

## Fourth Supplement to Memorandum 2007-45

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

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This supplement analyzes a comment from John Heuer, an attorney in Los Angeles, on an issue discussed in CLRC Memorandum 2007-45. Mr. Heuer's comment is attached as an Exhibit to this memorandum.

#### STOP PAYMENT NOTICE RELEASE BOND

Proposed Public Contract Code Section 44180 provides that if a contractor or subcontractor disputes a claimant's stop payment notice, a public entity may accept a release bond from the direct contractor, and release the withheld funds. However, the section also provides that the entity retains discretion *not* to accept an offered release bond. Section 44180 continues existing law.

Various commenters have argued for a change from existing law, suggesting that a public entity should not have discretion to refuse a release bond, if the bond is issued by an admitted surety insurer. CLRC Memorandum 2007-45, pp. 28-29. Although the staff in CLRC Memorandum 2007-45 offers language that *could* be used to implement the suggested change, the staff ultimately makes no recommendation as to whether such a change should be implemented, pending discussion at the upcoming Commission meeting.

In the First Supplement to CLRC Memorandum 2007-45, the staff presents a comment on this issue from the California State Council of Laborers Legislative Department and Construction Laborers Trust Funds for Southern California (hereafter, "Laborers Group"). Laborers Group argues that the proposed law should continue existing law, and continue to allow a public entity discretion to refuse any offered bond. First Supplement to CLRC Memorandum 2007-45, Exhibit p. 4.

Mr. Heuer also advocates that the proposed law continue existing law on this issue. Exhibit p. 1. He suggests that otherwise, a public entity's ability to manage a project could be hampered, and cites two cases to illustrate his contention.

### **Direct Contractor in Default**

Mr. Heuer first cites to *Harsco Corporation v. Department Of Public Works*, 21 Cal. App. 3d 272, 98 Cal. Rptr. 337 (1971). In *Harsco*, the court held that a public entity may properly refuse to withhold funds based on a subcontractor's stop payment notice, when the direct contractor on the project is already in default. The court held that the public entity in that situation, rather than holding the funds for the subcontractor, may use the funds to pay a replacement direct contractor.

Mr. Heuer suggests that if the proposed law were to require a public entity (that *had* withheld funds pursuant to a stop payment notice) to thereafter accept a release bond in that same situation, the entity might be obligated to release the withheld funds back to the defaulting direct contractor.

The staff is not convinced the *Harsco* holding would cease to be applicable, if the proposed law required a public entity to accept a tendered stop payment release bond. Although proposed Section 44180(b) would then preclude a public entity from withholding the released funds from the direct contractor *pursuant to the previously given stop payment notice*, the section would *not* appear to preclude withholding those same funds from the direct contractor for some *other* reason (such as a previous default by the direct contractor, as was the case in *Harsco*):

(b) On receipt of a release bond, the public entity shall not withhold funds from the direct contractor pursuant to the stop payment notice.

In fact, the *Harsco* holding was based on the fact that, under the circumstances of that case, the funds the stop payment notice claimant sought to have withheld pursuant to the notice were no longer funds that were "due" the direct contractor, and were thus not subject to the stop payment notice. *Harsco*, at 276. The same basic premise would appear to apply if at the time withheld funds were *released* pursuant to a stop payment notice release bond they were similarly no longer "due" the direct contractor.

### **Same Surety Issuing Release Bond and Payment Bond**

Mr. Heuer also cites to *Azusa Western, Inc. v. City of West Covina*, 45 Cal. App. 3d 259, 119 Cal. Rptr. 434 (1975). In *Azusa*, a public entity released a subcontractor's stop payment notice after accepting a release bond, and the surety on the release bond thereafter became insolvent, leaving the unpaid subcontractor unable to collect on the release bond.

The court held that the public entity had breached a statutory duty applicable to acceptance of the release bond, and required the public entity to pay the subcontractor's claim. The entity had accepted a release bond that had been issued by the same surety that had previously issued the mandatory payment bond on the project. The court held that the public entity had been required to insure that the two bonds were issued by separate sureties — presumably to prevent against exactly this occurrence — based on language in former Streets and Highway Code Section 5296 (which governed this particular project):

The sureties upon the [release] bond shall be jointly and severally liable to the claimant with the sureties upon the contractor's original labor and material bond posted by the contractor.

Although Streets and Highway Code Section 5296 has since been repealed, the language construed by the *Azusa* court has been continued in Public Contract Code Section 20463. Section 20463 sets forth bond requirements for legislatively authorized work on certain street and highway projects.

More importantly, this same language construed by the *Azusa* court is also contained in existing Civil Code Section 3196, the section proposed Public Contract Code Section 44180 continues:

The surety or sureties upon such bond shall be jointly and severally liable to the stop notice claimant with the surety or sureties upon any payment bond furnished pursuant to Chapter 7 (commencing with Section 3247).

It is likely a court would find the *Azusa* holding applicable to all public work projects, given the similarity of the construed language. If so, if the proposed law required a public entity to accept *any* release bond issued by an admitted surety insurer, a public entity might be required to accept a bond from a surety that had also issued the payment bond, in apparent violation of the *Azusa* holding.

