

By Sarah V. J. Spyksma and Kathryn M. McCarthy

New Rules on Providing Security for Construction Contracts

Civil Code Section 3110.5 creates uncertainty for owners, lenders, and contractors

California Civil Code Section 3110.5, which became effective January 1, 2002, was passed into law with little or no fanfare and apparently caught many practitioners off guard.¹ Among its provisions, the statute requires that the owner of an interest in real property provide security for the owner's payment obligations under a construction contract for certain works of improvement. It also provides the original (or prime) contractor with the right to suspend work on the contract if the security is not furnished.

The legislative history of Section 3110.5 makes it clear that the statute's proponents were responding to the injustice inherent in prior case law that required an original contractor to pay its subcontractors even if the original contractor itself had not been paid.² The legislators intended to provide contractors with sufficient leverage to induce owners to make progress payments promptly. Moreover, the statute declares that contractual waiver of its benefits is against public policy. Thus

the importance of understanding the requirements and ambiguities of Section 3110.5 cannot be overstated.

The obligations of Section 3110.5 apply to owners of interests in real property that enter into construction contracts with original contractors for works of improvement³ on the property. An owner of an interest in real property includes the fee simple absolute owner as well as owners of lesser interests in the property, such as a lessee or an easement holder.⁴

Certain property owners are exempt from the requirements of Section 3110.5. These include:

- 1) A qualified publicly traded company, or a wholly owned subsidiary of a qualified publicly traded company (provided that the qualified publicly traded parent guarantees the obligations of the subsidiary under the construction contract).

- 2) A qualified privately traded company, or a wholly owned subsidiary of a qualified privately traded company (provided that the qualified privately traded parent guarantees the obligations of the subsidiary under the construction contract).⁵

In order to be exempt, a publicly traded company must have nonsubordinated debt of at least investment grade quality, while a privately traded company must have a minimum net worth of not less than \$50 million as determined in accordance with generally accepted account-

ing principles.⁶ An exempt owner who ceases to qualify for an exemption at any time prior to final payment on a construction contract otherwise subject to Section 3110.5 will, upon losing the exemption, be obligated to provide the security required by the statute.⁷

Owners involved in large development deals may have assets sufficient to satisfy the net worth criteria. However, owners seeking to engage in smaller transactions may find themselves saddled with a new and unanticipated cost that may render the deals economically unsound or impractical. Although the security required by the statute is intended to be composed of a portion of the contract price, the interplay between the statute's requirements and the methods by which construction projects are typically financed will likely result in the owner at best incurring costs of making the security available in the manner required by statute and at worst being obligated to make the security available in addition to the entire contract price.

Further, while large companies themselves may be exempt from the requirements of the statute, the involvement of an exempt company as a partner or member holding less than 100 percent of the ownership interests in a property owner will not extend the exemption to the property owner, which must independently meet the exemption criteria.

The statute's requirements apply only to works of improvement that exceed certain minimum value thresholds. Section

3110.5 protections do not apply unless either the contracting owner has a fee simple interest in the property and the value of the contract exceeds \$5 million, or the contracting owner holds some lesser interest in the property and the value of the contract exceeds \$1 million.⁸ It is unclear whether owners will be able to avoid the applicability of the statute by contracting for works of improvement using multiple small contracts, thereby creating a situation in which no single contract meets the minimum threshold requirement. However, this mechanism could be challenged easily. First, even initial compliance with such a plan by an original contractor later could be characterized as an unenforceable waiver of the protections to which the contractor was entitled under the statute. Further, to the extent that these contracts were between the same owner and contractor and given that a "work of improvement" is defined as the entire scheme of improvements,⁹ courts would probably not have much difficulty characterizing groups of small contracts between an owner and a contractor as one contract for a single work of improvement.

