

#H-820

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

DISCUSSION DRAFT

Consumer Protection Options Under Home Improvement Contracts

December 2001

This discussion draft is being distributed so that interested persons can make their views known to the Commission. Any comments sent to the Commission will be a part of the public record and will be considered at a public meeting when the Commission determines the provisions it will include in legislation the Commission plans to recommend to the Legislature.

COMMENTS ON THIS DRAFT SHOULD BE RECEIVED BY THE COMMISSION NOT LATER THAN January 11, 2002.

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SUMMARY

The Law Revision Commission is studying special protections for homeowners who face potential double liability for labor and materials under home improvement contracts. This problem arises where the owner pays the prime contractor under the terms of their contract, but the prime contractor does not pay amounts due to subcontractors and equipment and material suppliers, who can then enforce their claims against the owner's property or construction funds.

In anticipation of the 2002 legislative session, the Commission is seeking comment on two approaches to address the double liability issue in home improvement contracts:

- (1) A privity rule, limiting mechanic's lien and stop notice rights to claimants who have a contract with the homeowner, coupled with recognition of a right for claimants without a contract to seek an equitable lien on the owner's property to prevent unjust enrichment.
- (2) A good-faith payment rule, limiting the liability of homeowners to the extent they have paid in good faith, but leaving existing mechanic's lien and stop notice remedies in place, applicable to amounts remaining unpaid.

Both proposals would apply only to home improvement contracts under a certain cap based on the contract price — most frequently mentioned amounts are \$10,000 or \$25,000. The Commission is interested in opinions on the appropriate level for the cap.

Finally, the Commission is soliciting comment on whether the cap should be based on the amount of the individual subcontractor's or supplier's contract, rather than the prime contract, and if so, what that amount should be.

The Commission has tabled its tentative recommendation proposing a mandatory 50% home improvement contract bond. As a general approach, the Commission has concluded that it would be preferable to seek simpler solutions that invoke market principles, rather than the more complicated statutory rules needed to implement mandatory bond and direct payment schemes.

CONSUMER PROTECTION OPTIONS UNDER HOME IMPROVEMENT CONTRACTS

1 **Introduction**

2 This discussion draft is a follow-up to the Tentative Recommendation on *The*
3 *Double Payment Problem in Home Improvement Contracts* (September 2001).¹ At
4 the November 20, 2001, meeting, the Law Revision Commission tabled the
5 mandatory 50% bond proposal set out in the tentative recommendation and
6 decided to take a simpler approach to address the double payment risk faced by
7 consumers under home improvement contracts. The double payment problem
8 arises because, even though the owner has paid the prime contractor according to
9 the terms of the contract, subcontractors and material suppliers are entitled to
10 enforce mechanic's lien rights against the owner's property if they are not paid by
11 the prime contractor.²

12 Attempts to address the double liability problem with additional rules, remedies,
13 forms, procedures, penalties, and regulatory authority, as proposed in the earlier
14 tentative recommendation, have not been favorably received.³ Accordingly, the
15 Commission is now focusing on simpler, easy to understand rules that directly
16 address the double liability problem where it is most common: in smaller home
17 improvement contracts. These are the situations where the work is likely to be
18 done quickly and there is less financial incentive for the homeowner to become
19 familiar with the intricacies of the mechanic's lien and stop notice statutes and
20 take the necessary protective steps to guarantee that payments are properly
21 applied.

22 Even cautious homeowners who take the time to learn the law and the available
23 options may find out too late that their faith in the prime contractor was misplaced.
24 The statute sets a trap through the "preliminary 20-day notice" under Civil Code

1. This study is being conducted pursuant to a request from the Assembly Judiciary Committee to undertake a "comprehensive review of [mechanic's lien] law, making suggestions for possible areas of reform and aiding the review of such proposals in future legislative sessions." See Letter from Assembly Members Sheila James Kuehl (Chair) and Rod Pacheco (Vice Chair), June 28, 1999 (attached to Commission Staff Memorandum 99-85 (Nov. 16, 1999)).

The Commission has long-standing authority from the Legislature to study mechanic's liens under its general authority to consider creditors' remedies, including liens, foreclosures, and enforcement of judgments, and its general authority to consider the law relating to real property. For the text of the most recent legislative authorization, see 2001 Cal. Stat. res. ch. 78.