Even if the *Azusa* holding were not held directly applicable to public work projects in general, the holding represents sound policy. As contrasted with a

private work (see Civ. Code §3159(a)(2)), on a public work the Legislature has clearly contemplated that a claimant's stop payment notice remedy should be separate and distinct from the claimant's payment bond remedy. If the proposed law allowed the same surety to issue both the mandatory payment bond as well as a stop payment notice release bond that the entity was required to accept, the two remedies would be too closely linked by a single linchpin — the solvency of that one surety.

**In the event the Commission decides to require a public entity to accept a stop payment notice release bond issued by an admitted surety insurer, the staff recommends that a codification of the *Azusa* holding be added to the language offered by the staff in CLRC Memorandum 2007-45:**

**§ 44180. Release bond**

~~44180. (a) If the direct contractor or a subcontractor disputes the correctness, validity, or enforceability of the claim stated in a stop payment notice, the public entity may, in its discretion, permit the direct contractor to give the public entity a release bond. A direct contractor may obtain release of funds withheld pursuant to a stop payment notice by giving the public entity a release bond.~~

(b) The bond shall be executed by an admitted surety insurer other than a surety on any payment bond given under Chapter 5 (commencing with Section 45010).

(c) The bond shall be in an amount equal to 125 percent of the claim stated in the stop payment notice, conditioned for the payment of any amount the claimant recovers in an action on the claim, together with court costs if the claimant prevails.

~~(b)~~ (d) On receipt of a release bond, the public entity shall not withhold funds from the direct contractor pursuant to the stop payment notice.

~~(c)~~ (e) The surety on a release bond is jointly and severally liable to the claimant with the sureties on any payment bond given under Chapter 5 (commencing with Section 45010).

**Comment.** Section 44180 restates former Civil Code Section 3196.

Subdivision (b) codifies the holding of *Azusa Western, Inc. v. City of West Covina*, 45 Cal. App. 3d 259, 119 Cal. Rptr. 434 (1975).

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Respectfully submitted,

Steve Cohen  
Staff Counsel

Exhibit

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**COMMENTS OF JOHN HEUER**

From: jheuer@gglt.com  
Date: October 17, 2007  
To: scohen@clrc.ca.gov  
Subject: Mechanics' Lien Law Message

Steve:

Sorry it's been awhile since we've corresponded about the lien law revisions, things have been a bit busy for me. However, I have been monitoring the progress of the Commission and the revisions that have been proposed/made. I did want to send you a few quick comments about the latest Memorandum (2007-45) that was just circulated today and the comments that are reflected therein.

**Stop Payment Notice Release Bond**

I believe the discretionary nature of a public entity's acceptance of a release bond should continue from existing law into the new law. Something that I believe is being missed in the discussion contained in the latest Memorandum (2007-45) is the underlying public interest in completing works of improvement. Pursuant to the decision in *Harsco Corp. v. Department of Public Works*, (1971) 21 Cal.App.3d 272, a public entity can disregard a stop notice and use contract funds to complete a work of improvement where the original contractor (or, in the new terminology, "direct contractor") has been defaulted. So, any language that might make acceptance of a tendered release bond mandatory, together with release of withheld funds (monies that would include earned retention) might have a real impact on a public entity's ability to complete troubled projects. Also, it is my recollection (although I could be wrong) that the release bond statutes were modified to permit parties other than the direct contractor from posting a release bond. Assuming that is the case, this could further erode the public entity's protection of funds to complete a project. The problem is illustrated as follows: the direct contractor is teetering on default and there are numerous subcontractors and suppliers demanding payment; public entity receives various stop notices and withholds money from direct contractor; direct contractor becomes insolvent and defaults; one or more subcontractors/suppliers presents the public entity with a release bond and demands release of the funds withheld by the public entity. Although this scenario doesn't happen on the majority of projects, it is a scenario that is not unusual. If it is mandatory that the public entity accept the presented release bond and release funds withheld on the stop notice, there is a distinct possibility that the public entity's funding pool could be

sufficiently depleted to prevent or, at least, restrict its ability to complete the project. This would not be in the public's interest.

Further, a public entity needs discretion on whether to accept a tendered release bond because it has potential exposure to a claimant were it to agree to a stop payment notice release bond issued by the same surety as the payment/performance bonds. See, *Azusa Western, Inc. v. West Covina* (1975) 45 Cal.App.3d 259. So, even if the public policy reason discussed above is not enough to retain the discretion that is currently given to a public entity, the problem presented by the factual scenario in the *Azusa Western* case should permit the public entity to retain the discretion whether to accept a release bond.

On this same point, I don't know if it was overlooked by the Laborers Group, but it would seem to me that their concern about release of funds following receipt of a bond from a surety on shaky footing would be somewhat offset by the fact that there would be a payment bond against which claims could still be made. So, there would be a bond remedy that could still be pursued. I don't think I'm missing anything here, but maybe I am.

I hope these comments are helpful. Should you have any questions regarding my comments, please don't hesitate to contact me. Hope all is well and continue the good work. John.

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