Using
Surety Bonds & Insurance
To Protect Consumers

California Contractors State License Board

October 1, 2001

Contractors State License Board

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Executive Summary

As mandated by Senate Bill 2029, the Contractors State License Board has considered a number of issues concerning the use of bonds and insurance to compensate California homeowners for losses caused by licensed contractors. The Board has attempted to identify the policy issues that must be addressed in the overall context of consumer protection, acknowledging that any solution addressing one area of consumer protection must necessarily affect other areas. Likewise, it is important to consider the scale of the problems the Board was asked to study. While a vast majority of the nearly 300,000 licensed contractors practice their trades safely and honestly, those few that don't harm both consumers and other contractors.

This report identifies a broad range of issues. The Board will work with the Legislature, the DCA Enforcement Monitor, the California Department of Insurance, and the Department of Consumer Affairs, as well as with industry representatives, and surety and insurance companies to develop an integrated approach to consumer protection.

The Contractors State License Board

The Contractor's State License Board licenses and regulates contractors and provides protection for California consumers. There are situations where the Board's disciplinary process cannot provide restitution for consumers harmed by the conduct of licensed contractors. These are the situations where bonds and insurance could fill the gap.

California's home improvement industry can be split into two categories—service and repair, and home improvement. Service and repair includes the simple repair jobs—leaking roofs or broken water heaters. Home improvements are the larger repair and improvement jobs—replacing the roof or building a room addition. Each category can result in its own kind of financial injury.

Cause of Injury

The causes of financial injuries in home improvement include: front-loaded contracts, where payments far exceed the work performed, mechanics' liens, which are placed on homes when prime contractors fail to pay subcontractors and material suppliers, poor business practices, and poor workmanship. To the homeowner's further detriment, these injuries often occur in combination.

The causes of injury in service and repair are typically overcharging for necessary work and performing unnecessary work.

Surety Bonds

The bond signifies that the contractor has demonstrated fiscal solvency and the ability to perform competently. The surety guarantees the contractor's performance. Surety companies assess a contractor's credit and competence as part of the underwriting process. If underwriting is done well, the surety won't have to pay. If the surety is mistaken about the contractor's credit and competence, the surety pays for that mistake by paying a claim. But surety is not insurance. There is not a pool of money available to pay all claims. If the surety pays a claim, the surety expects to be paid back. The surety suffers a loss when the contractor cannot pay the surety back.

Performance and Payment Bonds

Performance and payment bonds affirm to the homeowner that the surety has evaluated the contractor's track record. They guarantee satisfactory completion of the contract and payment of all potential lien claimants. Unlike commercial property owners, homeowners do not typically seek out performance and payment bonds. Homeowners do not understand the risks inherent in home improvement work.

Performance and payment bonds would be very helpful to protect all homeowners but would be most cost effective for larger home improvement contracts.

Performance and payment bonds would not be a solution for service and repair problems. These bonds do not address injuries resulting from overcharging or the performance of unnecessary work.

Payment Bonds

Payment bonds guarantee that labor, subcontractors, and material suppliers are paid. Mandating payment bonds would benefit industry. But these bonds would also help consumers by bringing underwriting to the California home improvement market. While the surety would not be guaranteeing performance, the surety would be evaluating the contractor's financial standing. This kind of credit check would help protect homeowners from contractors on the brink of bankruptcy. It would also protect consumers from mechanics' liens.

The California Law Revision Commission has proposed a mandatory payment bond to address the problem of mechanics' liens. Under CLRC's proposal, the Legislature would mandate payment bonds for home improvement contracts over $10,000.

Blanket Bonds

Blanket bonds are bonds that cover most or all of the work a contractor may perform. All types of blanket bonds raise the same question: what bond amount is necessary to cover the work the individual contractor performs? This report discusses a number of strategies for setting the penal sum.

There are two kinds of blanket bonds—the one-size-fits-all bond, like the contractors license bond, and a more tailored bond with a penal sum that matches the work a contractor actually performs. These blanket bonds can be payment bonds, or performance and payment bonds. Most blanket bonds could be posted on CSLB's website where the information would be readily available to homeowners, subcontractors and suppliers.

Joint Control Accounts

Joint Control is a type of escrow fund used to control disbursement. The property owner places all or part of the contract amount with the joint control company. The joint control company pays in accordance with an agreed-upon schedule of progress and makes sure laborers, subcontractors, and material suppliers are paid so as to prevent liens. A joint control account may be a less costly but effective method for using a third-party to protect consumers from mechanics' liens and overpayments.

Contractor License Bond

All contractors are required to carry a contractor's license bond. This bond is different from other surety bonds. Most bonds are comprehensively underwritten. The contractors' license bond is not. Thus, California consumers should not assume that this bond signifies that the contractor is creditworthy or competent.

The California construction industry spends more than $16.5 million on contractor's license bond premiums each year. About $4.5 million (27 percent) of that amount is paid out in bond claims. Sureties explain, however, that the value of the bond rests not in the money paid to consumers but in the sureties' efforts to mediate a settlement between the homeowner and the contractor.

Consumers complain that the process for securing a bond payout is not consumer friendly. The laws governing the legal standards for securing a bond payout are unclear and cumbersome. This report suggests ways the bond can be reformed to be more responsive to consumers.

General Liability Insurance

Consumers are at risk when a contractor fails to carry commercial general liability insurance. The Board has been strongly in favor of mandating commercial general liability insurance. (Certain, however, that such a measure would fail, the Board accepted mandatory disclosure instead.) The Board has created the notice required by SB 2029 to provide information about insurance to homeowners. The Board will continue to gather information about insurance to strengthen consumer protection in this area.

Summary of Issues

These are the issues identified in the Board's report "Using Surety Bonds & Insurance to Protect Consumers."

Issue 1.1

Service and repair contracts are decidedly different from home improvement contracts.

Should legislation be enacted to create different bond solutions for each?

Issue 3.1

One-size-fits-all bond solutions may limit the flexibility of consumer protection.

Should different bond solutions be adopted for small, medium and large home improvement contracts?

Should alternatives to bonds, such as joint control accounts, also be considered?

Issue 5.1

Consumers do not understand the standards for a contractor's license bond payout.

Should legislation be enacted to clarify the standards for a contractor's license bond payout?

Issue 5.2

In order to create a preference for homeowner claims against the bond, current law adds additional requirements for subcontractors and suppliers making claims on the contractor's license bond.

Should legislation be enacted to establish preferences for homeowners without creating artificial barriers to other potential claimants?

Issue 5.3

An inconsistent interpretation of the term "willful" creates a barrier for consumers seeking access to the contractor's license bond.

Should legislation be enacted to define "willful" for purposes of bond payouts?

Issue 5.4

Consumers who secure a finding against a contractor in small claims court, an arbitration hearing, or by final order of the Registrar, have difficulty turning that finding into a contractor's license bond payout.

Should this gap in consumer access to the contractor's license bond be addressed by better consumer information and/or changes to the law governing surety payouts?

Issue 5.5

Often multiple complainants must share the $7,5000/$10,000 penal sum.

Should the Legislature consider increasing the current penal sum?

Issue 5.6

The contractor's license bond is a continuous bond, meaning there is no statutory bond period. This situation reduces the amount of money available to consumers making bond claims.

Should legislation be enacted to restructure the statutory bond period?

Would restructuring the bond significantly increase the number of contractors who do not qualify?

Issue 5.7

The surety does not make payments for damages caused by a violation of law if, at the time the violation occurred, the license was suspended.

Should legislation be enacted identifying situations when bond coverage should continue even if the contractor's license bond is suspended?

Issue 5.8

Under current law, even though the jurisdiction of small claims court is set at $5,000, the court's jurisdiction over the bond is set artificially at $4,000.

Should legislation be enacted to raise the amount of the jurisdictional limit for surety bonds claims brought to small claims court?

ISSUE 5.9

Under current law, sureties can recover the fees and costs of interpleading (bringing multiple complainants to superior court) from the $7,500 penal sum.

Should legislation be enacted to modify Code of Civil Procedure Section 386.6 (a) to exclude fee and cost reimbursement from the contractor's license bond?

ISSUE 6.1

The Board has long recognized the value of Commercial General Liability Insurance (CGL).

Should the Legislature mandate CGL?

ISSUE 6.2

There are two different types of insurance policies—"claims made" vs. "occurrence" policies. The protections offered by these policies can create different coverage for consumers. In addition, some policies are written to exclude certain coverage.

Should legislation be enacted to require specific types of policies or coverage?

Should these issues be addressed by providing information to consumers about insurance coverage?

STATE OF CALIFORNIA Harry W. Low, *Insurance Commissioner*

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October 27, 2001

Ms. Ellen Gallagher, Staff Counsel
Contractors State License Board
9821 Business Park Drive
Sacramento, CA 95827

Subject: Senate Bill 2029—Contractors State License Board Study

Dear Ms. Gallagher:

The California Department of Insurance appreciates the opportunity to provide input on this study to the Contractors State License Board. As you are aware, we made several proposals, some of which were incorporated into your report. Those recommendations include deleting the terms "willful" and "deliberate" from the Contractors' License Law and requiring a continuous bond. We also support an increase in the contractor's license bond amount, requiring that the Registrar's final order be sufficient proof to trigger payment under the contractor's license bond, removal of the artificial limit on the amount of the bond that can be awarded in small claims court, a prohibition on sureties from reducing the amount payable under the bond for interpleader expenses, and exploring placing surety claims into the California Insurance Guarantee Association as described in California Insurance Code Section 1063 et seq.

