

**Mechanics' Liens and Double-Payment by Homeowners:  
A Proposal for Reform  
by  
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Section 3 of Article XIV of the California Constitution provides for mechanics liens as follows:

Mechanics, persons furnishing materials, artisans, and laborers of every class, shall have a lien upon the property upon which they have bestowed labor or furnished material for the value of such labor done and material furnished; and the Legislature shall provide, by law, for the speedy and efficient enforcement of such liens.

Various provisions of the Civil Code provide for creation and enforcement of mechanic's liens and govern payment provisions contained in contracts for works of improvement to real property. Civ. Code §§ 3109-3154.

The mechanic's lien law may operate to the detriment of an innocent homeowner who may, in effect, be required to pay twice for the same work. For example, the situation may arise where a homeowner or residential land improver executes a contract with a general contractor to make an addition to a home or improve a vacant lot. Often, the homeowner will agree to pay the general contractor in full for all services to be performed upon his or her land. The general contractor then hires subcontractors, laborers and materialmen to make the required improvements. In some instances, the general contractor may fail to pay these persons for the value of their work. These persons, under California law, have the right to place a lien upon the improved property, which forces the homeowner, whose property is encumbered, to pay twice or forfeit his or her land to satisfy the lien. Under current law, the homeowner may not interpose, as a defense, the fact that the homeowner already has paid the full contract price to the general contractor.

Existing law provides that the amount of a mechanic's lien shall be for the reasonable value of the labor, services, equipment, or materials furnished or for the price agreed upon, whichever is less, but that any original contractor or subcontractor may recover only such amount as may be due under the terms of a contract, after deducting all claims of other claimants for labor, services, equipment, or materials furnished and embraced within the contract. Existing law

authorizes the owner of property to petition the proper court for an order to release the property from the lien if specified conditions are met.

Several proposals to protect the homeowner from the burden of paying twice for the same work have been circulated for consideration. There are difficulties with each of these proposals, both political and practical, which have been noted at recent meetings of the California Law Revision Commission on this topic.

In an effort to assist the Commission and the Legislature in their consideration of this issue, we propose an alternative solution to the problem of double-payment by homeowners. As we see it, the double-payment problem is best approached through an insurance-type program. Under current law, most homeowners are at risk of a double-payment situation, although most homeowners are either unaware of the risk or willing to take that risk in order to avoid the costs of protecting themselves against it. In an idealized world, an enlightened homeowner who wished to avoid the risk of a mechanics' lien would purchase insurance against such a risk (or would self-insure). Then, if a mechanic's lien is placed upon the property because of non-payment by the general contractor, and the owner has already paid the general contractor, the lien holder could be paid from the insurance funds, resulting in the lien being discharged.

Assemblyman Honda's proposal during the 1999-2000 legislative session (AB 2113) seems to recognize the insurance-like nature of the problem. AB 2113 proposed creating a Contractor Default Recovery Fund ("CDRF") which would be used to satisfy claims of non-payment by sub-contractors who provide labor, service, equipment, or material to an improvement on residential property. This would protect homeowners who have already paid a general contractor from having to pay a sub-contractor to satisfy the lien obligation.

Although AB 2113 was intended to protect homeowners, it proposed to finance the CDRF by initially imposing a \$200 annual fee upon licensed home improvement contractors and giving the Contractors' State License Board the responsibility for recommending adjustments to the fee to meet the projected claims over the next year.

On first glance, it is arguably appropriate to finance the CDRF from fees paid by home improvement contractors since those contractors, as well as home owners, stand to benefit from creation of the CDRF. However, under current law, home improvement contractors already have a potent weapon to collect payments through the lien law, a weapon that has constitutional support. Thus, from the perspective of home improvement contractors who are comparing AB 2113 with existing law, AB 2113 increases the cost of doing business without creating

significantly greater security for payment than currently exists. Moreover, it is not at all clear that the burden of additional fees would actually weigh equally upon all contractors. For example, sub-contractors who have established long-standing, stable relationships with general contractors and who may never face the problem of non-payment will be required to pay the same fee as sub-contractors who are at a much greater risk of non-payment.

Arguably, since AB 2113 would impose the identical fee upon all home improvement contractors, the increased costs would ultimately be borne, at least in some measure, by homeowners (since subcontractors would attempt to pass the increased cost to general contractors who, in turn, would attempt to pass the increased cost to homeowners). Since the primary benefit of AB 2113 is to homeowners (compared to existing law), it is appropriate that homeowners be responsible for paying for any statewide insurance program.