Certain types of construction contracts are themselves exempt from the statute's requirements. These exempt contracts are for the construction of:

- 1) Single-family residences, including those located within a subdivision or "any associated fixed works that require the services of a general engineering contractor." A single-family residence is defined in Section 3110.5 as an "improvement used or

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intended to be used as a dwelling unit for one family.”

2) Public works projects.

3) Housing developments eligible for a density bonus.¹⁰

Section 3110.5 is clear in its exclusion of single-family residential projects. Less clear is whether apartment projects and condominium or townhouse projects that are intended as single-family residences but possess many of the characteristics of multiuser projects would be exempt from the statute as well.

The Security Requirement

If an owner enters into a contract that is subject to Section 3110.5, the owner is required to provide the original contractor with security for the owner's payment obligations under the construction contract. The amount of the security should consist of at least 25 percent of the total amount of a construction contract providing for substantial completion within 6 months, or 15 percent of the total amount of any other construction contract.¹¹ If the construction contract does not contain a fixed price, the amount of security must be based on a percentage of a guaranteed maximum price; if there is no guaranteed maximum price, the security amount is determined “with reference to” the contracting owner's and original contractor's good faith estimate of the contracting owner's payment obligations under the construction contract.¹²

If the valuation of a contract is uncertain, Section 3110.5 does not provide guidance for the parties in determining whether the statute applies. The statute provides for the use of a good faith estimate, if necessary, to ascertain the amount of the construction contract for the purpose of determining how much security should be provided. This mechanism, however, is not extended to the valuation of the contract for the purpose of determining whether the statutory obligations attach. Therefore, parties cannot avoid the statute by intentionally omitting a contract price and giving “good faith estimates” that the contract will be worth less than the minimum threshold requirements. On the other hand, the statute does not address what parties should do when there is genuine uncertainty about whether the contract exceeds the statute's minimum value thresholds.

The contracting owner may provide the required security in one of three alternative forms: a payment bond,¹³ an escrow account,¹⁴ or a letter of credit that is issued by a financial institution.¹⁵

For a payment bond to satisfy the requirements of Section 3110.5, it must be payable if the contracting owner has defaulted on an

undisputed payment obligation¹⁶ under the contract and the obligation has been due and payable for more than 30 days.¹⁷ This option may be unattractive to some owners because bonds are increasingly less available and more expensive, and bonding companies are accustomed to dealing with and issuing bonds to contractors rather than owners.

In order to meet the security requirement with an escrow account,¹⁸ the contracting owner must establish the account before work commences under the construction contract with an initial deposit of an amount that is not less than the minimum required security.¹⁹ If the construction contract provides for retentions from progress payments, the retentions must be deposited into the escrow account as the progress payments are made. However, the outstanding balance of the escrow account at any given time need not exceed the total amount of remaining payments to the original contractor under the construction contract.²⁰ While the funds in the escrow account remain the property of the contracting owner, they are subject to a first priority security interest in favor of the original contractor²¹ and are effectively unavailable to the owner until released.

Funds held in an escrow account may be disbursed only upon either the joint authorization of the owner and contractor or in accordance with a court order that is binding on both parties.²² The conditions for disbursement upon the joint authorization of the owner and contractor are subject to negotiation between the parties so long as the required minimum balance is maintained. Because the owner and the contractor can negotiate additional conditions to the disbursement of funds from a Section 3110.5 escrow account, a construction lender may be able to require the owner to add a condition of prior consent from the construction lender. It is unclear, however, whether courts will see this type of condition as an impermissible impediment to construction contract payments or will evaluate the requirement with recognition of the need of the contracting owner to obtain financing.

The provisions regarding escrow accounts almost certainly conflict with the customary construction loan draw procedures, which often provide that the construction loan funds do not belong to the borrower until the funds are advanced (at which point they will accrue interest). Alternatively, if the construction loan funds are deemed advanced at the origination of the construction loan, the funds would be subjected to a first priority security interest in favor of the construction lender. Moreover, under a typical construction loan, the lender will hold all retainages as additional collateral. Because Section 3110.5

expressly does not require a lender to deposit its funds into the escrow account, the borrower may have to fund the escrow with separate money, resulting in a significant duplication of certain funds required for a financed project. This would render many prospective transactions a practical impossibility for developers that need to borrow funds in the first place.