We look forward to working with the Contractors State License Board, the surety industry, consumers, other stakeholders and the legislature in formulating a balanced solution to the problems identified in the study that will result in greater protections for consumers while not unreasonably impacting the surety and construction industries.

Sincerely,

Tony Cignarale

Tony Cignarale
Supervising Compliance Officer

Using Surety Bonds & Insurance To Protect Consumers

"The Board shall conduct a comprehensive study in consultation with the Department of Insurance, on the use of surety bonds to compensate homeowners for financial injury sustained as a result of a contractor's fraud, poor workmanship, malfeasance, abandonment, failure to perform, or other illegal acts. This study shall include consideration of the payout criteria of bonds, increasing the bond amount; a "step-bonding" approach based on the amount of the prime contract, and the requirement of performance or payment bonds. This study shall additionally consider whether to require contractors to carry general liability insurance and whether to establish a guarantee program in order to provide the appropriate insurance and bond coverage in connection with a homeowner's employment of a contractor."

SB 2029, Section 7021(c), CSLB Sunset Report

Introduction

The Contractors State License Board (Board or CSLB) licenses and regulates contractors. When consumers are harmed by the dishonesty or incompetence of a licensed contractor, the Board can often secure compensation for the consumer through its disciplinary process. In order to comply with a citation for poor workmanship, for example, a contractor can be ordered to pay damages to the consumer. Failure to pay the damages assessed in the citation can result in the contractor losing his or her license.

There are situations where the Board cannot use the disciplinary process as leverage to secure restitution. For example, when the contractor surrenders the license, threats to suspend or revoke the license have no effect. When a contractor declares bankruptcy, unless the Board can prove fraud in bankruptcy court, the debt to the consumer is discharged and the Board loses leverage. Likewise, accidental damage is not usually addressed by disciplinary action. These are the situations when bonds and insurance can fill the gap.

It is with better compensation for consumers in mind that the Legislature ordered the Board to examine and report on a variety of financial mechanisms and ways to make these mechanisms available to homeowners. Although the financial mechanisms discussed here must be understood to play a role in the Board's strategy for consumer protection, the Board has neither regulatory authority nor subject matter expertise in the areas of surety and insurance. This authority and expertise rests in the California Department of Insurance (CDI). As directed by the Legislature, the Board consulted with CDI in the preparation of this report.

Method

A questionnaire was distributed to the major sureties writing contractors' license bonds and insurance company representatives who participated in the Board's 1999 study of Commercial General Liability Insurance. A draft of the report was sent to the sureties and insurance representatives who responded to the questionnaire. Where appropriate, the draft has been changed to reflect the sureties' responses. In some instances, the sureties' responses have been included as separate items in the text. The Surety Company of the Pacific requested that the Board attach a copy of its August 31, 2001, response.

Chapter 1.

Causes of Financial Injury to California Homeowners

The Legislature asked the Board to examine the use of bonds and insurance to protect homeowners contracting for home improvement work. To sensibly discuss the use of bonds and insurance, this report begins by examining the circumstances that result in financial harm to homeowners.

California's home improvement industry can be split into two categories—service and repair, and home improvement. There is some overlap between the two. For the most part, however, service and repair includes the simple repair jobs—leaking roofs or broken water heaters. Home improvement is usually the larger repair and improvement jobs—replacing the roof or building a room addition. Each category can result in its own kind of financial injury.

Home Improvement

The causes of financial injuries in home improvement include front-loaded contracts, mechanics' liens, poor business practices and poor workmanship. To the homeowner's further detriment, these injuries often occur in combination.

Front-loaded Contracts

Homeowners can lose both money and control of their projects when contractors front-load contracts. Front-loading occurs when payments get ahead of the work. For example, the contractor may collect an excessive down payment or take payments ahead of the progress of the work.

If a homeowner has paid the contractor 50 percent or even 100 percent of the money allotted in the contract but the contractor has completed a lesser percentage of work, the homeowner has limited leverage with the contractor. If the project goes off track, the homeowner cannot fire the contractor—there would not be enough money left to complete the project. The homeowner usually has no choice but to continue with the contractor. The homeowner pours additional funds into a "money pit" in the hope that the contractor will come through. If the contractor ultimately abandons the project, the losses can be substantial.

Mechanics' Liens

Under present mechanics' lien law, unpaid subcontractors or suppliers who have contributed to a construction project may place what is called a mechanics' lien on the improved property. Even if the homeowner pays the prime contractor, if the contractor fails to pay the laborers, subcontractors and material suppliers, these individuals can place a lien on the property. The lien has immediate consequences for the homeowner. The lien affects the homeowner's credit rating and reduces the homeowner's ability to borrow money. Unpaid lien claimants can seek judicial foreclosure of the home to satisfy the lien. While foreclosure is rare, *even though the homeowner has already paid the contractor,* the homeowner may have to pay the subcontractor or supplier. This is referred to as the "double payment " problem.

Front-loading is prohibited by law

Down payments in home improvement contracts are limited to the lesser of $1,000 or 10 percent of the contract amount ($200 or 2 percent for swimming pools).[1]

Despite this restriction, contractors often collect much more. The Board usually finds out about excessive down payments only when consumers file a complaint about something else.

Contractor's License Law requires payments to be limited by a schedule that allows a contractor to be paid only as progress is made on the project. Unfortunately, homeowners do not understand that, to be effective, the schedule of payments must be tied to completed work. When homeowners don't know the law, some contractors take as much as they can.

[1] Business & Professions Code Section 7159 (d).

Relationship of contractor credit and mechanics' lien rights

Last year, a company doing business as Olympic Roofing Company and operating in Sacramento County did shoddy work on a number of home roofing jobs and abandoned others. Most customers had paid in full. After the contractor disappeared, a single roofing material supplier filed lien claims against 12 homeowners for a total of $45,000.

These homeowners got a crash course in mechanics' lien rights. Most paid twice—once to the contractor for shoddy work and once to the material supplier. This situation illustrates how, unknown to the homeowner, the subcontractors and material suppliers can effectively "lend" the homeowner's assets to untrustworthy contractors.

Because subcontractors and suppliers rely on the mechanics' lien right, these potential lien claimants do not need to check the contractor's credit or make sure the contractor has paid other subcontractors and suppliers. Indeed, despite a pattern of not paying, the lien right allows an unscrupulous contractor to continue to receive goods and services.

Poor Business Practices

Some contractors are fine artisans but terrible at managing businesses. To qualify for a license, applicants must take and pass the Law and Business examination and must demonstrate four years of journey-level experience in the particular license category and/or classification. Most of this experience is gained as an employee.

The assumption underlying CSLB licensing standards is that applicants with qualifying experience can decide for themselves whether they have enough experience to run a contracting business and how large that business can be. Some contractors, for example, take on more work than they can successfully complete. Although the marketplace may ultimately decide which contractor will be successful and which contractor will not, the ferreting out process can be risky for consumers.

Poor Workmanship

Most licensed contractors perform competent work and are never subject to the CSLB disciplinary system. However, a small percentage of licensees perform work that does not meet the accepted industry standards.

Commercial property owners tend to be sophisticated business people, and usually understand that possession of a license does not mean a contractor has an adequate track record in every aspect of construction that falls under the relevant license category. Homeowners, on the other hand, do not routinely evaluate whether the contractor they are considering has adequate experience with the particular type and scope of the planned remodel. Unchecked, some contractors agree to perform work beyond the scope of their experience.

These Causes of Injury Act in Combination

If a home improvement project is appropriately managed, the contractor will collect a legal down payment, perform competent work according to the contract schedule, bill for completed work, and pay laborers, subcontractors and suppliers as the homeowner pays for the completed work.

If, however, a contractor fails to maintain strong business practices, the contractor can quickly get into financial trouble. Strapped for cash, the contractor will collect money from homeowners in advance of completing the work. The contractor will begin juggling payments to subcontractors and suppliers. Instead of cutting the contractor off, subcontractors and suppliers will continue to provide the contractor with undeserved credit by relying on the mechanics' lien right.

Because the contractor needs more money to catch up, he or she will focus on getting the next home improvement contract instead of completing open contracts. Because the homeowner has not retained enough of the contract amount, the homeowner has no leverage to force the contractor to finish the project. Work that is completed is often rushed and substandard.

When this house of cards collapses, the contractor may abandon the work, often declaring bankruptcy. Meanwhile, the subcontractors and suppliers are holding the homeowner's home equity hostage in the form of a mechanics' lien. The project is incomplete and the work that is complete may not be up to trade standards.

ISSUE 1.1

Service and repair contracts are decidedly different from home improvement contracts.

Should legislation be enacted to create different bond solutions for each?

Service and Repair

The causes of financial injury in the service and repair sector are different from those in the home improvement sector. Service and repair contractors almost always complete their work and are less likely to be charged with incompetence. Liens are unusual. The service and repair sector is not problem-free, however. The cause of injury in service and repair is typically overcharging for necessary work and performing unnecessary work.

Chapter 2.

