California Civil Code §3110.5: Is the Cure Worse Than the Disease?

by Robert J. "Mike" Cathcart and Bryan C. Jackson

Seeking to cure perceived slow payment practices by owners, the California Legislature may have created an ineffective cure that is worse than this infrequent disease by enacting Civil Code §3110.5. This new statute was sponsored by the Construction Employers' Association, supported by several subcontractor associations, and passed through the Legislature without any significant opposition or notoriety. Now, a broad range of construction consumers and contractors are scrambling to understand §3110.5 and how it affects their projects. Essentially, §3110.5 will add significant costs to private projects, increase the possibility of disputes, and will probably fail in its primary goal of securing the contractor's timely payment stream from the owner. During these recessionary times, neither the contractors nor the owners should welcome the expensive burdens imposed by §3110.5. Adequate "traditional" protections already existed to secure payments to contractors through mechanics' liens, stop notices, prompt payment rights, bond remedies, work stoppage rights, and private contract rights, to name a few. Perhaps a better cure for slow-paying owners would be to streamline these traditional protections rather than to invent a new, and arguably ineffective, costly, and burdensome scheme.

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SUMMARY OF §3110.5

Provide and Maintain Security: This new statute requires non-exempt owners of non-residential, private construction projects costing more than $5 million, or owners of less than a full interest in such projects costing more than $1 million, to provide and maintain a payment bond, an irrevocable letter of credit or a construction security escrow account inuring to the benefit of the original contractor. The amount of such bond, letter of credit, or escrow account must be 25 percent of the contract amount for projects scheduled to be completed within six months, and 15 percent of the contract amount for projects scheduled for six months or more. The bond, letter of credit, or escrow account is intended to secure the owner's timely payment obligations to the general contractor on the project.

Threshold Levels: Owners of a fee simple interest in the project, defined to include certain leases of 35 years or more, and owners of lesser interests, are obligated to provide the required financial security. If the owner is a fee simple owner or long-term lessee under the statute, the security is required for projects with a construction cost in excess of $5 million. If the owner holds a non-fee simple interest, such as a lease with a term less than 35 years , then the security requirement is triggered for projects costing in excess of $1 million.

Disclosure of Loan Amounts: At the time of contracting for any construction project covered by §3110.5, the contracting owner must supply to the original contractor a certified copy of the recorded construction mortgage or deed of trust disclosing the amount of the loan. Requiring an owner to provide loan amounts could constitute an invasion of privacy and may encourage contractors to assert claims for more money if they perceive that additional funds are available on the project.

EXEMPTIONS

Majority Ownership: Owners who are a majority owner of the original contractor are exempt from the requirement of posting the security. Perhaps this exemption will spur the formation of new joint ventures with contractors. However, owners who hope to form such joint ventures will have to have their own contractor's licenses before forming such joint ventures under current law, Cal. Bus. & Prof. Code § 7029. Alternatively, rather than joint ventures, perhaps this statute will cause more owners to acquire subsidiary construction companies.

Qualified Publicly Traded Companies: By its terms, §3110.5 does not apply to those owners who pass certain financial strength tests. One exemption is for "qualified" companies whose non-subordinated debt securities are rated as "investment grade" by a nationally recognized rating agency and are publicly traded on the New York, American, or NASDAQ stock exchanges. If a qualified company's stock is downgraded below investment grade, it will no longer be exempt from §3110.5. Also, an owner is excluded if it is a wholly owned subsidiary of a qualified company provided the parent guarantees "the obligations of the subsidiary under the construction contract." The statute does not appear to limit the guarantee to the payment obligations of the owner.

Qualified Private Companies: Also, §3110.5 does not apply to "qualified private companies" with "net worths" in excess of $50,000,000. The net worth must be calculated according to "generally accepted accounting principles." The statute is silent as to how that net worth must be demonstrated, whether by letter, certificate, affidavit or declaration under penalty of perjury, unqualified or qualified opinion, or by whom.