The Commission's study of mechanic's liens has been largely consumed by the double payment problem. However, the Commission is also studying general revisions of the mechanic's lien law.

2. See Civ. Code § 3123. A subcontractor may also be the defaulting party, failing to pay lower tier subcontractors and suppliers.

3. See, e.g., letters attached to Commission Staff Memorandum 2001-99 (Nov. 21, 2001) and its Second Supplement (Nov. 29, 2001). It should be noted, however, that almost all commentary is from subcontractors and suppliers. The Commission has received little input from homeowners' groups or general contractors, and limited commentary from other stakeholders, such as lenders and sureties.

1 Section 3097, which guarantees mechanic’s lien and stop notice rights relating
2 back 20 days before the notice is given. In smaller, quicker jobs, such as roofing,
3 fencing, driveways, and the like, the homeowner is more likely to have paid most
4 or all of the home improvement contract price before receiving any notice. And
5 then it is too late to avoid double liability if the prime contractor is insolvent or
6 fraudulent.

7 Because subcontractors and suppliers have the mechanic’s lien right permitting
8 them to pursue payment even from homeowners who have fully paid the prime
9 contractor, they have less incentive to follow standard business credit practices or
10 take any special steps to protect their right to payment from the prime contractor or
11 higher-tier subcontractor.

12 The mechanic’s lien law is unfairly balanced against the average consumer. It is
13 natural for the homeowner to rely on his or her relationship with the prime con-
14 tractor and to have confidence that payments under a home improvement contract
15 are directed to the subcontractors, material and equipment suppliers, and laborers
16 who have contributed to the project, in full satisfaction of the owner’s obligations.
17 If the prime contractor or a higher-tier subcontractor does not pay subcontractors
18 and suppliers, the homeowner won’t find out about it until it is too late to avoid
19 some double payment liability and perhaps an incomplete project.

20 **Adjusting Risk**

21 The double payment problem may be viewed as a question of who should bear
22 the risk of nonpayment by the prime contractor (or by a subcontractor higher in the
23 payment chain) where the owner has paid, and which parties are in the best
24 position to be knowledgeable about the risks and remedies and take the appropriate
25 steps. Under the existing scheme, homeowners assume all of the risk associated
26 with the failure of prime contractors to pay subcontractors and suppliers.

27 A major defect that has been identified in the existing system is reliance on the
28 homeowner to sort through the various notices and correctly anticipate the best
29 remedy. Homeowners are likely to initiate few home improvement projects in a
30 lifetime, whereas contractors and suppliers have daily experience in the business.
31 This principle lies at the heart of consumer protection. Of course, there may also
32 be significant inequalities in business and legal sophistication, bargaining power,
33 financial soundness, and risk aversion among prime contractors, subcontractors,
34 and suppliers, but as a class, those in the construction business and trades should
35 be expected to have greater knowledge and sophistication about how things work
36 than homeowners.

37 The scores of letters received in the course of this study, and remarks of persons
38 attending Commission meetings, reveal problems with the operation of the home
39 improvement marketplace. Work may be done without a written contract; credit
40 checks are infrequent; Contractors’ State License Board regulations are ignored or
41 unenforced; sharp practices are not uncommon; funds are misdirected; subcontrac-
42 tors and suppliers continue to work with contractors even after experiencing pay-

1 ment problems. Facilitating many of these problems and temptations is the ability
2 of subcontractors and suppliers to compel double payment from the homeowner.

3 The two options presented in this discussion draft would address the problems
4 by reallocating risk in lower-priced home improvement contracts so that subcon-
5 tractors and suppliers would need to take more care in determining the credit-
6 worthiness of their customers or assume the risk of nonpayment. It is appropriate
7 to rely on those in the construction business to take minimal steps to protect their
8 interests, particularly where it is much easier and cheaper for them than for home-
9 owners. Subcontractors and suppliers are in a better position to determine whether
10 to extend credit to the prime contractor or subcontractor, or whether other steps
11 should be taken such as joint control or bonding.