Introduction to Surety Bonds

The biggest misunderstanding about surety is that it is confused with insurance. Most people have a working knowledge of insurance and how it works. Not so with surety bonds. This chapter describes surety and compares it to insurance.

According to *The Basic Bond Book*,[2] "a surety bond is a promise to be liable for the debt, default or failure of another." The bond is a surety's financial guarantee that a contractor will perform certain agreed upon acts. Bonds can be used to guarantee virtually anything. In the construction industry, bonds range from those used to "bond around" specific lien rights to the most comprehensive of bonds—the performance and payment bond—a guarantee that the contractor will satisfactorily perform a specific construction contract and will pay all laborers, subcontractors, and suppliers.

The way the surety guarantee usually works is that the contractor seeking a bond submits comprehensive verifiable information about the project and the contractor's capacity to complete the project. Based on this information, the surety determines whether to guarantee the contractor's performance.

Surety companies never write a bond intending to pay a bond claim. If the surety does a good job underwriting the bond, the surety rarely has to pay. This is the first of many points that distinguish surety from insurance.

Insurance is designed to pay. Surety is not.

Main Differences

Surety companies never write a bond intending to pay a bond claim. If the surety does a good job underwriting the bond, the surety rarely has to pay. This is the first of many points that distinguish surety from insurance.

Insurance is designed to pay. Surety is not.

Type of Claim

Whether a claim is against insurance or surety depends on the different causes of damage. An insurance claim usually addresses damage arising out of an unexpected or accidental occurrence. A surety claim arises out of damages caused by a contractor's failure to do what is expected—perform the contract according to the plans and specifications and pay money that is owed. For example, suppose a roofing contractor has a surety bond covering her performance. The same contractor also has a comprehensive commercial general liability insurance policy. Months later, the roof leaks and ruins grandma's quilt and the newly refinished floor. The bond should cover fixing the roof. Insurance should cover the floor and the quilt.

Duty to Defend

An insurance claim triggers a duty for the insurer to defend the contractor. Although a surety may defend the contractor in order to avoid paying a claim, the surety has no absolute duty to defend the contractor.

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[2] Joint publication of the Associated General Contractors of America (AGC) and the National Association of Surety Bond Producers (NASBP), published in 1993.

Repayment

The surety company expects to be paid back. The insurance company does not.

Because insurance risk is spread over all like insureds, the insured contractor who suffers a loss does not have to pay the insurance company back—the premiums everyone pays are pooled to cover the cost. This, of course, is the purpose of insurance. Everyone pays so that one individual or business entity won't have to.

In surety, however, the surety premium is, in effect, a prequalification fee. Even though surety premiums may be adjusted to cover expected losses, there is no pool to cover losses; the surety expects to be paid back by the contractor.

Underwriting

According to the Basic Bond Book, *there are three main categories of information necessary for surety underwriting.*

1. *Does the contractor have the capacity to perform the contract? This includes such items as the contractor's overall track record, trade references, the experience of key people and a continuity plan in case key people aren't available to finish the project.*
2. *Does the contractor possess sufficient financial strength as demonstrated by a review of the contractor's finances?*
3. *Whether, and to what extent, does the contractor agree to personal indemnity?*

Underwriting

The most important difference is underwriting. Insurance spreads risk among like insureds. For example, the insurer collects data and determines that 1 in 100 houses will burn down this year. The insurer sets premiums so that the owners of all 100 houses will pay to rebuild the one burned house. In contrast, surety does not routinely spread risk. Surety risk is assessed individually—can *this* contractor complete *this* project and pay all the bills for the contract price?

The value of a surety bond is that property owners can trust the evaluation of the contractor's business practices to the surety's expertise. This point brings us full circle to why insurance companies expect to pay and surety companies do not.

When a consumer is insured against the possibility of fire, flood, or another unexpected occurrence, underwriting determines how often and at what cost these possibilities will occur and establishes a premium that reflects the amount the insurance company believes it will need to pay.

Surety underwriting, on the other hand, examines whether individual contractors can competently perform. For the most part, the premium covers the cost of evaluating the contractor, paying agent's commissions, paying premium taxes, paying losses, and, of course, making a profit. If the surety has appropriately underwritten a construction project, the surety company will only rarely have to pay on that bond.

There is risk in surety underwriting, however. Some contractors will not perform and will not have the capacity to pay the surety back. Some of this risk is reflected in the premium. The better a contractor's track record, the lower the bond premium. Conversely, a less than convincing track record leads to higher premiums. In some cases, a bond can be issued to a contractor with a poor track record only if the contractor puts up property as collateral. There comes a point, however, where a surety will not write a bond. When the surety won't issue a bond because of the contractor's poor performance, the bond is doing just what it is supposed to do—evaluating the contractor's potential for performance. When the surety won't issue a bond because the contractor fails to pay subcontractors and suppliers, again the bond is doing what it is designed to do. Sometimes, however, a competent contractor who pays subcontractors and suppliers may still have poor personal credit. The underwriting process would deny a bond to these contractors as well.

NOTE: The Surety Association of America (SAA) in conjunction with the American Insurance Association (AI) responded to this section by noting that the text may mislead some readers. They explain that surety is not completely different from insurance. In fact, according *to California law, it is a class of insurance. They also note that paying losses is an important part of a surety's function.*

Surety Solvency

In July of 2001, Amwest, an admitted surety conducting business in California and other western states, went bankrupt. Any projects Amwest guaranteed became exposed. Unlike California's insurance industry, where policyholders have some protection in the form of a guarantee fund, no such protection exists in the California surety market. Amwest wrote about 2,600 contractors' license bonds. In September, 2001, another surety, Frontier Pacific Insurance Company, also was declared insolvent. Frontier wrote about 27,000 of CSLB's contractor's license bonds.

The State of Nevada has addressed surety insolvency by requiring admitted sureties who do business in Nevada to be "A" rated. California sureties responded to this solution by explaining that the authorization of the California Department of Insurance should be sufficient to conduct business in California.

Andy Faust of American Contractors Indemnity Company explained that requiring an A rating is unnecessary and would bring chaos to the market. He claims no A-, B++, B+, or B ever went insolvent without first being downgraded. It takes some time for sureties rated at these levels to drop through the various levels into insolvency. Other sureties disagree, however, that there is always adequate time to identify when a surety is on the brink of insolvency.

The Board will consult with the California Department of Insurance (CDI) to determine if California consumers are sufficiently protected under CDI's present authorizations and/or, if there can be an "early warning system" for surety insolvency. In response to discussions about surety insolvency, CDI is exploring a surety guarantee much like the California Life and Health Insurance Guarantee Association described in Insurance Code Section 1067 et seq. When a participating surety becomes insolvent, the other surety would step in to continue coverage.

Chapter 3.

Types of Bonds Available and Their Use in the Home Improvement Market

If bonds are mandatory, some contractors will be forced out of the market. This is because the underwriting process will identify contractors who cannot demonstrate the credit, capacity and competence to adequately perform.

One surety representative commented that a bond can be issued to guarantee almost anything. Lien release bonds "bond around" lien claims to allow projects to go forward when there is a payment dispute. Bid bonds ensure that contractors bidding for work will actually enter into a contract. Only the bonds most relevant to the issues raised in SB 2029 will be discussed here.

It is important to note that not all contractors can qualify for all bonds. If bonds are mandatory, some contractors will be forced out of the market. This is because the underwriting process will identify contractors who cannot demonstrate the credit, capacity and competence to adequately perform.

Performance and Payment Bonds

A **performance bond** guarantees that the contractor will build in accord with the particular project's plans and specifications and perform other obligations set out by the contract. A **payment bond** guarantees that material and equipment suppliers, subcontractors and laborers who work on a particular project will be paid.

Performance and payment bonds are often packaged together to make sure the project is completed and labor and material suppliers paid. These bonds' responsibilities are not unlimited, however. Each bond has an amount, called a "penal sum." If the cost of completing the contract and paying all contributors exceeds the penal sum, the surety can pay the penal sum to the property owner in lieu of completion and payment.

Application to Home Improvement Projects

Any project can go off track if the contractor lacks the assets to continue the project or the expertise to complete it. This is as true in the home improvement sector as it is in the commercial sector. Commercial property owners routinely protect themselves against these problems by requiring the contractor to secure performance and payment bonds.

Recognizing the value of this protection, the Legislature has long encouraged homeowners contracting for home improvement projects to require the contractor to get performance and payment bonds.[3] But even though homeowners are subject to the same risks as commercial property owners, homeowners rarely opt for these bonds. Why?

First, as noted in the introduction, homeowners do not understand the risks involved—mechanics' liens, front-loading, paying only for progress, etc.

Second, even if homeowners understood the problems that could occur, the perceived cost of payment and performance bonds dissuades them from using them. Homeowners are usually on tight budgets for their home improvement projects.

[3] Bus. & Prof. Code Section 7159 (g) provides in pertinent part: "The contract shall contain . . . a notice . . . that the owner or tenant has the right to require a contractor to have a performance and payment bond."

Paying a premium to make sure the contractor does what consumers believe the contractor is already being paid to do—satisfactorily complete the project and pay for labor and material—makes no sense to homeowners.