Fairness Concerns: The financial strength exemptions seem unfair and prejudicial to smaller or midsize owners and lack a credible nexus to the alleged purpose of securing timely payment to the contractor from the owner. Small owners, despite excellent payment histories, will be unfairly saddled with significant additional transaction costs while bigger "qualified" owners will have the advantage of avoiding the added §3110.5 transaction costs, even if the qualified owners have checkered payment histories. Again, the Legislature should have left the evaluation of owner payment risks to a contractor's own due diligence rather than placing unfair and arbitrary thresholds on transactions to the disadvantage of smaller to midsize owners with excellent payment histories.

HISTORY

Legislative Analysis: The Legislative Analysis for the underlying bill indicates that the bill was proposed in response to *Wm. R. Clarke Corp. v. Safeco Ins. Co.,* (1997) 15 Cal. 4th 882 ("Safeco") and *Capitol Steel Fabricators, Inc. v. Mega Construction Co., Inc.,* (1997) 58 Cal. App. 4th 1049 ("Mega"), which held that construction contract "pay if paid" clauses are unconstitutional waivers of subcontractor mechanic's lien rights, even if the contract specifically agreed to preserve those rights. According to sup-

porters of Civil Code §3110.5, under *Safeco* and *Mega*, a contractor may no longer delay paying its subcontractors while waiting for payment from the owner. Therefore, supporters of §3110.5 argued that without the "pay if paid" clause, contractors may be required to pay their subcontractors before they receive payment from a "slow-pay" owner. Accordingly, contractors may, in a sense, become financial guarantors of a portion of the owner's payment obligations on the project.

The bill's supporters, including the Construction Employers' Association, the California Chapter of the American Fence Contractors' Association and the Flasher/Barricade Association apparently argued that the existing traditional remedies available to contractors and subcontractors to secure payments from owners were insufficient. Traditional remedies include statutory mechanic's lien and stop notice rights, payment and performance bonds, and contractual protections that the parties might fashion. Also enacted in 1998 in response to *Safeco*, Civil Code §3260.2 allows contractors to stop work upon ten days' notice for non-payment of undisputed amounts by the owner. Essentially, §3260.2 provides stop work remedies similar to §3110.5 without the costly bond, letter of credit, or escrow account requirements. Nevertheless, proponents of the Civil Code §3110.5 complained that the existing legal remedies could take too long. Perhaps the Legislature should have shortened deadlines and streamlined procedures in existing traditional remedies, rather than create a whole new set of costly barriers to private construction projects.

Governor's Analysis: Governor Davis signed this law in October 2001, even though Governor Wilson vetoed a similar bill in 1998. Also, according to the legislative history, a similar bill previously "died" in the Legislature. As Governor Wilson stated in his veto message, "[c]ontract matters such as payment terms and the use of security instruments are best left to the contracting parties. General contractors are free to negotiate terms that are similar to the provisions of this bill. Similarly, property owners should be able to negotiate these issues without legislative interference."

Now, rather than leaving payment terms and security to the contracting parties, and rather than relying on all the other traditional protections referenced above, the bill's sponsors, supporters, the Legislature and Governor Davis have created an ambiguous, burdensome, and expensive scheme that cannot be waived contractually. Participants in the construction industry now face the challenge of how to accommodate new and ongoing construction projects under the requirements of §3110.5.

APPLICABILITY OF CIVIL CODE §3110.5

The statute became effective January 1, 2002. By its terms, it applies to construction, alterations, or repairs on real property. It does not apply to public works, to single family residences including subdivisions, or to housing developments eligible for Government Code §65915 density bonuses. The term "single family residences" means "a real property improvement used or intended to be used as a dwelling unit for one family." Although somewhat vague and susceptible to dispute, the language probably does not exempt apartment or condominium projects unless the density bonuses apply.

