

Additional Payment Protection May Exist for General Contractors Working on Large Commercial Projects in California

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Most construction contractors are familiar with the "traditional" remedies under California law that protect their right to payment, including the mechanic's lien, stop payment notice and payment bond remedies. Far fewer contractors are aware of the significant additional payment protection they may have if they are under contract to perform a large commercial project that meets certain statutory requirements. This short article is designed to provide an overview of this often overlooked payment security option.

The applicable law is entitled "Security for Large Project," was formerly found at Civil Code Section 3110.5 and was relocated to Civil Code Sections 8700 - 8730 as part of the revisions to the mechanic's lien statutes that became effective July 1, 2012. The law applies if the owner of a fee interest in property contracts for a work of improvement with a contract price of greater than \$5 million, or if the owner of less than a fee interest in the property (for example, a tenant) contracts for a work of improvement with a contract price of greater than \$1 million. If a tenant holds a lease of one or more lawful parcels under the Subdivision Map Act for at least 35 years, the tenant is considered an owner of a fee interest for purposes of the law. The law does not apply to single family residences or to a housing development eligible for a density bonus under Government Code Section 65915. The law also does not apply if the owner (i) is a "qualified publicly traded company" (as defined in the statute), (ii) a subsidiary of a qualified publicly traded company if the obligations of the subsidiary under the construction contract are guaranteed by the parent, (iii) a "qualified private company," generally defined to be one that has no equity securities listed for trading on any markets and has a net worth of more than \$50 million, or (iv) a subsidiary of a qualified private company if the obligations of the subsidiary under the construction contract are guaranteed by the parent.

If the foregoing conditions are satisfied, and the owner is not the majority owner of the general contractor (now referred to in the California statutes as the "direct contractor"), then the owner must provide the direct contractor with (i) security for the owner's payment obligations under the contract, to be used only if the owner defaults on its payment obligations to the direct contractor, and (ii) a certified copy of any mortgage or deed of trust that secures the construction loan for the work of improvement and discloses the amount of the loan. If the owner fails to provide the security, the direct contractor may send a notice (that must comply with specific statutory requirements) demanding the security. If the owner does not provide the security within ten days of receiving the notice, the direct contractor may suspend the work until the security is provided. Significantly, neither the direct contractor's rights nor the owner's obligations under this law may be waived by any provisions in the contract.

The owner may provide the security in one of three forms: (i) a bond executed by an admitted surety insurer in the amount of 15% of the contract price or, if the work is to be substantially completed within six months of commencement, 25% of the contract price, (ii) an irrevocable letter of credit issued by a qualified financial institution in the amount of 15% of the contract price or, if the work is to be substantially completed within six months of commencement, 25% of the contract price, or (iii) an

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escrow account to which the owner makes an initial deposit of no less than 15% of the contract price or, if the work is to be substantially completed within six months of commencement, 25% of the contract price, with disbursements from the account to be made only upon joint authorization of owner and direct contractor or upon Court order. If the contract price is not a fixed price then the amount of the security to be given under any of the three forms shall be the guaranteed maximum price, or if there is no guaranteed maximum price, then the owner's and direct contractor's good faith estimate of the reasonable value of the work.

By requiring owners to provide security for their contractual payment obligations, this law offers significant protection to direct contractors falling under its purview. However, whether a direct contractor should make a demand for such security, and the timing of such a demand, are decisions that should be made carefully and after consultation with counsel due, among other things, to the impact on the owner-contractor relationship. Further, because the law leaves many details of the security to the agreement of the parties (including the language for the letter of credit and the escrow account) counsel for both parties will need to be intimately involved in the process once the demand for security is made.

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