Third, contractors often discourage homeowners from getting these bonds. Contractors who pay their bills and satisfy their customers say the bonds are not necessary. Of course, contractors who do not pay their bills and do not satisfy their customers *also* say that bonds are not necessary. Contractors in precarious financial shape do not want surety companies evaluating their capacity to contract.

Finally, it is widely believed that small, undercapitalized contractors would not be able to qualify for performance and payment bonds.

Cost of performance and payment bonds

Whenever the question of performance and payment bonds for home improvement projects is raised, there is usually a general agreement that these bonds would cost the same for home improvement projects as for commercial industry— three to five percent.

In response to a draft of this report, however, sureties writing these bonds expressed doubt that the cost would be so high. One placed the cost at one to three percent and another at 1.5 percent. Thus, the cost of performance and payment bonds may be more reasonable than previously thought.

Protection Provided by Performance and Payment Bonds

A homeowner would be protected by a performance and payment bond in a variety of ways:

- If payments to the contractor got ahead of the work (front-loading), the homeowner might still lose control of the project but the risk of financial loss would be significantly reduced.
- Once the homeowner paid the contractor, payments to laborers, subcontractors, and suppliers would be guaranteed (mechanics' liens).
- The homeowner would be better protected from a contractor's poor business practices because the surety would have attested to his or her capabilities.

Drawbacks

There is some question about whether these performance and payment bonds can be written for all home improvement contracts. The transaction costs (including underwriting) of full performance and payment bonds might be too expensive, particulary for smaller contracts. But even if these bonds are not efficient for smaller contracts, they may be very useful for large projects of $50,000 and above.

Application to Service and Repair Work

A performance and payment bond would not be very useful to protect homeowners contracting for service and repair work. The injuries associated with service and repair are excessive charges and unnecessary work, injuries a performance and payment bond does not address.

Payment Bonds

As noted above, a **payment bond** guarantees that material and equipment suppliers, subcontractors and laborers who work on a particular project will be paid. In the home improvement context, a payment bond would protect homeowners from the risk of a mechanics' lien.

Newly Proposed Use of Civil Code 3235 (50 percent) Bond

On June 19, 2001, the California Law Revision Commission (CLRC) distributed a draft proposal addressing the problem of residential mechanic's liens. The

CLRC's approach is based on the existing payment bond strategy found in Civil Code Section 3235.[4]

Under Civil Code Section 3235, the contractor eliminates the property owner's exposure to a mechanics' lien by recording a payment bond of 50 percent of the contract amount in the office of the county recorder. This bond would guarantee payment up to 50 percent of the contract amount for unpaid subcontractors, material suppliers and laborers. One surety estimated that the cost of this payment bond would range from .5 percent to three percent. The range is assumed to be a reflection of the contractor's track record for paying.[5]

Choosing payment bonds is good for subcontractors and suppliers. Choosing this approach also has benefits for homeowners.

First, it solves the "double payment" problem. Once the homeowner makes a good faith payment to the contractor, the homeowner will be safe from potential liens.

Second, it helps solve problems of unfair competition when unscrupulous contractors (who have no intention of paying subcontractors and suppliers) underbid home improvement projects. By the time the market recognizes the problem, the contractor has declared bankruptcy or moved beyond the reach of CSLB. In any event, the money is gone.

Third, the cost to contractors who maintain a good payment record will be slight, while contractors who do not maintain a good record will pay a larger premium. Thus, a mandatory payment bond approach would force many contractors to undergo underwriting, a process which would, in turn, curb the ability of contractors to take jobs when the risk is great that subcontractors and suppliers will not be paid. As noted in Chapter 2, however, an unknown number of contractors would not qualify for these bonds.

At this writing, the CLRC's approach includes mandatory 50 percent bonds on all individual home improvement contracts over $10,000. According to the CLRC's proposed recommendation, bonds would not be required for contracts under $10,000.

A payment bond would bring the benefits of underwriting to the California home improvement market at less cost than a performance and payment bond.

Blanket Bonds

A blanket bond is a bond written to cover more than one project. There are two kinds of blanket bonds—the one-size-fits-all approach of the contractor's license bond, and the sliding scale bond that increases as the amount of work increases.

The blanket bond concept has many applications. A blanket *payment and performance* bond could be written to cover all of a contractor's contracts. A blanket *payment* bond

[4] Civil Code section 3235 provides: In case the original contract for a private work of improvement is filed in the office of the county recorder of the county where the property is situated before the work is commenced, and the payment bond of the original contractor in an amount not less than 50 percent of the contract price named in such contract is recorded in such office, then the court must, where it would be equitable so to do, restrict the recovery under lien claims to an aggregate amount equal to the amount found to be due from the owner to the original contractor and render judgment against the original contractor and his sureties on such bond for any deficiency or difference there may remain between such amount so found to be due to the original contractor and the whole amount found to be due to claimants.

[5] For an in-depth look at this payment bond strategy, see CLRC Memorandum 2001-52.

could be written to guarantee that the contractor will pay all for all labor and supplies.

Contractor's License Law currently makes use of two types of blanket bonds—the contractor's license bond and a blanket payment and performance bond approved by the Board as a "bond equivalent."[6]

The State of Nevada also uses a blanket bond approach called "step bonding" that limits the amount of work a contractor can perform.

Contractor's License Bond

The contractor's license bond is designed to cover any damage arising out of a violation of contractor's license law and will be discussed in more detail in Chapters 4 and 5. Basically, the contractor's license bond is one $7,500/$10,000 bond, no matter how much work a contractor performs. Regardless of whether the contractor agrees to perform five $1,000 jobs, one $100,000 job, or 500 $30,000 jobs, there is only one bond.

"Bond Equivalent"

Business & Professions Code section 7159(g) allows a contractor carrying a "bond equivalent" approved by the Board to be exempt from some of the home improvement contract requirements. Contractors who meet this provision are not limited to the down payment restrictions. They are not required to set a schedule of payments, and do not have to provide homeowners with information about liens.

Over the years, the Board has approved only one type of "bond equivalent"—a blanket performance and payment bond. As of September 1, 2001, only 10 contractors in California have been approved to use a blanket bond.

The main issue the Board faces in approving the use of blanket bonds is determining how large the penal sum of the blanket bond must be to cover all the work a contractor performs each year. To date, the Board has relied on sworn statements by those responsible for the company's finances. The Board will review its approach to this policy.

Step Bonds

A step bond is a blanket bond that has specific gradations. The State of Nevada employs a step bond system. The Nevada Board sets the amount of the bond "with reference to the contractor's financial and professional responsibility and the magnitude of his operations."[7] The amount of the bond relates to the size of the contract a Nevada contractor can agree to perform. For example, if a contractor has a $50,000 bond, the contractor can do any number of contracts of $50,000 or less. To bring flexibility to the system, the Nevada Board allows a contractor to seek a one-time exception for a contract above his or her step amount.

Such a system could not easily be implemented in California. In order to determine the amount of work a contractor can safely perform, Nevada requires each applicant to provide detailed financial statements including assets and liabilities, credit histories, and other information that the Nevada Board uses to assess whether this individual may do business in Nevada. The Nevada Board uses this information as a

[6] Business & Professions Code Section 7159 (g).

[7] Nevada Revised Statutes Section 624.270.

building block for its decision to set the limit on the size contracts the contractor can agree to perform.

By contrast, California does not collect any information about an applicant's assets. Instead, California requires each applicant to affirm under penalty of perjury that he or she has operating capital exceeding $2,500.[8] In order to implement a system like Nevada's, California would need to significantly increase its review of each applicant's financial information.

Nevada has just fewer than 14,000 licensees. California has more than 224,000 active licensees. These numbers make Nevada's approach impractical in California.

Proposed New Blanket Payment Bond

As previously discussed, the CLRC is proposing a mandatory requirement that each home improvement contract over $10,000 must be covered by a payment bond of 50 percent of the contract amount. This bond would be a substitute for subcontractor and material supplier mechanics' lien rights.

In a letter to the CLRC dated February 23, 2001, LRC, George Peate, the Senior Vice President-Underwriting of Surety Company of the Pacific, expressed the opinion that one blanket bond issued annually would be less costly than individual bonds. He wrote, "[T]he concept of having several different levels of bond sizes tied to the contractor's annual sales in past years seems like a reasonable and practical approach." Assuming that the bond described by Mr. Peate would cover the same ground as the individual, section 3235 bonds, a blanket bond would significantly reduce transaction costs. In a blanket payment bond system, the bond could be electronically filed with the Board rather than recorded at the County Recorder's Office. The value of placing this information at the CSLB cannot be understated. A homeowner, subcontractor or supplier could find out about bonding by a simple inquiry on the CSLB's website or by calling the CSLB.

Some sureties doubt, however, that such a bond could be written. If a contractor did a million dollars worth of work a year, the penal sum of the blanket bond would be $500,000. Some sureties are concerned that, because the bond would cover a number of individual contracts, the surety's exposure might be too great.

Reducing the required penal sum of the blanket bond might increase sureties' participation. For example, a blanket bond covering 20 percent of all contracts could be chosen. Even though this plan would not cover all the money that could be lost by subcontractors and suppliers, this bond would require underwriting, thereby bringing additional oversight to the home improvement arena.

