrower and ultimately to the consuming public.”

Nibbi Brothers, Inc. v. Home Federal Sav. & Loan Assn., 205 Cal. App. 3d 1415, 1421, 253 Cal. Rptr. 289 (1988) (emphasis added).

In sum, the cases expressly construing Section 3264 do seem to at least suggest that the section was intended only to govern claimants. However, that may be too broad a reading of the opinions, as the rights of non-claimants were not at issue in any of the cases.

Conclusion and Recommendation

The staff is unable to determine with certainty whether Section 7500 as drafted would affect a surety’s existing rights against a construction fund, because the staff is unable to determine exactly what rights a surety *has* under existing law against a construction fund. Further, the staff is reluctant to recommend any revision to Section 7500 that could prove to be a significant substantive change in existing law or practice.

However, to the extent Section 3264 as drafted allows for an argument that a surety may assert a subrogation claim against a construction fund, **Section 7500 as drafted would largely foreclose that argument.** Therefore, in order to assure continuity of existing law — whatever that existing law may be — the staff recommends **revising Section 7500 to precisely track the exact language used in existing Section 7264:**

§ 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. The rights of all persons furnishing work for any work of improvement, with respect to any fund for payment of construction costs, are governed exclusively by this chapter, and no person may assert any legal or equitable right with respect to such fund, other than a right created by direct written contract between such person~~

and the person holding the fund, except pursuant to the provisions of this chapter.

Comment. Section 7500 ~~restates former~~ continues Section 3264 without substantive change, but except that it is limited to a private work.

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The staff notes that this revision twice continues use of the word “such,” a word disfavored by the Office of Legislative Counsel. The use of the word is intentional, as our intention is to preserve existing law exactly.

If the Commission approves the proposed revision, the staff will apprise the Office of Legislative Counsel of the rationale for the unusual usage.

Respectfully submitted,

Steve Cohen
Staff Counsel

Exhibit

COMMENTS OF JOINT SURETY COMMENTERS

From: Steve Cohen
Sent: Thursday, February 15, 2007
To: Gallagher, Edward
Subject: California Law Revision Commission mechanics lien revision

Mr. Gallagher,

Another question re a comment made by your group about one of the sections in our proposed revision.

Our proposed Section 7500 restates existing law relating to stop notices. Your group advocates (at the bottom of page 11 of your 9/29/06 letter to us) that sureties should also be authorized to give a stop notice, and that at minimum Section 7500 should not preclude the surety from exercising “contractual, statutory, or common law rights that otherwise exist to have contract funds held for paying contract obligations.”

My question focuses on the latter part of your group’s comment. Section 7500 expressly preserves any contract right a surety has that is based on a contract between the surety and the holder of the construction fund. Can you advise what other “contractual, statutory or common law rights” your group is referring to in the latter part of the comment referenced above?

Thanks much. If you have time to dash off a quick reply or make a quick phone call today or tomorrow, it would be most appreciated.

From: egallagher@surety.org
Subject: California Law Revision Commission mechanics lien revision
Date: February 15, 2007
To: scohen@clrc.ca.gov
Cc: mmccallum@nasbp.org, KMoore@aiadc.org

Mr. Cohen,

A surety that either finishes the contract work pursuant to its performance bond or pays the subcontractors and suppliers pursuant to the payment bond has a right to receive any

contract funds still held by the owner. The theory is that the contractor breached the contract, the owner could have used the contract funds to complete the work or to pay the subcontractors and suppliers, and the surety having met the obligations is subrogated to the rights of the owner (as well as the rights of the subcontractors and suppliers it paid and the contractor). Often the contractor is in bankruptcy, and the litigation is between the surety and the bankruptcy debtor or someone claiming through the debtor like a bankruptcy trustee or judgment creditor.

The leading case on this issue is *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 141, 83 S.Ct. 232, 9 L. Ed. 2d 190 (1962) in which the Court stated:

“We therefore hold in accord with the established legal principles stated above that the Government had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.”