RETROACTIVE APPLICATION

Another potential for dispute arises from the lack of language discussing retroactive application. While some will cite constitutional protections against retroactive application, the more troubling arguments will probably center on the ongoing payment obligations of various owners that occur after the law became effective on January 1, 2002. In other words, while the statute should squarely apply to construction contracts executed after January 1, 2002, will it also apply to payment obligations that commenced before January 1, 2002 but continue after that date? Further, does the statute apply to contracts signed in 2001 where work does not commence until 2002? Does the statute apply to projects where the work commenced in 2001, but the contract is not executed until 2002? What if the parties sign a contract in 2002 but date it "as of" 2001? In short, the statute's silence on these and similar issues may lead to disputes and uncertainty.

SECURITY

The amount of the security, whether through a bond, letter of credit, or escrow account, is 25 percent of the construction cost if the project is to be completed within six months, and 15 percent of the construction cost for projects scheduled for six months or longer. The amount is based on the fixed price contract amount, the guaranteed maximum price ceiling, or the parties' "good faith estimate" as to the total cost anticipated to be incurred if the contract is neither a fixed price nor a guaranteed maximum contract.

The security "shall be used only when the contracting owner defaults on his or her contractual obligations to the original contractor." Those obligations do not appear to be limited to the financial obliga-

tions of the owner except by implication from the other terms of the statute. This ambiguity could be used by a contractor to argue for securing non-payment obligations, such as delay, extra work, and injury claims which would increase the required security if they are converted to mutually agreed change orders that increase the contract amount.

The statute provides that the security may be in one of the three described forms. It does not give the contractor the right to demand one or another of the specified forms of security. Presumably, the owner may opt for whichever form it wants to provide.

Payment Bond: The bond option is a payment bond issued by a specifically defined, California-admitted surety in the required amount "payable upon default by the contracting owner of any undisputed amount under the contract that has been due and payable for more than 30 days." Again, while the intended purpose of the statute is to secure payment to the contractor, many owners may "dispute" their alleged late payments, thereby preventing timely payment to the contractor through the payment bond.

Letter of Credit: The letter of credit must be provided by a financial institution as defined in Financial Code §5107, in the 15 percent or 25 percent amount, "inuring to the benefit of the original contractor," with a maturity date and terms to be determined by agreement among the owner, original contractor and issuer of the letter of credit. The letter of credit must be maintained "until the contracting owner has satisfied all of its payment obligations to the original contractor." Of the three security options, the letter of credit allows the most flexibility by allowing the terms to be determined by the owner and contractor. Accordingly, perhaps the letter of credit can be fashioned to create the best mutually beneficial arrangement between the parties. Further, because most owners will obtain financing from a construction lender for their projects, the hope is that such lenders will begin to offer affordable §3110.5 letters of credit that are underwritten and funded by the construction loan. Essentially, if a lender has already underwritten a construction loan for the project, it should be able to provide a letter of credit that would be secured by the construction loan in the amount of 15 percent or 25 percent of the contract amount. Further, such letter of credit could only be drawn by the contractor pursuant to the specific terms and requirements contained in the letter of credit.

Escrow Account: The escrow account option is defined in the statute with the most detail. The account holder must be licensed or properly exempt from such licensing requirement under the Escrow Law contained in the Financial Code. The account must be located in California. Also, the owner is required to reasonably satisfy the original contractor that it has "a perfected, first priority security interest in the construction security escrow account and all funds deposited by the contracting owner therein and the proceeds thereof." Such satisfaction may be by a written opinion of counsel, which may increase transaction costs and malpractice risks when using escrow accounts.

Although the escrow funds are the property of the contracting owner, the funds are held as security on deposit for perfection of the secured interest. The funds are to be disbursed only on joint authorization of the owner and original contractor. Accordingly, there must be a certain level of cooperation between the parties before the funds can be released. Thus, if there is a dispute, either party may abuse this joint authorization requirement thereby again vitiating the underlying purpose of §3110.5, which is timely payment to the contractor.