12 **Scope of Special Protections — Home Improvement Contracts**

13 The Commission continues to focus on “home improvement contracts,” as
14 defined under the Contractors’ State License Law.⁴ Home improvement contracts
15 are appropriate for special treatment under the mechanic’s lien law because this
16 class of construction contracts has been the subject of special Legislative attention
17 for more than 30 years.⁵ Home improvement contracts are required to be executed
18 on a special form, and it should be relatively easy for those not in privity with the

4. “Home improvement” is defined in Business and Professions Code Section 7151:

7151. “Home improvement” means the repairing, remodeling, altering, converting, or modernizing of, or adding to, residential property and shall include, but not be limited to, the construction, erection, replacement, or improvement of driveways, swimming pools, including spas and hot tubs, terraces, patios, awnings, storm windows, landscaping, fences, porches, garages, fallout shelters, basements, and other improvements of the structures or land which is adjacent to a dwelling house. “Home improvement” shall also mean the installation of home improvement goods or the furnishing of home improvement services.

For purposes of this chapter, “home improvement goods or services” means goods and services, as defined in Section 1689.5 of the Civil Code, which are bought in connection with the improvement of real property. Such home improvement goods and services include, but are not limited to, carpeting, texture coating, fencing, air conditioning or heating equipment, and termite extermination. Home improvement goods include goods which are to be so affixed to real property as to become a part of real property whether or not severable therefrom.

“Home improvement contract” is defined in Business and Professions Code Section 7151.2:

7151.2. “Home improvement contract” means an agreement, whether oral or written, or contained in one or more documents, between a contractor and an owner or between a contractor and a tenant, regardless of the number of residence or dwelling units contained in the building in which the tenant resides, if the work is to be performed in, to, or upon the residence or dwelling unit of the tenant, for the performance of a home improvement as defined in Section 7151, and includes all labor, services, and materials to be furnished and performed thereunder. “Home improvement contract” also means an agreement, whether oral or written, or contained in one or more documents, between a salesperson, whether or not he or she is a home improvement salesperson, and (a) an owner or (b) a tenant, regardless of the number of residence or dwelling units contained in the building in which the tenant resides, which provides for the sale, installation, or furnishing of home improvement goods or services.

5. See, e.g., 1969 Cal. Stat. ch. 1583 (enacting Bus. & Prof. Code §§ 7151.2, 7159). Special rules, including home improvement certification requirements are set out in Business and Professions Code Sections 7150-7168.

1 owner to determine whether the job is subject to special rules in the Contractors'
2 State License Law and special statutory exceptions.

3 **Setting the Cap on Homeowner Protections**

4 Both proposals would apply only to home improvement contracts under a certain
5 cap based on the contract price — most frequently mentioned amounts are \$10,000
6 and \$25,000. The Commission is interested in opinions on the appropriate level for
7 the cap.

8 The Commission is also soliciting comment on whether the cap should be based
9 on the amount of the individual subcontractor's or supplier's contract, rather than
10 the prime contract, and if so, what that amount should be.

11 Protecting homeowners under small contracts serves the fundamental purpose of
12 providing a meaningful degree of consumer protection without complicated forms
13 and technical deadlines. Setting a \$10,000 floor also recognizes that subcontractors
14 and suppliers will rarely pursue the mechanic's lien remedy under existing law for
15 smaller amounts because of the costs involved. The Commission is informed that
16 the lack of recoverable attorney's fees in mechanic's lien foreclosure makes it
17 impractical for subcontractor or supplier to pursue amounts under \$5,000 or
18 \$8,000 (depending on the assessment of the particular business). In most cases, an
19 individual subcontractor or supplier's portion of a home improvement contract
20 under \$10,000 would likely fall in the range of unforclosable liabilities.

21 **Option 1 — Limited Privity Rule**⁶

22 The privity rule would limit mechanic's lien and stop notice rights to claimants
23 who have a contract with the homeowner⁷ as to home improvement contracts
24 under a certain cap, whether \$10,000, \$25,000, or some other amount. Change
25 orders and extras would not affect application of the cap.

26 Under this option, subcontractors and suppliers would either assume the risk
27 based on their assessment of their customer, or require that the homeowner deal
28 directly with them. Where the owner has a direct contract with a trade contractor
29 or material supplier, the possibility of misdirected funds paid to the prime contrac-
30 tor is eliminated, and along with it, the potential for double liability caused by
31 exercise of mechanic's liens and stop notice remedies.

32 In order to avoid unjust enrichment of homeowners who have not paid for the
33 labor, services, equipment, or materials furnished in the home improvement pro-
34 ject, this proposal is coupled with statutory recognition of a right for claimants

6. See draft language *infra* at 7-8.

7. The privity rule was originally suggested by James Acet, although he does not believe there should be a monetary cap. See Letter from James Acet, Nov. 27, 2001 (attached to Second Supplement to Commission Staff Memorandum 2001-99, Exhibit p. 1 (Nov. 29, 2001)).