Other cases on the issue include: *In Re Modular Structures*, 27 F.3d 72 (3rd Cir. 1994); *Pennsylvania National Mutual Casualty Ins. Co. v. City of Pine Bluff*, 354 F.3d 945 (8th Cir. 2004); *Capitol Indemnity Corp. v. United States*, 452 F.3d 428 (5th Cir. 2006) and a whole series of cases involving federal contracts such as *Travelers Indemnity Co. v. United States*, 72 Fed.Cl. 56 (Fed.Cl. 2006). A recent case applying California law is *In re Colt Engineering, Inc.*, 2006 WL 2255842 (9th Cir. August 7, 2006).

In order to protect these contract funds and prevent them from being dissipated while the subcontractors and suppliers are unpaid, the surety can give notice that the contractor has not paid its obligations and demand that the funds be withheld. See, for example, the *City of Pine Bluff* and *Travelers v. US* cases cited above.

In our comment, we just want the revised statute not to open the door to an argument that these well established surety rights have been changed or overruled. I have lots of Briefs and Articles on these issues. If you want copies or any other information, just let me know.

Edward G. Gallagher
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From: Steve Cohen
Sent: Monday, February 19, 2007
To: Gallagher, Edward
Subject: California Law Revision Commission mechanics lien revision

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I have another question for you.

Almost everything I've reviewed seems to concern public works projects, most outside of California. As such, none seem to concern an interpretation of existing Civil Code Section 3264. Are you aware of any California state opinion that holds that, in a private work of improvement, notwithstanding the apparent bar in Section 3264 against any claim against a construction fund other than through a direct contract or a stop notice, a surety may nevertheless assert an equitable right of subrogation against the fund if it has paid on a payment bond?

Thanks much.

Steve Cohen
California Law Revision Commission
(916) 739-7068
scohen@clrc.ca.gov

From: egallagher@surety.org
Subject: California Law Revision Commission mechanics lien revision
Date: February 20, 2007
To: scohen@clrc.ca.gov

The *In re Colt Engineering, Inc.* case, 2006 WL 2255842 (9th Cir. August 7, 2006) involved a California private job although it did not discuss Civil Code section 3264. As I read section 3264 it applies to claims by "persons furnishing labor, services, equipment, or material for any work of improvement." That is, when it says "no person" may assert any legal or equitable right, it means no person described in the beginning of the sentence. For example, on a private job it would not bar an IRS Levy or a garnishment by a judgment creditor. Similarly, it should not bar a surety from asserting its equitable or subrogation rights. The surety is not a person furnishing labor, etc although it could impact the success of the surety's claim to the extent the surety was subrogated to the rights of a subcontractor or supplier. To the extent the surety asserted the rights of the owner or the contractor, though, section 3264 would not apply. That is one reason we would like it to be clear that the new sections 7500 and 44110 do not foreclose any rights the surety otherwise may have.

The second problem is that section 3264 starts out defining whose rights are addressed, “persons furnishing labor, services, equipment, or material for any work of improvement.” As re-written in proposed sections 7500 and 44110, the second part of section 3264 is put first, without the predicate of who are “persons.” So, the new sections are easier to read as foreclosing the rights of people other than “persons furnishing labor, services, equipment, or material for any work of improvement.”

Manos v. Degen, 203 Cal.App.3d 1237, 250 Cal.Rptr. 493 (1988) stated, “The policy behind section 3264 is to relieve lenders from ‘the expense and risk of policing the ultimate distribution of construction funds’ by abolishing the subcontractor’s old nonstatutory judicially developed equitable lien remedy.” Instead, subcontractors and others furnishing labor and material can use the statutory remedies. For persons who did not furnish labor or material (the contractor’s trustee in bankruptcy, taxing authorities asserting levies, judgment creditors, sureties) section 3264 does not insulate contract funds from otherwise valid claims.