The contracting owner is required to deposit the escrow funds into the account prior to commencement of the work in the same required amount of either 25 percent or 15 percent of the construction costs depending on the time for completion. If the contract authorizes withholding of retention, retention amounts are to be added to the escrow account as they are withheld. Accordingly, for owners, the escrow account may be the least desirable option since it has the added costly requirement of holding retention in addition to the underlying amounts. Accordingly, on a typical 10 percent retention project, the owner will need to advance 15 percent or 25 percent of the construction loan proceeds to fund the escrow prior to the commencement of work and then add retention amounts every month thereby causing up to 25 percent to 35 percent of the construction funds to be advanced and placed in an escrow account during the construction work. This retention requirement makes the escrow account option even more expensive in terms of interest amounts charged on such advanced funds.

The escrow funds can be used for progress payments to the contractor whenever the amounts on deposit exceed the amount remaining to be paid under the construction contract. When the original contractor has been paid in full under the contract, any remaining funds can be disbursed to the

owner. However, again, all of these payment options must be accomplished with the authorization of both parties. Therefore, if one of the parties decides to create difficulties, perhaps to gain leverage in another dispute, they might withhold their authorization for disbursements, again defeating the intent of the statute to secure timely payment to the contractor.

Finally, the statute allows the owner and original contractor to agree to additional conditions for the disbursement of the escrow funds, so long as the amounts required to be deposited are not less than the required amounts.

No Waiver: The statute provides that it is "against public policy to waive the provisions of this section in any contract for any private work of improvement to which this section applies."

REMEDY FOR NONCOMPLIANCE

The statute requires that the owner provide and maintain one of the three specified forms of security. The only remedy under the statute for the owner's failure to provide and maintain the required security is the contractor's right to stop work. Upon any such failure, the original contractor may make a written demand for compliance with §3110.5. If the owner fails to provide the required security under §3110.5 within 10 days of the written demand, the original contractor "may suspend work until the required security is provided and maintained in accordance with this section." However, since work suspension is not mandatory, the contractor may forego the statutory remedy and secure payment through other means, including the traditional means listed at the beginning of this article.

Contrary to the stated purpose, the statute does not provide an expedited or self-executing remedy. Except for the payment bond option, which requires that the bond be payable as to "undisputed amounts" not paid within 30 days, no expedited self-executing procedure for prompt payment exists. Further, as detailed above, if the owner disputes such payment, then even payment under the bond can be withheld. Therefore, the statute might not lead to speedier, more efficient legal remedies for the contractor as envisioned.

UNRESOLVED ISSUES

Contractors, owners and lenders are concerned about the impact of §3110.5 on construction projects. The statute is sufficiently ambiguous so as to make its applicability nebulous. The added cost through payment bond premiums, increased fees for a letter of credit or an escrow account, and increased interest charges from lenders having to advance construction funds for a letter of credit or escrow account can be greater than any supposed increase in benefits otherwise provided by traditional remedies under existing law.

Accordingly, the statutory vagueness of §3110.5 raises several initial questions:

- Does the statute apply to apartment and condominium projects? Although it probably does, that conclusion is arguable.
- Can an owner who lacks sufficient bonding capacity require a contractor to obtain the security, or to supply a guarantee or other evidence of bonding capacity in order to facilitate the owner's acquisition of a bond?
- Would such an effort constitute an impermissible attempt to waive the statute?

Although the payment bond option includes a requirement that the payment bond be payable if the owner is more than 30 days in arrears on undisputed payments, there is no similar requirement for payments under the letter of credit and the escrow account options, which only appear to provide "security" for the owner's payment obligations. In fact, the escrow account option apparently requires that amounts be disbursed "only upon the joint authorization of the contracting owner and the original contractor, or in accordance with an order of any court." Accordingly, will this joint authorization requirement lead to additional disputes, when one party withholds authorization of a disbursement to gain leverage in another dispute? Will an uncooperative contractor then be liable under its construction agreement indemnity clause, delay clause, or consequential damages clause?

Can the construction contract provide that the original contractor must hold the owner harmless from any consequential damages or third-party claims for delay, acceleration, or other losses resulting from the original contractor's stop-work rights under §3110.5, or will such contract provisions constitute impermissible waivers of §3110.5?

POSSIBLE EXEMPTIONS

Owners and contractors have several options for dealing with Civil Code §3110.5, assuming the statute applies to their project.