For a discussion of the constitutional issues concerning this type of proposal, see the Tentative Recommendation on *Double Payment Problem in Home Improvement Contracts* (September 2001), at pp. 12-33.

1 without a direct contract to seek an equitable lien on the owner's property. This
2 procedure would also give claimants the right to record a lis pendens to establish
3 priority and prevent sale of the property free of the claim.⁸ Thus, in appropriate
4 circumstances, subcontractors and suppliers would have the same protection
5 afforded by the mechanic's lien statute against the owner's property. However,
6 since its purpose is to prevent unjust enrichment, the equitable lien could not be
7 used to extract double payment from the owner.

8 **Option 2 — Limited Protection for Good-Faith Payments**⁹

9 The good-faith payment rule would protect homeowners by limiting their liabil-
10 ity to the extent they have paid amounts due under the home improvement contract
11 in good faith.¹⁰ This rule is consistent with common sense, fairness, and the
12 normal expectations arising in consumer dealings with other businesses.

13 As with the privity rule discussed above, this proposal would apply only to home
14 improvement contracts under a certain cap, such as \$10,000, \$25,000, or other
15 amount. Change orders and extras would not affect application of the rule.

16 Protection of homeowners' good faith payments would leave existing mechan-
17 ic's lien and stop notice remedies in place, but applicable only to the extent that
18 amounts remaining unpaid under the home improvement contract. Subcontractors
19 and suppliers would thus continue to serve preliminary 20-day notices, if desired,
20 but the mechanic's lien liability would be limited to amounts remaining unpaid, or
21 in the rare case, amounts that were not paid in good faith. This rule would be an
22 explicit exception to the so-called "direct lien" under existing law.¹¹

23 The homeowner, however, is still in need of the protection afforded by the good-
24 faith payment rule. It is suspected that many of the abuses probably occur in
25 smaller home improvement contracts, such as roofing or fencing jobs, where the
26 work can be completed quickly with one delivery of materials. The preliminary
27 notice, with its 20-day relation back feature, does not protect consumers because
28 the owner may not receive any notices until after payments have been made to the
29 prime contractor. Under the proposed law, the owner is protected from double lia-
30 bility for payments made in good faith, even if there is no payment bond.

8. Case law makes clear that the claimant has a right to record a lis pendens in an equitable lien action. See, e.g., *Okuda v. Superior Court*, 144 Cal. App. 3d 135, 141, 192 Cal. Rptr. 388 (1983) (action to establish or foreclose equitable lien affects title or right to possession of real property, giving rise to right to record lis pendens).

9. See draft language *infra* at 8.

10. This proposal was an element of the Tentative Recommendation on *Double Payment Problem in Home Improvement Contracts* (September 2001), and received the most favorable comment, amongst the generally negative reviews. See letters attached to Commission Staff Memorandum 2001-99 (Nov. 21, 2001) and its Second Supplement (Nov. 29, 2001).

11. See Civ. Code § 3123. For a discussion of the constitutional issues concerning this type of proposal, see the Tentative Recommendation on *Double Payment Problem in Home Improvement Contracts* (September 2001), at pp. 12-33.

1 From the owner's perspective, common sense and fairness dictate that payment
2 to the contractor in good faith under the contract should be the end of the owner's
3 liability.

DOUBLE PAYMENT PROTECTION OPTIONS

1 **Note.** Two alternative drafts to address the double payment issue for smaller home
2 improvement contracts are set out below.

3 The Commission will decide whether to make recommendation to the Legislature in 2002
4 based on one of these proposals at its January 2002 meeting.

5 **The Commission would like to receive comments on the optimal level for application of**
6 **these proposals**, taking into account the goals of protecting the most vulnerable owners while
7 limiting the impact on subcontractors and suppliers. In reviewing the two approaches, consider
8 the following questions:

9 **(1) Which contract amount should the cap be based on?**

- 10 (a) The total amount of the contract between the owner and the prime contractor.
11 (b) The contract amount of the individual claimant's share of the job.