Our proposal builds upon Assemblyman Honda's AB 2113. As with AB 2113, we propose creation of a fund, called the Homeowner's Relief Recovery Fund ("HRRF"), to be administered by the Contractors' State License Board, which would be used to make payments to sub-contractors or homeowners in situations where the homeowner has already paid the general contractor for work performed by the sub-contractor. The payment would be made after the homeowner files a claim with the Board and it is determined to be valid. Since the primary benefit of the fund is to homeowners, we propose that a modest Homeowner's Lien Protection Fee be added to residential building permit fees. The Homeowner's Lien Protection Fee would be collected by the local jurisdiction at the time a residential building permit is issued and, after a deduction for local expenses associated with collection of the fee, would be forwarded to the State Treasury for deposit in the HRRF.

We are not breaking any new ground in proposing that a state fund be financed by fees on building permits. The Strong Motion Instrumentation Program (Pub. Res. Code §§ 2700-2709.1) requires that all persons receiving building permits pay an additional fee, the amount of which is in relation to the total value of all labor and material to be used within a building project. Pub. Res. Code § 2705. Thus, there is already a mechanism for using county and city building permit fees to support a statewide program.

As with the Strong Motion Instrumentation Program, we propose funding the Homeowner's Relief Recovery Fund through a small fee added to the fees already charged for the issuance of residential building permits which are issued to the homeowner or land improver. This fee would be a small fraction of the value of the proposed improvement, including the value of all labor and materials used. Under this approach, the cost of protecting homeowners against the risk of double-

payment will be borne by homeowners themselves, which is appropriate since they are the ones who most directly benefit from the change in law proposed by this legislation.

Because of the uncertainty regarding the exact scope of the double-payment problem, we have not attempted to suggest how large the fee should be to provide sufficient funds for the Homeowner's Relief Recovery Fund to operate properly. However, if a reliable estimate of the yearly costs can be developed, it will be a straightforward process to determine the rate for the fee based upon the funds raised by the Strong Motion Instrumentation Program.

The system we propose would operate as follows:

Assume that a homeowner contracts with a licensed general contractor for services to add an additional room to his or her home. The homeowner agrees to pay in full for all services performed on the home. The general contractor contracts for services with a subcontractor but does not pay the subcontractor upon completion of the job. Under current law the subcontractor has the right to file a lien against the homeowner for payment of services rendered. The subcontractor would go to the county recorder's office to file a lien against the homeowner.

Under the proposed legislation, the county recorder notifies the homeowner of the lien as well as their rights, including a toll free 800 number the homeowner can call to get more information. The homeowner has 90 days from the time the lien is recorded to file a claim under the HRRF. When the homeowner calls the toll free 800 number, they receive information on how to file a claim with the HRRF. The Board sends them information and paperwork necessary to file the claim. The homeowner would include documentation as required, such as statements regarding the services performed, proof of payments such as cancelled checks, copy of any preliminary notice given by the lien holder and a copy of the lien itself. At that time the claim is opened and filed with the Board.

The Board notifies the lienholder and the general contractor of the claim and they have 15 days in which to file a response. The response from the general contractor should include any detail concerning their defense of the claim, if any, and any documents to support the defense. If the general contractor does not respond to the notice, the hearing officer officially determines that the general contractor was paid in full by the homeowner. The value of the claim is determined with the documentation provided and the lienholder is paid.

If the general contractor responds, the board sets a hearing date within 60 days near to the site of the work performed. If, at the hearing, the hearing officer determines that the homeowner has not paid the general contractor in full, the

claim is dismissed and the lienholder may pursue foreclosure of the lien. If the hearing officer determines that the homeowner paid the general contractor in full, the hearing officer determines the value of the claim and orders the Board to pay the lienholder that amount. In order to receive the payment, the lienholder must file a release of the lien in the county recorders' office. Once the lienholder files the release, the case is closed.

No system to resolve payment disputes is guaranteed to work properly every time. We recognize, in particular, that our proposal, which permits payments to be made to a lienholder from a state fund, may create an opportunity for fraud and collusion between a lienholder and homeowner. At this stage in the development of the proposal, we do not have what we consider an entirely satisfactory mechanism for discovering potential fraud. Whether fraud would actually occur under this system is speculative since lienholders and homeowners may be adequately deterred from such conduct by the existing serious consequences that would flow from a discovery of fraud (including criminal sanctions and loss of contractor's license).

In light of the complexity of this topic, we are confident that our proposal can be improved upon, and we look forward to receiving criticisms and comments from interested and informed reviewers.

## APPENDIX

### Proposed "Homeowners Relief Recovery Fund" Act

SECTION 1. Article 8 (commencing with Section 3155) is added to Chapter 2 of Title 15 of Part 4 of Division 3 of the Civil Code, to read:

#### Article 8. Home Owners Relief Recovery Fund

3155. This article shall be known and may be cited as the Homeowners Protection Act of 2001.

For purposes of this article, the following definitions shall apply:

(a) "Board" means the Contractors' State License Board.