Andy Faust of American Contractors Indemnity Company proposed another approach. A contractor would purchase a group of bonds, for example five $20,000 bonds, and the surety would provide documents the contractor could give to the subcontractors and suppliers affirming the bond coverage. Mr. Faust's type of blanket bonds would not be reported centrally on a CSLB website.

[8] Operating capital is defined by Board Rule 817 as " the difference between current assets and current liabilities."

Discussions with CALBO indicate that:

- *Most home improvement contracts require building permits.*
- *Most local (city and/or county) building permit processes are computerized.*
- *There is a remarkable uniformity to the five or so software programs that are used to gather local information. Thus, collecting information might not be a daunting task.*
- *Only a few small counties have not yet implemented modern data collection.*
- *Data regarding home improvement contracts can be broken out from data regarding commercial projects and new home construction.*

Setting the Penal Sum of an Individual Contractor's Blanket Bond

All types of blanket bonds raise the same question: what bond amount is necessary to cover the work each individual contractor performs? This year as part of its ongoing discussions with the California Building Officials (CALBO), the Board found that sufficient information is gathered during the building permit process to assist in setting ceiling amounts or as an aid to auditing contractor reporting. Of course this approach would require technological improvements to the Board's data collection process.

One possible approach would require each contractor to disclose under penalty of perjury the aggregate amount of all contracts let the previous year and the proposed amount of contracts in the present year. The Board would audit these reports to ensure veracity. Exceeding the reported amount of contracts would be cause for discipline.

Rather than have the CSLB determine the penal sum, another solution could be to have the surety set the penal sum. To control its exposure, the surety would audit to make sure the contractor is correctly reporting the work he or she is performing. The surety could also have access to CALBO's data and could use this information and any other information to assist in underwriting these bonds. This is the method used by insurance companies to make sure that premiums are appropriate.

Joint Control Accounts

Although the Legislature did not specifically ask about joint control accounts, no discussion of possible protections for homeowners would be complete without a brief discussion of joint control. Joint control is a type of escrow fund that controls disbursement. The property owner places all or part of the contract amount with the joint control company. The joint control company pays in accordance with an agreed schedule of progress and makes sure subcontractors, laborers and material suppliers are paid so as to prevent liens. Surprisingly, joint control accounts rarely contain comprehensive quality control components.

Board Joint Control Form

The Board has approved one joint control form that, pursuant to Business & Professions Code Section 7159 (g), exempts contractors from some home improvement contract requirements. Under this joint control form, the joint control company acts like a check writing service with the homeowner monitoring progress and providing information to the joint control company. Under the Board form, the joint control cannot release the final payment until the local building authorities have inspected and approved the work. Note, however, that this quality control is minimal. Just because a building official affirms that a project meets code requirements does not mean that the project meets the contract requirements or trade standards regarding workmanship.

Increased Oversight

Consumers can increase the oversight of the joint control company by adding an addendum to the control agreement to require the joint control company to make on-site inspections. Adding this addendum would, however, appreciably increase the joint control company's liability and, therefore, the cost of the joint control account.

Availability of Joint Control Accounts

Joint control accounts are generally unavailable. In late 2000, as part of the search for solutions to the mechanics' lien double payment problem, Board staff made calls to escrow companies and lenders in the Sacramento area and could not locate even one joint control company in the area. Staff could not find even one mortgage broker who had knowledge of joint control. During the two years the CLRC studied alternatives to mechanics' lien rights, only one representative of a joint control company appeared before the Commission.

Despite the fact that the joint control approach to lien prevention has never caught on, joint control could make sense for contractors who cannot be bonded because of credit problems that may have nothing to do with the contractor's work performance. Although such a check-writing service approach is not presently available, if this approach were seriously considered as an alternative to bonding, it is probable that this service would become readily available.

ISSUE 3.1

One-size-fits-all bond solutions limit the flexibility of consumer protection.

Should different bond solutions be adopted for small, medium and large home improvement contracts?

Should alternatives to bonds, such as joint control accounts, also be considered?

Summary

As this brief overview indicates, there are a number of approaches that can be adopted to protect California consumers. While choosing any one approach might be the simplest solution, the depth and variety of problems faced by California homeowners opt against a one-size-fits-all approach.

Chapter 4.
The Contractor's License Bond

The contractor's license bond is different from other surety bonds. This chapter describes the differences between this bond and other surety, and examines the value of the bond.

In 1964, the Legislature enacted a statute requiring every licensed contractor to carry a contractor's license bond. The first bond was for $1,000 and was designated to benefit members of the public who suffered financial injury as a result of a contractor's violation of the Contractor's License Law. Over the years, the Legislature refined the categories of bond beneficiaries. One refinement pertinent to this report is a special category for homeowners to enable them to get preference over other possible claimants.

Who benefits from a contractor's bond?

Two types of bond beneficiaries are relevant to this study:

1. *Homeowners damaged as a result of a violation of contractor's law.*
2. *Any person damaged as a result of a willful and deliberate violation of contractors law or by fraud in the execution or performance of a contract.*

The difference between the two groups is that claimants who are not homeowners must not only demonstrate that a violation of law occurred, but also that the violation was willful ***and*** *deliberate. This additional requirement is generally understood to have been designed to make it more difficult for claimants who are not homeowners to collect from the bond so that homeowners could get better access to the entire penal sum.*

Over the years, the Legislature has gradually increased the penal sum of the bond. Today the penal sum of the contractor's license bond is $7,500 for most contractors and $10,000 for swimming pool contractors. The swimming pool bond is higher because the Legislature found that the risk of damage is greater for swimming pools than for any other contractor classifications. Hereinafter, this report will refer to the bond as a "$7,500 bond."

Comparison of the Contractor's License Bond to Other Surety Bonds

Although the contractor's license bond is a surety bond, it works much differently than other bonds. For example:

- In construction work, most surety bonds are written to cover specific contracts. The contractor's license bond, on the other hand, is a blanket bond, written to provide compensation for *all* the work a licensee agrees to perform.
- Most surety bonds are written to cover one specific contract dollar amount, while the contractor's license bond is one $7,500 bond. Regardless of whether the contractor agrees to perform five $1,000 jobs, one $100,000 job, or 500 $30,000 jobs, there is only one $7,500 bond.
- Most bonds are designed to pay claims when the contractor breaches the contract by failing to perform under the contract's specific terms. The contractor's license bond is not designed to cover damages arising out of breach of contract but, instead, to cover damages arising out of a violation of contractor's license law. As discussed below, sureties may place more emphasis on this difference than is warranted by the legislative scheme.
- When any other bond pays out, sureties seek repayment from the contractor. The surety has strong help getting paid back from a contractor's license bond payout, however. If the contractor's license bond pays out, the Registrar must suspend the contractor's license until the surety has been repaid.[10]
- When a contractor lacks the credit or competence to work on a large project, the surety won't issue a performance and/or a payment bond, and the contractor

[10] Business & Professions Code Section 7071.11.

cannot be awarded that project. If a surety won't issue a contractor's license bond, the contractor must post a cash deposit of the penal amount with the Board or the contractor cannot be licensed at all.

- The most important distinction between most surety bonds and the contractor's license bond, however, is that most bonds are comprehensively underwritten while the contractor's license bond is not.

Underwriting Contractors' License Bonds

As noted in Chapter 2, sureties traditionally rely on underwriting to determine whether to issue a bond. The premium is not designed to create a pool of money to cover damages. Instead, the premium is designed to cover the cost of underwriting and administering the bond. Contractors' license bonds, on the other hand, are not comprehensively underwritten. In fact, in many cases, surety companies perform a rudimentary credit check or no underwriting at all.

This raises the question, how do sureties writing these bonds manage their businesses? If, as the California Department of Insurance maintains, underwriting is one of the basic tenets of suretyship, what do sureties writing contractors' license bonds substitute for underwriting?

Some Sureties Maintain a Larger Pool of Money than for Other, Underwritten Bonds

One substitute for underwriting was acknowledged by a surety representative who commented that the contractor's bond is more like insurance than surety. A surety writing these bonds must assess risk more like insurance companies than a surety. Instead of underwriting with an eye toward restricting the work a contractor can agree to perform, the surety must assume that some claims will be paid out but not repaid by contractors. Of course, unlike insurance, surety companies still expect contractors to pay them back.

Most Sureties Spend Effort and Energy Educating the Contractor as to the Valid Reasons the Contractor Should Settle.

The replacement for underwriting most useful to consumers is the work the surety undertakes *after* the bond is issued and a complaint is filed. All sureties responding to the Board's request for information asserted that the primary value of the bond is the sureties' efforts to get the parties to settle. Sureties can claim a high success rate. For example, in 1999, the Surety Company of the Pacific (SCP) received 2,672 claims against the contractors' license bond and were able to settle 44 percent (1,181) of the claims. The value of the sureties' efforts in securing payments to homeowners, subcontractors and material suppliers must be acknowledged.

Surety Company of the Pacific (SCP) asked the Board to explain the role of sureties in two situations where the surety may be more useful to consumers than the CSLB process—contractor bankruptcy and investigations involving payments to subcontractors and material suppliers.

Sureties explain that the value of the bond is less in the payments to consumers than in the effort the surety takes to encourage resolution.

Bankruptcy

When a contractor declares bankruptcy, the money due to the consumer is often discharged in bankruptcy. When the contractor's financial obligation to the consumer is discharged, CSLB often loses the ability to order restitution.