First an owner can try to rely on the exemption for a "qualified" company if it is publicly traded on the New York, American, or NASDAQ exchange and

has investment grade nonsubordinated debt securities, as defined in the statute. Similarly, an owner could rely on the exemption for a "qualified private company" if it maintains a net worth exceeding $50,000,000 "in accordance with generally accepted accounting principles." More small- to mid-size companies might form joint ventures or vest property ownership in wholly-owned subsidiaries of "qualified" companies thereby gaining the economic advantage of being exempt from §3110.5. In fact, more joint ventures and creative ownership formations may be the unforeseen response to §3110.5.

Second, an owner can provide a guarantee of its obligations from a parent "qualified publicly traded company" or "qualified private company." Under the terms of the statute, and by implication, the guarantee should be limited to the financial obligations of the owner to make timely payments of undisputed amounts under the contract. Unfortunately, the express language of the statute at subsection (f) requires that the "obligations of the subsidiary under the contract" be guaranteed. Nevertheless, a prudent parent company should carefully consider limiting its guarantee to avoid onerous performance obligations such as provision of a coordinated design, construction administration services, or other duties. If the contractor ever threatens to stop work by alleging that the guarantee is too narrow, the parent company should carefully consider fighting such threats rather than expanding its guarantee to cover anything more than the payment of undisputed amounts under the contract.

Third, even if the statute applies to the project and the owner is not exempt, the owner and original contractor can choose to do nothing. The statute does not require any specific act until or unless the original contractor decides to serve notice demanding security on penalty of a work stoppage. For many participants in the construction process, acting in good faith, performing carefully, working together, communicating openly, and trusting each other could work to avoid compliance with §3110.5, which drives up the cost of construction for the owner, and ultimately, the users of such projects. For others, or on projects where the "honeymoon" turns sour, Civil Code §3110.5 provides the original contractor with another "arrow in its quiver" leading to a work stoppage and an additional dispute. The problem with the strategy of ignoring §3110.5 is that construction lenders will most likely add compliance with §3110.5 to their long list of requirements. Therefore, if an owner wants a loan, it will most likely have to comply and further certify that it is in compliance with "all" laws.

However, if initially not complying with §3110.5 remains an option for an owner, any risk that the security demand will surface should dictate steps to line up the security in advance, whether the security will be a payment bond, a letter of credit, or an escrow account. Preparatory steps to verify bonding capacity or the availability of a loan or loan terms to cover the escrow or letter of credit requirements could avoid the added trouble and expense of a last minute effort to do so under the threat of a 10-day stop-work notice from the contractor.

Finally, if a letter of credit, escrow account, or payment bond is the chosen vehicle for security, advance negotiation of the terms with the issuer, surety, or lender in order to facilitate issuance or funding if and when necessary during the project can forestall a work stoppage. Then, if the contractor demands that the security be provided and maintained, the process should be smoother. Nothing in the statute prevents the letter of credit, bond, or escrow account from being secured by loan funds, and prior planning could make the terms for such a procedure more acceptable. Novel loan products, creative arrangements for issuance of letters of credit secured by the construction loan, and innovative escrow accounts funded on a contingency basis from the construction loan will hopefully be created by the lending community to address these needs.

CONCLUSION

The Legislature has created a series of problems that only an underemployed lawyer could love. Owners and contractors, eager to get about the business of construction will have to retain counsel to navigate through the various demands created by Civil Code §3110.5. What the Legislature and the statute's proponents intended as a cure for slow payment may be worse than the perceived illness. At a minimum, many owners will need to re-evaluate project feasibilities, with increased construction costs attributable to the costs of providing the required security or arranging for it in advance in case the dreaded 10-day notice to stop work is asserted by the contractor. During the current recession and anticipated recovery, §3110.5 and its costly burdens on the development industry could not be more poorly timed. Perhaps a careful reevaluation of the traditional remedies should be undertaken by the Legislature, contractors and owners, so that costly overreactions to slow-payment concerns can be remedied in more effective ways.