(b) "Claimant" means an "owner" as defined in subdivision (f) who has filed a claim with the Homeowners' Relief Recovery Fund pursuant to this article and who has notice of a lien recorded against their real property for the reasonable value of labor, services, equipment, or material provided or supplied to the property.

(c) "Full payment" and "paid in full" means that the person who provided his or her labor, services, equipment, or material has received compensation for that labor, service, equipment, or material in an amount equal to the reasonable value of that labor, service, equipment, or material. A person shall not be considered to have been paid in full if 10 percent or more of any retention proceeds have been withheld.

(d) "Fund" means the Homeowners' Relief Recovery Fund.

(e) "Original contractor" is a person who has a direct contractual relationship with the owner of an existing single-family, owner-occupied dwelling to provide labor, services, equipment, or material toward a work of improvement on that property.

(f) "Owner" is a person who is the record owner of a single-family dwelling that is his or her primary residence.

(g) "Building" is any structure built for the support, shelter, or enclosure of persons, animals, chattels, or property of any kind.

3155.2.(a) A lienholder shall not be entitled to maintain an action to foreclose a recorded lien against the property pursuant to any other provision of law unless a hearing officer determines that the claimant has not paid the original contractor in full in a hearing held pursuant section 3155.12 or the claimant has not complied with subdivision (b).

(b) In order for a claimant to receive the protection of this article against foreclosure on a lien, the claimant shall hire only licensed contractors pursuant to a written contract.

3155.3.(a) There is hereby established within the State Treasury the Homeowners' Relief Recovery Fund, which is hereby continuously appropriated for the purpose of administering this article, including paying the compensation of hearing officer appointed pursuant to Section 3155.11, and providing monetary relief to any lienholder who is not paid in full for labor, services, equipment, or material.

(b) The state shall not be liable for any claims against the fund except as provided in this article.

3155.4. In order to establish a claim from the Homeowners Relief Recovery Fund a claimant shall provide evidence that he or she has a lien recorded against their real property pursuant to this chapter.

3155.5.(a) The Contractors' State License Board shall administer the Homeowners' Relief Recovery Fund and shall develop rules and regulations, which shall be as informal as possible to administer the fund pursuant to this article.

(b) The board may file a civil action against any licensed original contractor in order to obtain reimbursement to the fund for any payments made to a lienholder upon a finding by a hearing officer that the original contractor failed to pay the lienholder in full.

(c) The Board shall establish a toll free telephone number to provide information to all parties involved concerning the Homeowners Relief Recovery fund, the hearing process, and requirements under this article.

1355.6.(a) All counties and cities shall collect a fee from each applicant for a building permit. Each such fee shall be an amount determined by the Contractors' State Licensing Board.

(b) The board shall annually determine whether the fees collected are sufficient to meet the projected claims over the next year and annually report to the Legislature on the need to increase or decrease fees accordingly. In making this determination, the board shall not include in any fund balance moneys in the fund that are encumbered by claims approved pursuant to this article.

(c) The board shall be responsible for an annual review or audit of the fund.

3155.7.(a) All fees collected pursuant to Section 3155.6 shall be deposited in the State Treasury in the Homeowners Relief Recovery Fund, which is to be used exclusively for the purposes of this chapter.

(b) This chapter shall become operative January 1, 2002.

3155.8. Notwithstanding any other provision of law, the time for a lienholder to bring an action to foreclose a lien shall be extended to, and include, 60 days following service of the decision by a hearing officer regarding the claimant's claim against the Homeowners Relief Recovery Fund.

3155.9. Within 90 days after the lienholder has recorded a lien on a single-family owner-occupied dwelling which is the primary residence of the owner, the owner shall file with the Contractors' State License Board a statement of claim. This statement of claim shall include, but may not be limited to, the following:

(a) A copy of any preliminary notice given by the lienholder, together with the proof of service accompanied thereby, if a lienholder is otherwise required to serve a preliminary notice.

(b) A copy of the mechanic's lien recorded in the office of the county recorder.

(c) A statement of account showing all charges, credits, and balance due.

(d) Proof of payment including but not limited to a receipt of payment, credit card receipt or statement, or cancelled check.

3155.10. Once the statement of claim described in Section 3155.9 has been filed with the Contractors' State License Board, the board shall notify the original contractor and the lienholder of the filing of the claim. The original contractor and the lienholder shall file a response within 15 days after receipt of the notice. This response shall state in detail the defense against the claim and include all documents which the respondent claims support this defense. If the original contractor contends that it has not been paid in full, the original contractor shall provide a copy of all documents in support of this contention. The lienholder, original contractor, and claimant shall submit any other information to assist the hearing officer to make the determination required by this article.