According to SCP, however, bankruptcy does not exonerate the surety company. Thus, after a bankruptcy, a surety bond may be the only source of restitution for the consumer.

Subcontractors and Suppliers

SCP wants the Legislature to know that CSLB has more latitude than sureties to close cases involving unpaid subcontractors and material suppliers. As an example, SCP points to a CSLB letter directing a contractor and material supplier to civil court. Surety companies want the Legislature to know that sureties do not have the option of sending these complainants to civil court. Sureties must resolve all the complaints.

For its part, CSLB has, by all accounts, ceased this practice. Present management's strategy is to attempt to facilitate a settlement or, if appropriate, refer the dispute to CSLB arbitration. Formal disciplinary action is taken against contractors committing egregious or repeated acts.

Is the Bond Cost-Effective?

In order to determine the overall effectiveness of the contractor's license bond, the Board first sought to compare the yearly premiums paid with the amount paid out to California consumers. CDI does not maintain records specific to individual bonds. Consequently, CDI cannot tell the Board how much California contractors spend in premiums to maintain the contractor's license bond. Thus, determining the amount contractors pay to maintain a contractor's license bond must be extrapolated from other data.

Based on its own premiums, SCP extrapolated that premiums paid for contractors' license bonds in 2000 totaled $16,505,439.[11] According to CSLB's records, during the same time period, sureties paid out a total of $4,549,042 (27.6 percent) to consumers.

The Board continues to support the use of the contractor's license bond.

Sureties argue, however, that the aggregate payments to consumers should not be the sole means of evaluating the bond's effectiveness. Sureties explain that the value of the bond is less in the payments to consumers than in the effort the surety takes to encourage resolution.

As all responding sureties assert, the contractor's license bond is a well-established feature of California's licensing scheme. The Board continues to support the use of this bond, but as described in Chapter 5, seeks a reduction of the impediments faced by consumers seeking access to the bond and an increase in the penal sum.

[11] Other surety sources provided a higher estimate. SCP's estimate was used because it was based on accessible data.

Chapter 5.

Consumer Complaints About Access to the Contractor's License Bond

The Board receives numerous complaints each year about difficulties consumers face in accessing the contractor's license bond. This chapter identifies the barriers consumers face and suggests ways the bond can be reformed to be more responsive to consumers.

Since the Board does not have regulatory responsibility over surety companies, the Board usually responds to consumer complaints about the bond by referring the consumer to the California Department of Insurance (CDI), the state agency that regulates surety bonds.

To comply with the Legislature's mandate to review the use of this and other bonds to compensate homeowners, the Board reviewed the complaints consumers have long made about the unresponsiveness of the contractor's license bond.

- Consumers complain first and foremost about the difficulty of the process. Without help, consumers contend they cannot navigate the legal issues.
- Consumers complain about a lack of information about how to secure a bond payout in small claims court and arbitration hearings. Consumers want to know why a finding by the Registrar is not enough to trigger a surety payout.
- Consumers complain that other laws and situations create barriers to the consumer's ability to access the bond.

Consumers Find it Difficult to Navigate the Process

ISSUE 5.1

Consumers do not understand the standard for a contractor's license bond payout.

Should legislation be enacted to clarify the standard for a contractor's license bond payout?

Standard for Proving a Claim Is Not Known

Despite the fact that the contractor's bond has been in place for more than 35 years, the standard for payout is unclear. Surety companies responding to Board inquiries did not articulate a common standard.

One surety explained that the standard of payout is "a combination of clear liability, preponderance of the evidence and disciplinary action." Another surety explained that the preponderance of evidence standard applies only to litigation and pointed instead to the "reasonably clear" standard found in Insurance Code Section 790.03 (h)(3), which describes a surety as practicing unfair methods of competition and unfair and deceptive acts or practices by "not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear." This surety also pointed to Section 2695.10(d) of the Department of Insurance Fair Claims Settlement Practices Regulations, which requires the surety to diligently pursue claims but to seek "only information reasonably required to resolve the claim." Another group of sureties responded by referring the Board to the Business & Professions Code.

The difference of the responses was surprising. It seems basic that sureties should know and agree on a standard. More important, these explanations could not sensibly be used by an average consumer to determine how to proceed in a bond claim.

One group of sureties suggested a novel solution. Noting that consumers do not know how to navigate the process, this group suggested that CSLB be used to bring claims against the bond. CSLB could serve as a guide to consumers in matters of procedure and documentation. CSLB could also identify claims that lack evidence or required documentation.

Sureties Demand Excessive Documentation

Despite the California Department of Insurance regulation requiring a surety to seek "only information reasonably required to resolve the claim," consumers complain that no matter how much information they send to the surety company, there is always something more required. This is also one of the complaints that the California Department of Insurance has identified as a major problem for consumers.

Role of Willful and Deliberate

The specific problem bond claimants have the most difficulty handling is the meaning of "willful" and "deliberate" in the law. The willful and/or deliberate language appears in two contexts. It purportedly establishes a preference for homeowners by requiring all other beneficiaries to meet a higher standard, and, in some Business & Professions Code sections, it appears to require a higher level of intent to demonstrate a violation of law.

ISSUE 5.2

In order to create a preference for homeowners seeking access to the bond, current law adds additional requirements for subcontractors and suppliers making claims on the contractor's license bond.

Should legislation be enacted to establish preferences for homeowners without creating artificial barriers to other potential claimants?

Establishing a Preference for Homeowners

The willful and deliberate language appears first in the Section 7071.5 (b), the section allowing *any person* to benefit from the bond if they are damaged by a contractor's willful and/or deliberate violation of contractor's license law. This is the code section used by commercial property owners, subcontractors, and material suppliers.

In contrast, Section 7071.5 (a), the section that allows homeowners access to the bond, does not include these qualifications. The purpose of placing willful *and* deliberate language in subdivision (b) is generally understood as to make it harder for commercial property owners, subcontractors and suppliers to gain access to the bond and, therefore, easier for a homeowner.

This approach has not been successful in creating a preference for homeowners. Instead, it creates an artificial barrier for commercial claimants who may not even be competing with a homeowner for a payout.

The Meaning of "Willful" and "Deliberate"

The requirement that an act be "willful" and/or "deliberate" is interspersed through the individual code sections of Contractor's License Law. For example, Section 7109 requires a "willful departure in any material respect from accepted trade standards . . ." and Section 7110 requires "willful or deliberate disregard and violation of the building laws . . ." Thus, even though this language is not included in the statute describing when a homeowner may benefit from the bond, proof of willfulness is still an issue for homeowners.

The inclusion of the term "willful" appears to mean that a contractor must not just disregard the building laws; the contractor must *willfully* disregard the building laws. The inclusion of the qualifier "willful" makes it seem as if something really special is needed to prove a violation. Some sureties give meaning to these terms by explaining that the contractor cannot be held liable for an honest mistake or inadvertent conduct.

ISSUE 5.3

An inconsistent interpretation of the term "willful" creates a barrier for consumers seeking access to the contractor's license bond.

Should legislation be enacted to define "willful" for purposes of bond payouts?

According to Senior Supervising Attorney General Robert Heron, however, when the CSLB takes disciplinary action against a contractor, the CSLB interprets "willful" as described in Section 7 of the Penal Code, as follows:

> *The word "willfully," when applied to the intent with which an act is done or omitted, implies simply a purpose or willingness to commit the act, or make the omission referred to. It does not require any intent to violate law, or to injure another, or to acquire any advantage.*

Sam Abdullaziz, a California attorney who frequently represents contractors in CSLB hearings, disagrees with Mr. Heron's interpretation. Mr. Abdullaziz argues that this kind of interpretation would make the word "willful" superfluous. To avoid any argument about interpretation, the California Department of Insurance alternatively recommends deleting the word "willful" from the Contractor's License Law entirely.

Surety Company of the Pacific (SCP) strongly opposes deleting the word entirely. They believe that, without the inclusion of willful in the statute, contractors would be liable for "accidents, honest mistakes and other types of intentional or inadvertent conduct." SCP also provided numerous letters from contractors written in opposition to Senator Figueroa's 1999-2000 bill (SB 1524) that would have deleted these terms.

Other sureties responding to the recommendations did not oppose the deletion of willful. They did not believe deleting willful would make much difference in the way they do business. This disagreement between experienced sureties highlights the need for clearer standards.

Sureties Fail to Independently Investigate Claims

Pursuant to Section 2695.10(d) of the Department of Insurance Fair Claims Settlement Practices Regulations, the surety is required to diligently pursue claims but to "seek only information reasonably required to resolve the claim." Yet consumers often complain that sureties don't investigate. Consumers claim that instead, the surety delays resolution waiting for additional, often repetitive, documentation or for the CSLB to complete one task or another. For example, the surety claims it must wait until the CSLB provides an industry expert report or completes the investigation. In some cases, the surety claims it must wait until the CSLB appeal process is over because the licensee may substantiate his position through an appeal of a disciplinary action or through civil proceedings.

It is the Board's understanding, however, that the surety has an independent obligation to investigate, not to rely on what CSLB may or may not do.

Securing a Bond Payout

Consumers who secure a finding against a contractor in small claims court, an arbitration hearing, or by final order of the Registrar, have difficulty turning that finding into a contractor's license bond payout.