There are several criteria for using a letter of credit to fulfill the security requirement of Section 3110.5. The letter of credit 1) must be irrevocable, 2) must inure to the benefit of the original contractor, and 3) must be maintained in effect until the owner has satisfied all of its payment obligations to the original contractor.²³ As long as these criteria are met, the maturity date and other terms of the letter of credit may be determined by the contracting owner, the original contractor, and the issuer of the letter of credit.²⁴ Because contracting owners may have difficulty obtaining payment bonds, and because an escrow account ties up substantially more funds, the letter of credit may be the most attractive choice for owners, at least in financed projects. Although issuers of letters of credit increasingly require cash collateral—and this, like an escrow account, restricts available funds—the parties may find that construction financing can be structured to provide for a letter of credit when collateral has already been provided. However, even under this scenario, the lender that issues the letter of credit will likely include the amount of the letter of credit (whether or not drawn) in the financing and thereby reduce the net proceeds of the loan. As a result, the contracting owner may still find itself short of funds.

If the contracting owner fails to provide or maintain the security required by Section 3110.5, the original contractor may make a written demand on the owner.²⁵ If the contracting owner fails to comply with the requirements of Section 3110.5 within 10 days of the contractor's demand, whether or not the owner has timely performed its payment obligations to date, the original contractor may suspend work until compliance occurs.²⁶

Other Interested Parties

Section 3110.5 as drafted also may confer benefits upon parties other than the original contractor. These include contractors other than the original contractor (for example, subcontractors) that have provided work at a particular property. Section 3110.5 explicitly provides that it does not affect other provisions in the Civil Code regarding mechanic's liens, stop notices, bond remedies, or prompt payment rights of subcontractors (including the payment responsibilities of the original contractor).²⁷ Since any payment bond pro-

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vided by the contracting owner must satisfy the requirements of Civil Code Section 3096, which contemplates a bond covering a range of claimants, the bond provided by the contracting owner under Section 3110.5 may be subject not only to the claims of the original contractor but also to the claims of others.

Further, under the Civil Code, a wide range of claimants may give stop notices to either the contracting owner or the construction lender.²⁸ The Civil Code defines "construction lender" broadly to include "any escrow holder or other party holding any funds furnished or to be furnished by the owner or lender or any other person as a fund from which to pay construction costs."²⁹ This definition includes the issuers of Section 3110.5 letters of credit and the escrow agents of Section 3110.5 escrow accounts. Thus, any party entitled to issue a stop notice pertaining to a particular work of improvement could presumably enforce this right against an issuer of a Section 3110.5 letter of credit or the escrow agent of a Section 3110.5 escrow account.

Contractors and owners will not be the only parties grappling with the practical application of Section 3110.5. Indeed, construction lenders also will be interested in the requirements of the statute, particularly the extent to which they can obtain interests in Section 3110.5 security.

Construction lenders may want to be certain that they obtain from owners specific covenants to ensure that the parties are in compliance with Section 3110.5, including covenants regarding the present and continued exemption of the owner or construction contract from the statute's requirements. This will create added pressure on the transaction, since neither the lender nor the owner will want to increase the project costs, but the lender will want the ability to act quickly to prevent the stoppage of work should that issue arise.