12 **(2) Depending on your evaluation of issue (1), what should the cap amount be?**

13 The Commission has generally discussed cap amounts ranging from \$10,000 to \$25,000, as
14 indicated in brackets in the language set out below, but the ultimate decision would be made in
15 the legislative process, if this approach is adopted. The Commission is not wedded to these
16 numbers.

17 **OPTION 1 — LIMITED PRIVITY RULE**

18 **Civ. Code § 3113. Privity requirement for certain home improvement contracts**

19 SECTION 1. Section 3113 is added to the Civil Code, to read:

20 3113 . (a) Notwithstanding any other provision in this title, in the case of a home
21 improvement contract executed in an amount less than [ten thousand dollars
22 (\$10,000)] [twenty-five thousand dollars (\$25,000)], a claimant does not have
23 mechanic's lien or stop notice rights unless the claimant has a direct contractual
24 relationship with the owner.

25 (b) This section applies to home improvement contracts described in subdivision
26 (a) regardless of any extras or change orders that increase the total amount of the
27 contract.

28 (c) Nothing in this title restricts the right of a claimant to establish an equitable
29 lien on the owner's property for labor, services, equipment, or materials furnished
30 in cases under this section.

31 (d) As used in this section, "home improvement contract" has the meaning
32 provided by Section 7151.2 of the Business and Professions Code.

33 **Comment.** Section 3113 restricts mechanic's lien and stop notice rights to claimants in privity
34 with the owner for home improvement contracts under the statutory limit. This limitation applies
35 to mechanic's liens under this chapter as well as the stop notice rights under Chapter 3
36 (commencing with Section 3156), which incorporate the provisions of this chapter. See Section
37 3158 (who may give stop notice). As made clear by the introductory clause of subdivision (a),
38 this section provides an exception to the "direct lien" rule in Sections 3123 and 3124.

1 Subdivision (b) makes clear that change orders do not affect the application of the basic
2 consumer protection rule in subdivision (a).

3 Subdivision (c) provides statutory recognition of the right to an equitable lien to avoid unjust
4 enrichment in cases covered by this section. This rule is not in conflict with Section 3264, since
5 that section abolishes equitable liens only with regard to construction funds, not the owner's real
6 property. The intent of subdivision (c) is to provide a remedy for claimants not in privity who
7 have no other effective remedy for labor, services, equipment, or materials furnished. Case law
8 makes clear that the claimant has a right to record a lis pendens in an equitable lien action. See,
9 e.g., *Okuda v. Superior Court*, 144 Cal. App. 3d 135, 141, 192 Cal. Rptr. 388 (1983) (action to
10 establish or foreclose equitable lien affects title or right to possession of real property, giving rise
11 to right to record lis pendens). See also Code Civ. Proc. §§ 405.4 ("real property claim" defined),
12 405.20 (recording notice of pendency of action), 405.24 (constructive notice). Thus, in
13 appropriate circumstances, subcontractors and suppliers would have the same protection afforded
14 by the mechanic's lien statute against the owner's property. However, since its purpose is to
15 prevent unjust enrichment, the equitable lien cannot be used to extract double payment from the
16 owner.

17

18 **OPTION 2 — LIMITED PROTECTION FOR GOOD-FAITH PAYMENTS**

19 **Civ. Code § 3113. Limitation on owner's liability**

20 SECTION 1. Section 3113 is added to the Civil Code, to read:

21 3113. (a) Notwithstanding any other provision in this title, the liability of an
22 owner under a home improvement contract executed in an amount less than [ten
23 thousand dollars (\$10,000)] [twenty-five thousand dollars (\$25,000)] is limited to
24 the amount remaining unpaid under the contract. Payments made to the original
25 contractor in good faith discharge the owner's liability to all claimants to the
26 extent of the payments.

27 (b) This section applies to home improvement contracts described in subdivision
28 (a) regardless of any extras or change orders that increase the total amount of the
29 contract.

30 (c) As used in this section, "home improvement contract" has the meaning
31 provided by Section 7151.2 of the Business and Professions Code.

32 **Comment.** Section 3113 protects owners who, in good faith, pay the prime contractor
33 according to the terms of a home improvement contract. This section is intended to shield owners
34 from liability for double payment in cases where subcontractors and suppliers do not receive
35 payments that have been made by the owner. As made clear by the introductory clause of
36 subdivision (a), this section provides an exception to the "direct lien" rule in Sections 3123 and
37 3124. Existing rights and procedures under this title remain applicable as to the amount remaining
38 unpaid.