Impediments to Securing a Payout

Consumers complain that the surety does not pay even after the consumer has secured an award in small claims court or through an arbitration award.

Sureties identify two main reasons for not paying even though there has been a legal

ISSUE 5.4

Consumers who secure a finding in small claims court, an arbitration hearing or by final order of the Registrar have difficulty turning that finding into a contractor's license bond payout.

Should this gap in consumer access to the contractor's license bond be addressed by better consumer information and/or changes to the law governing surety payouts?

ISSUE 5.5

Often multiple complainants must share the $7,5000/ $10,000 penal sum.

Should the Legislature consider increasing the current penal sum?

Penal Sum of the Contractor's License Bond Since 1964

1964		$1,000
1972		2,500
1980		5,000
	Swimming Pool	10,000
1994		7,500
	Swimming Pool	10,000

finding of liability in small claims court. First, under present law, if the surety has not been named a party to the action, sureties argue that they have not been given notice and an opportunity to be heard. Second, even if the surety is named, most consumers do not know that they must specifically plead a violation of contractor's license law, not just a breach of contract.

CSLB arbitration hearings suffer from the same limitation. The surety cannot be named in the arbitration and, therefore, the surety is not bound by the award. Sureties explain that arbitration awards and small claims court judgments may not be completely useless, however. Even though these decisions are not binding on the surety, sureties explain that they often use these decisions as evidence of the contractor's liability.

Consumer complaints indicate that the findings of an arbitrator or a small claims court judge have little effect on whether the surety pays.

Finding of the Registrar is Not Enough

As noted, the general rule is that the surety is not bound by a finding of liability against the contractor. This rule is used to deny payment even if the CSLB has issued a citation or filed an accusation. Even if the Registrar determines that the Contractor's License Law was violated and damages are owed, the surety can still deny payment.

Other Barriers Faced by Consumers

Consumers complain about other barriers they face when attempting to gain access to the contractor's license bond.

Multiple Complaints

Even though 80 percent of the injuries alleged in CSLB's individual claims fall well under the $7,500 penal sum, multiple complaints are often made against the same $7,500 bond. When things start to go wrong, a contractor can be engaged in multiple projects in various stages of completion and may have gotten behind in payments to subcontractors and material suppliers. When this house of cards falls, many can be harmed and the potential for meaningful recovery disappears.

Another way to view the bond is to consider that the one $7,500 bond covers a two-year period. The actual coverage can be thought of as $3,750 each year. (But see the section on the continuous bond below for more information on bond coverage.)

The penal sum of the bond has been raised three times since 1964 *(See table at left)*. Each time the penal sum has been raised the amount has been described as the highest amount surety companies can afford to pay without forcing new contractors out of business.

Yet, the cost of the premium has always been more than reasonable. Currently, premiums range from $65 to $250 depending on the surety, with discounts for two and three-year extensions. Thus, with some exceptions, the cost of premiums would not keep a new contractor out of business.[12]

Instead, it is said that if the penal sum is raised significantly, sureties would need to increase their underwriting of these bonds. Underwriting would force new applicants

[12] Some bond premiums are exceptionally high, however, a contractor who had defaulted on child support payments shopped for a bond but was ultimately charged $600.

and contractors with poor credit out of the market, or worse, into the underground economy.

Sureties who participated in this study expect the bond to be raised again. The question is how high? The goal for this bond might be to raise the penal sum as high as it can be raised without requiring the need to comprehensively underwrite it.

Issue 5.6

The contractor's license bond is a continuous bond, meaning there is no statutory bond period. This situation reduces the amount of money available to consumers making bond claims.

Should legislation be enacted to restructure the statutory bond period?

Would restructuring the bond significantly increase the number of contractors who do not qualify?

Continuous Bond

The contractors license bond is written to cover a two- year license period. The bond covers damages resulting from violations of the contractor's license law during the two- year period.

The bond is also a continuous bond. If there is no payout during the two-year license period, the bond continues for the next two years and for subsequent years. As long as there is no payout or cancellation, the same bond continues. This situation can result in the bond covering not just 2 years as expected but 4 years.

To illustrate: suppose that a contractor violates the contractor's license law in the first license period but the surety does not pay out until the second license period. If a consumer files a claim in the second license period, even though there is a new license period and a new bond period, the bond is already exhausted. This is because there is only one continuous bond.

One way to address this problem might be to make the bond begin and end with the statutory license period. Sureties note, however, that the surety's exposure would double. This increased exposure would in turn require significant additional underwriting. The worry is that small, undercapitalized contractors would be unable to get a bond and be forced into the underground economy.

Issue 5.7

The surety does not make payments for damages caused by a violation of law if, at the time the violation occurred, the license was suspended.

Should legislation be enacted to identify situations when bond coverage should continue even if the contractor's license is suspended?

Surety Does Not Pay Out While License Is Suspended

Under Contractor's License Law, the contractors' license bond runs concurrently with the contractor's license. If the license is suspended during the time an act or omission occurs, the surety will deny the claim even though the bond has not been canceled.

James Acret, an experienced construction attorney, recently wrote to the Board to draw attention to the plight of a homeowner who was denied access to the contractors' license bond. The reported facts of the case are that an insolvent contractor took money up-front, did no useful work and absconded with the homeowner's money. At the same time, the insolvent contractor had stopped paying his worker's compensation premiums and the Board suspended his license. The surety denied the bond claim because, at the time the contractor took the money, the contractor's license was under suspension for the failure to pay the workers compensation premium.

Mr. Acret writes: "The legislature could not have intended that the surety would be exonerated because the contractor's license had been suspended or revoked for a violation of the license law. That would withdraw the protection of the bond just when it is most likely to be needed, and would be a windfall to the surety which has accepted a premium to cover the period for which the license was issued."

Sureties responded to this recommendation by noting that bond is written to cover licensed activities only.

ISSUE 5.8

Under current law, even though the jurisdiction of small claims court is set at $5,000, the jurisdiction over the bond is artificially set at $4,000.

Should legislation be enacted to raise the amount of the jurisdictional limit for surety bonds claims brought to small claims court?

Limited Jurisdiction of Small Claims Court

Before 1992, the jurisdiction of small claims court was set at $2,500. In 1992, the court's jurisdiction was raised to $5,000. At that time, sureties opposed raising the limit from $2,500 because the court's decision would preclude other claimants from having access to the bond. The court's jurisdiction over surety bonds was not raised.

In 1998, Assemblyman Margett sought to raise jurisdiction over the bond to match the $5,000 jurisdiction of small claims court. In the face of opposition by the surety companies, however, the bill was amended to raise the amount to only $4,000. The committee reports do not indicate any public policy reason for artificially limiting the amount a consumer can be awarded in small claims court.

SCP explained that the purpose of the $4,000 limit was to compensate the surety for having to submit to small claims court jurisdiction without benefit of the discovery process that takes place in higher courts.

ISSUE 5.9

Under current law, sureties can recover the fees and costs of interpleading (bringing multiple complainants to superior court) from the $7,500 penal sum.

Should legislation be enacted to modify Code of Civil Procedure Section 386.6 (a) to exclude fee and cost reimbursement from the contractor's license bond?

Fees and Costs in Superior Court

Non-Judicial Pro-Rata Distribution

When multiple claims are made against the same bond, sureties have two methods of deciding how to distribute the penal sum. Under the first method, identified as a "non-judicial pro-rata distribution procedure," the surety evaluates the individual claims to determine if the contractor, and therefore the surety, is liable for each, and then offers each complainant a pro-rata share based on the valid claims. This non-judicial distribution is the most frequently used method to manage multiple claims.

Interpleader

The second method is the interpleader process set forth in Code of Civil Procedure Section 386. Under this method, the surety places the amount of the bond with the court and the court decides how the sum should be distributed between the claimants. The interpleader method has benefits for the surety. The surety can stop investigating claims; the court will now decide. If additional claims are filed, the surety simply directs the new claimants to intervene in the court suit. SCP asserts that the value of the interpleader process for consumers is that it prevents a race to the courthouse.

The interpleader has drawbacks for consumers. First, the legal documents notifying the consumer of the surety's interpleader action are intimidating and nearly incomprehensible. Consumers call the Board worried that they are being sued. Some consumers drop their claims because they are afraid of litigation.

Second, the law governing interpleader bond actions allows the surety to request an award of reasonable attorney's fees and costs. These costs and fees are deducted from the penal sum. These costs and fees are minimally set at 10 percent of the bond ($750) and up. CSLB staff has seen surety fee and cost awards of up to $1,200.

These fees and costs are deducted from the $7,500 penal sum, thereby reducing the amount available for distribution.

A way to remedy this situation might be to exclude fee and cost reimbursement from the contractor's license bond. SCP opposes this change on grounds that the interpleader is well-established dispute resolution procedure supported by strong public policy. The Board points out, however, that this suggestion does not concern the value of the interpleader process; it targets only the reduction of the $7,500 penal sum.

Consumers May Not Know There Is a Bond or Understand How It Works

Because of a quirk in the contractor's license law, contractors are prohibited from telling consumers that they carry a contractor's license bond. This contributes to consumers' lack of information about their recourse options.