Construction lenders may also consider taking a security interest in Section 3110.5 escrow accounts or letters of credit. Section 3110.5 does not prohibit the granting of such a security interest but clearly contemplates that the contractor will have a first priority security interest in Section 3110.5 escrow accounts, and that letters of credit issued pursuant to the statute will be in favor of the original contractor.³⁰ Further, Civil Code Section 3166 provides that an assignment of any construction loan funds by an owner or contractor will not have priority over the rights of a claimant giving a stop notice to a construction lender, whether the assignment was made before or after the stop notice was given.³¹ Since a stop notice could also be issued to an escrow agent or issuer of a letter

of credit holding Section 3110.5 security, the lien of a construction lender on the security would likely be junior to the rights of other stop notice claimants.

Practitioners should pay heed to Section 3110.5, which creates considerable uncertainty for owners, contractors, and lenders. At least initially, the statute presumably will result in a significant increase in project costs for all but the most substantial developers. And construction financiers may be less inclined to finance transactions that are subject to Section 3110.5 requirements. ■

¹ 2001 Cal. Stat. ch. 833 (AB 1534).

² See <http://www.leginfo.ca.gov>. In 1997 the California Supreme Court ruled that "pay if paid" provisions in contracts between the general contractor and its subcontractors are unenforceable. *WM. R. Clarke Corp. v. Safeco Ins. Co. of Am.*, 5 Cal. 4th 882 (1997).

³ See CIV. CODE §3106.

⁴ CIV. CODE §3110.5(a)(1). If there are multiple parties with interests in the same property, the obligations of §3110.5 fall only upon the owner contracting for the work of improvement. Thus the landlord whose tenant has contracted for a work of improvement has no obligation under §3110.5—although the tenant's failure to comply with the statute may have detrimental consequences for the landlord whose tenant defaults and leaves behind a partially completed project.

⁵ CIV. CODE §3110.5(f).

⁶ *Id.*

⁷ *Id.*

⁸ CIV. CODE §3110.5(a)(2).

⁹ CIV. CODE §3106.

¹⁰ CIV. CODE §3110.5(e).

¹¹ CIV. CODE §3110.5(b)(1-3).

¹² CIV. CODE §3110.5(c).

¹³ CIV. CODE §§3110.5(b)(1), 3096.

¹⁴ CIV. CODE §3110.5(b).

¹⁵ "Financial institution" means a thrift institution, a commercial bank, or a trust company. CIV. CODE §3110.5(b)(2); FIN. CODE §5107.

¹⁶ The statute offers no guidance as to what is an "undisputed" payment and therefore on what basis the contractor may make a claim. However, since the type of payment bond that may be provided under Civil Code §3110.5 is the same form of bond to be provided by contractors and subcontractors under Civil Code §3096, it may be reasonable to infer that the dispute mechanisms applicable to §3096 bonds also are applicable to §3110.5 payment bonds. See CIV. CODE §3110.5(b)(1).

¹⁷ CIV. CODE §3110.5(b)(1).

¹⁸ In order to satisfy the requirements of §3110.5, the escrow account must be 1) designated as a "construction security escrow account," 2) maintained with a licensed or exempt escrow agent, and 3) located in California. CIV. CODE §3110.5(b)(3)(A).

¹⁹ CIV. CODE §3110.5(b)(3)(B).

²⁰ CIV. CODE §3110.5(b)(3)(B).

²¹ CIV. CODE §3110.5(A).

²² CIV. CODE §3110.5(b)(3)(B).

²³ CIV. CODE §3110.5(b)(2).

²⁴ *Id.*

²⁵ CIV. CODE §3110.5(c).

²⁶ *Id.*

²⁷ CIV. CODE §3110.5(d).

²⁸ CIV. CODE §§3158, 3159.

²⁹ CIV. CODE §3087.

³⁰ CIV. CODE §3110.5(b)(3)(A) (escrow accounts), CIV. CODE §3110.5(b)(2) (letters of credit).

³¹ CIV. CODE §3166.



Judgments Enforced

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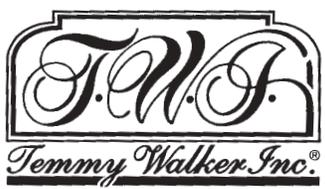
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