3155.11. If the original contractor fails to respond to the claim filed by the claimant, the hearing officer shall find that the claimant paid the contractor in full and then determine the value of the claim based upon the documentation provided.

3155.12. The board shall set a hearing date within 60 days of receipt of the statement of claim at the office of the Contractors' State License Board nearest to the site of the work of improvement before a hearing officer appointed by the board pursuant to Section 3155.10 to hear the presentation of the lienholder, the original contractor, and the claimant. To the extent possible, all claims submitted on the same project shall be consolidated and heard in the same hearing. The

Contractors' State License Board shall provide notice to the original contractor, the claimant, and the lienholder of the date, time and location of this hearing.

3155.13. At the hearing, the hearing officer shall first determine whether the claimant has made a full payment to the original contractor. If the hearing officer determines that the claimant has not paid the contractor in full, the hearing officer shall dismiss the claim and issue a finding that the lienholder may pursue foreclosure of its mechanic's lien in the appropriate court. If the hearing officer determines that the claimant has paid the original contractor in full, the hearing officer shall determine the validity and reasonable value of the claim and, if determined to be valid, enter an order addressed to the Contractors' State License Board directing it to pay the lienholder the amount of the claim, subject to subdivision (a) of Section 3155.3.

3155.14. (a) The hearing shall be conducted in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code.

(b) The hearing officers appointed by the Contractor's State License Board shall be attorneys licensed to practice in this state with at least five years of experience in mechanic's lien law.

3155.15. (a) The findings of the hearing officer shall be final and impose obligations upon the claimant, original contractor, and lienholder only to the extent that the claimant, original contractor, or lienholder agree to be bound by those obligations. However, the remedies available to a party pursuant to this article, including the right to receive payment from the fund, shall not be available to a party that does not agree to the obligations. A lienholder shall be deemed to agree to the obligations only by recording a release of the lien in the county recorder's office where the real property is located. The findings of the hearing officer may be entered into evidence in any subsequent civil action or proceeding. The findings of the hearing officer shall be served on the lienholder, original contractor, the claimant, and the board no more than 10 days after the hearing.

(b) The Contractors' State License Board shall pay to the lienholder, upon receipt of an order pursuant to Section 3155.13 the amount of the claim, subject to subdivision (a) of Section 3155.3 within 10 days of receiving evidence that the lienholder has recorded a release of its lien in the county recorder's office where the real property is located. The evidence shall be submitted within 15 days after the findings of the hearing officer are served.

3155.16. A finding by the hearing officer that the original contractor was paid in full by the claimant and failed to make timely payments to any lienholder on the work of improvement, except a finding made pursuant to Section 3155.11, shall be grounds for immediate suspension of the original contractor's license. The original

contractor shall be given notice of a hearing to challenge the finding, which shall be conducted within 60 days of the date of the suspension, pursuant to the procedures of the Contractors' State License Board. If the finding is sustained, the contractor's license shall be immediately revoked and shall not be reinstated until the original contractor can supply to the Contractors' State License Board a contractor's license bond as provided in Section 7071.8 of the Business and Professions Code in the sum of fifty thousand dollars (\$50,000).

3155.17. (a) The Contractors' State License Board shall adopt and make available forms for the notice regarding the claimant's rights under this article.

(b) The county recorders office shall provide information pursuant to subdivision (c) of section 3155.5 at the same time that notice is sent to an owner of property upon which a lien is recorded.

Section 2. Any firm, corporation, partnership, or association, or any person acting in his or her individual capacity who aids, abets, solicits, or conspires with any person to knowingly present or cause to be presented any false or fraudulent claim for the payment of a loss under the provision of this act is guilty of a felony punishable by imprisonment in the state prison for two, three, or five years, and by a fine not exceeding fifty thousand dollars (\$50,000), unless the value of the fraud exceeds fifty thousand dollars (\$50,000) in which event the fine may not exceed double of the value of the fraud.

Section 3. No reimbursement is required by this act pursuant to Section 6 of Article XIII B of the California Constitution for certain costs that may be incurred by a local agency or school district because in the that regard this act creates a new crime or infraction, within the meaning of Section 17556 of the Government Code, or changes the definition of a crime within the meaning of Section 6 of Article XIII B of the California Constitution.

However, notwithstanding Section 17610 of the Government Code, if the Commission on State Mandates determines that this act contains other costs mandated by the state, reimbursements to local agencies and school districts for those costs shall be made pursuant to Part 7) commencing with Section 17500) of Division 4 of Title 2 of the Government Code. If the statewide cost of the claim for reimbursement does not exceed one million dollars (\$1,000,000), reimbursement shall be made from the State Mandates Claims Fund.