Consumers who know about the bond often believe the $7,500 bond covers their individual contract, not all the work a contractor performs.

The Board will review the issue of whether a contractor should be allowed to advertise that he or she is bonded when the bond is the contractor's license bond.

CSLB already published a pamphlet describing the bond claim process. To clarify these issues for consumers, Board staff will rework this pamphlet in light of information developed as a result of this study.

Chapter 6.

Commercial General Liability Insurance

Survey

In May of 1999, CSLB conducted two surveys to determine the extent of problems that should be addressed by commercial general liability insurance. CSLB Call Center staff kept a running tally of all the questions related to insurance, as well as complaints that appeared to have a general liability insurance component. In addition, one of CSLB's field offices reviewed a month of closed complaints.

***Call Center:** Of 3,015 calls, 2,812 were for general information and 203 were to report a complaint. Of the 2,812 information calls, seven were general questions related to insurance. Of the 203 complaints, 23 (11 percent) included damages that should be covered by insurance.*

***Closed Complaints**: Of 118 closed cases, only five cases specifically identified issues that should be covered by CGL (less than four percent). Even though the number of insurance related complaints was small, in two cases, the harm involved was great. In one, children ingested an unknown substance found on the worksite. In the other, an employee driving the contractor's truck struck the homeowner's car, injuring the homeowner and totaling the car.*

This chapter describes the risk to homeowners when a contractor chooses not to carry Commercial General Liability (CGL) insurance, and discusses issues that must be addressed if such insurance is to be mandated.

Contractor's License Law does not require contractors to carry CGL. CSLB does not track and, therefore, can't quantify how many contractors carry this insurance.

Role of CGL in Modern Construction

In 1999-2000, the Board conducted a review of the role of commercial general liability insurance. The Board found that:

Commercial Property Owners Uniformly Require Contractors to Carry CGL

These property owners understand that expensive mishaps can and do occur in construction projects. These property owners generally insist that contractors be adequately insured.

Many Contractors Carry CGL Even if They Are Working for Property Owners Who Do Not Require Insurance

These contractors carry insurance not because they altruistically want to protect consumers but because they want to protect *their own* assets. Contractors recognize that they can be forced out of business by uninsured occurrences. Conversely, the Board concluded that the contractors who do not carry insurance usually have few assets to protect.

Unlike Commercial Property Owners, Homeowners Rarely Require Contractors to Carry CGL

The primary reason given by homeowners for not requiring the contractor to carry CGL is that they don't think of it. It simply doesn't occur to a homeowner that a contractor would perform work without being insured.

The few homeowners who do think of insurance also think that any damage will be covered by their homeowner's insurance. But these homeowners are only partly right. Some damages will be covered but some will not. And even where damage is covered, the homeowner risks higher rates in the future or outright cancellation because of an insurance claim.

In 1999, after an in-depth analysis of the value of CGL and the risk to consumers when contractors don't carry this insurance, the Board concluded that CGL insurance would protect both contractors and consumers. The Board began work on a proposal to mandate CGL.

Opposition to Mandatory CGL

Opposition to mandatory insurance was strong. A number of insurance companies opposed mandating insurance, explaining that if all contractors were required to have insurance, the risk (and the premiums) would substantially increase. Further, some contractors would not qualify under usual underwriting standards. Since these

ISSUE 6.1

The Board has long recognized the value of Commercial General Liability Insurance (CGL).

Should the Legislature mandate CGL?

If not, should CSLB law be amended to define "insured" as referring only to CGL?

individuals would still need to be insured, the insurance industry would probably have to set up a pool for uninsurable contractors. Insurers did not want such a pool.

A number of small contractors opposed mandatory insurance, worrying that they would not be able to afford the premiums and would be driven out of business.

Finally, some very high volume contractors opposed the proposal because they wouldn't be able to "self-insure."

Taking a completely different tack, some insurance companies opposed mandatory insurance because the Board, unwilling to rely on a paper-based reporting system, wanted an electronic transfer requirement. Insurance companies noted how difficult it has been for the Department of Motor Vehicles to get on-line insurance information.

Interim Solution: Mandatory Disclosure

Given the opposition, the Board determined that legislation mandating CGL insurance would be unlikely to pass. Instead, the Board proposed that contractors working in the home improvement arena disclose whether or not they carry CGL. The Legislature passed this proposal as part of SB 2029. The bill also required the Board to create a regulation explaining the value of CGL. The Board has adopted this regulation. It will become effective three months after the notice is filed with the Secretary of State. The three-month delay was chosen by the Legislature to give contractors sufficient time to come into compliance. (See the attached SB 2029 notice.)

False or Misleading Insurance Information

Now that CGL disclosure is required and information about insurance is becoming available through the new notice, the Board must address other related issues, such as how to address false or misleading information about insurance and whether all policies are alike. These questions must also be answered if the Legislature opts to mandate CGL.

One of the issues raised by the SB 2029 insurance notice was how to make sure the contractor gave correct information. Enforcement representatives suggested that the disclosure approach adopted in SB 2029 would be more effective if there was a direct tie to CSLB's ability to take disciplinary action against a contractor who misleads consumers. Giving incorrect or misleading information about insurance should be a cause for discipline.

Along the same lines, contractor advertisements often include the claim that the contractor is "bonded and insured." These ads can be misleading. When contractors make claims about being insured, many are referring to workers compensation insurance and not general liability insurance.[13]

Not All Insurance Policies or Insurance Companies Are Alike

Even if the contractor's claim to be "insured" is limited to contractors who actually carry CGL, other issues should be addressed to make sure this protection is not illusory.

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[13] As noted in Chapter 5, under current law, a contractor is prohibited from advertising that he or she is bonded. Thus, the claim "bonded and insured" is a problem for two reasons.

Right now, contractors carry insurance voluntarily. As insurance becomes more necessary for contractors who want to compete in the home improvement market, care should be taken that contractors do not skimp on coverage. As noted above, contractors primarily carry insurance to *protect their own* assets. Contractors who do not have assets but who want to remain competitive might choose riskier but less expensive insurance carriers or choose less comprehensive coverage. Examples include:

ISSUE 6.2

There are two different types of insurance policies—"claims made" vs. "occurrence" policies. The protections offered by these policies can create different coverage for consumers. In addition, some policies are written to exclude certain coverage.

Should legislation be enacted to require specific types of policies or coverage?

Should these issues be addressed by providing information to consumers about insurance coverage?

"Claims Made" and "Occurrence" Plans

A "Claims Made" policy means that, to be covered, claims must both occur and be made (i.e. filed) against the insured during the policy term.

"Occurrence" policies cover claims that occurred during the policy period, even if the claim is made after the policy expiration.

This difference is of great consequence to consumers. Suppose a roofing contractor has a "claims made" policy with a policy renewal term of October to September. The roofer puts on a roof in August. The policy is set to run for 60 days from the date the claims period expires. In December, the roof leaks. Under a "Claims Made" policy, there is no coverage. The claim was not made during the policy term.

As the issue of insurance emerges in the home improvement market, the Board and the Legislature must determine whether merely providing information to consumers is adequate to ensure consumer protection. Or, for example, should an "Occurrence" policy be the only kind of insurance a contractor can carry and be able to claim to be insured?

The Individual Policy Can Be Written to Exclude Some Damages

Another issue concerns the extent of a policy's coverage. Not every insurance policy is written to cover the same ground. An insurance policy can be written to exclude nearly as much as it covers. For example, a roofer's policy could be written to exclude water damage.

Admitted Carriers and Non-Admitted Carriers

A more global question is whether consumers should care if the carrier is an admitted or a non-admitted carrier. Admitted carriers are backed by funds held by the California Insurance Guarantee Association. If an admitted carrier goes out of business, the fund will see that the public is protected. Non-admitted carriers, on the other hand, are not backed by such a fund nor are they subject to state rules governing solvency.

The California Department of Insurance (CDI) does not license and does not regulate non-admitted carriers. This means that the CDI does not investigate and cannot assist a consumer with a complaint against a non-admitted carrier.

While sufficient resources may support many non-admitted carriers, some insurers have questionable financial resources. In the past, non-admitted carriers have gone out of business, leaving claimants without insurance coverage.

This matters to homeowners because it reflects on the ability of the insurer to pay claims and/or the ability of the CDI to resolve claim disputes.

Summary

The Board is strongly in support of mandating Commercial General Liability Insurance. The Board accepted mandatory disclosure as a step toward better consumer protection. The Board has created the notice required by SB 2029 to provide information to consumers. The Board will continue to gather information about insurance requirements that might strengthen consumer protection in this area. The results of this review may require legislation, regulation and new consumer information.

Guarantee Program

In SB 2029, the Legislature asked the Board to consider whether to establish a guarantee program in order to provide appropriate insurance and bond coverage. Staff could find no difference between a revolving recovery fund and a guarantee fund.

Under both, contributors are assessed enough to cover the losses of participating contractors. For example, Connecticut contractors contribute to a fund that pays consumer damages. In California, the fund administered by the California Insurance Guarantee Association is a guarantee fund. All admitted insurance carriers must participate. If an admitted carrier becomes insolvent, the other admitted carriers are assessed an amount to cover the debt.

Please refer to the separate CSLB report, *Analysis of State Recovery Funds*, for a comprehensive overview of issues related to recovery funds.