

SENATE JUDICIARY COMMITTEE
Senator Thomas Umberg, Chair
2023-2024 Regular Session

AB 2677 (Chen)
Version: April 17, 2024
Hearing Date: June 25, 2024
Fiscal: No
Urgency: No
AM

SUBJECT

Sureties: liability

DIGEST

The bill specifies that attorney's fees that may be assessed as costs when authorized by contract, statute, or law are included under existing provisions of law that limit the aggregate liability of a surety to the amount of a surety bond issued by that surety.

EXECUTIVE SUMMARY

This bill seeks to abrogate the holding in *Karton v. Ari Design and Construction* (2021) 61 Cal.App.5th 734, which held that a surety was liable for attorney fees awarded even though they were greater than the amount of the contractor license bond issued by the surety. This bill would specify that a surety is not liable for costs or attorney fees assessed by a court pursuant to an authorization in a contract, statute, or other law that are greater than the amount of the surety bond. The author and sponsor of this bill argue that this is necessary to ensure that the surety insurance market is not thrown into turmoil, noting that the second largest writer of surety bonds in California has already withdrawn from writing contractor license bonds. The bill is sponsored by Flasher Barricade Association and supported by various organizations, including, among others, those that represent the insurance industry, contractors, and the building industry, and the Contractors State License Board. The bill is opposed by several consumer protection organizations, including the Consumer Federation of California and Consumers for Auto Reliability and Safety.

PROPOSED CHANGES TO THE LAW

Existing law:

- 1) Provides that the aggregate liability of a surety to all persons for all breaches of the condition of a bond is limited to the amount of the bond. (Code of Civ. Proc. § 996.470(a).)
 - a) Establishes that, except as otherwise provided by statute, the liability of the principal is not limited to the amount of the bond. (*Ibid.*)
 - i. If a bond is given in an amount greater than the amount required by statute or by order of the court or officer pursuant to statute, the liability of the surety on the bond is limited to the amount required by statute or by order of the court or officer, unless the amount of the bond has been increased voluntarily or by agreement of the parties to satisfy an objection to the bond made in an action or proceeding. (*Id.* at subd. (b).)
- 2) Establishes that the liability of a surety is limited to the amount stipulated in either of the following circumstances:
 - a) the bond contains a stipulation that the liability of a personal surety is limited to the worth of the surety, as provided; or
 - b) the bond contains a stipulation that the liability of a surety is an amount less than the amount of the bond pursuant to a statute that provides that the liability of sureties in the aggregate need not exceed the amount of the bond. (*Id.* at subd. (c).)
- 3) Provides that partial payment of a claim by a surety is not to be considered satisfaction of the claim and the beneficiary may enforce the liability on the bond. (Code of Civ. Proc. § 996.480(b).)
- 4) Provides that if the nature and extent of the liability of the principal is established by final judgment of a court and the time for an appeal has expired or, if an appeal is taken, the appeal is finally determined and the judgment is affirmed, then both of the following apply:
 - a) a surety may make payment on a bond without awaiting enforcement of the bond; and
 - b) if the beneficiary makes a claim for payment on a bond given in an action or proceeding after the liability of the principal is so established and the surety fails to make payment, the surety is liable for costs incurred in obtaining a judgment against the surety, including a reasonable attorney's fee, and interest on the judgment from the date of the claim. (Code of Civ. Proc. § 996.480 (a).)

- 5) Establishes that the amount of the bond in 4a), above, is reduced to the extent of any payment by the surety in good faith. (*Id.* at para. (1) of subd. (a).)
- 6) Specifies that payment by a surety of the amount of a bond constitutes a full discharge of all the liability of the surety on the bond. (Code of Civil Proc. § 996.490 (a).)
- 7) Clarifies that a judgment of liability on a bond may be enforced in the same manner and to the same extent as other money judgments. (Code of Civ. Proc. § 996.495.)
- 8) Establishes that a judgment of liability on a bond is in favor of the beneficiary and against the principal and sureties and obligates each of them jointly and severally. (Code of Civ. Proc. § 996.460 (a).)
- 9) Specifies that a beneficiary may enforce the liability on a bond against both the principal and sureties. (Code of Civ. Proc. § 996.410(a).)
- 10) Defines “admitted surety insurer” as a corporate insurer or interinsurance exchange to which the Insurance Commissioner has issued a certificate of authority to transact surety insurance in the state, as defined in Section 105 of the Insurance Code. (Code of Civ. Proc. § 995.120(a).)
- 11) Defines “surety” as a party who guarantees the performance of a contract or the fulfillment of an obligation by another party, known as the principal. (Civil Code § 2787.)
- 12) Establishes that attorney’s fees, when authorized by contract, statute, or law are allowable as costs. (Code of Civ. Proc. § 1033.5(a)(10).)
- 13) Provides that where a person assumes liability as surety upon a conditional obligation, their liability is commensurate with that of the principal, and they are not entitled to notice of the default of the principal, unless they are unable, by the exercise of reasonable diligence, to acquire information of such default, and the creditor has actual notice thereof. (Civ. Code § 2808.)
- 14) Provides for the licensure and regulation of contractors under the Contractors State License Law (Contractors Law) by the Contractors State License Board (CSLB). (Bus. and Prof. Code § 7000 et seq.)
 - a) Requires an applicant or licensee to file or have on file with the CSLB a contractor’s bond in the sum of \$25,000. (Bus. and Prof. Code § 7071.6(a).)

This bill:

- 1) Specifies that attorney's fees that may be assessed as costs when authorized by contract, statute, or law are included under the provision that limits the aggregate liability of a surety to the amount of the bond.
- 2) Defines "aggregate liability" to include liability for damages, costs, or attorney's fees, if recoverable.
- 3) Defines "surety" to mean an admitted surety insurer as defined in Section 995.120 of the Code of Civil Procedure. (*See* 10), above.)

COMMENTS

1. Stated need for the bill

The author writes:

The purpose of AB 2677 is to cap the liability of a state-mandated surety bond to the penal sum of the bond. That will ensure that surety license bonds, including contractor and car dealer license bonds, remain affordable and widely available to maintain consumer protections intended by the legislature up to the license bond's penal sum. For these reasons, it is imperative that AB 2677 be enacted.

2. This bill is brought in response to two recent California Appeals Court Decisions that have found a surety can be liable for attorney fees even if they are in excess of the surety bond

a. Surety bonds

"Surety" means a party who guarantees the performance of a contract or the fulfillment of an obligation by another party, known as the principal. (Civ. Code § 2787.) A surety license bond refers to a type of bond that certain professionals and businesses are required to obtain as a prerequisite to conducting business in this state. If the bonded professional or business is found in violation of the law the bond can be used to compensate clients or consumers of the professional or business. Per the express terms of the surety bond, the principal agrees to indemnify the surety for any amounts paid by the surety on the bond and other costs incurred. The Code of Civil Procedure governs how liability may be enforced on a bond and specifies that a beneficiary may enforce the liability of a bond against both the principal and the surety in a civil action where both the principal and surety are to be joined as parties. (Code of Civ. Proc. §§ 996.410 & 996.430.)

b. Contractor license bonds

According to the author, contractors comprise the largest group of licensed bond holders in California, with over 285,000 licensed contractors in the state. Generally, the premium for a contractor license bond is the same irrespective of the size or experience of the contractor seeking bondage. The idea behind this structure is that it hopefully encourages licensure and therefore regulation by the CSLB, which was established to protect the public from violations of the Contractors Law.

c. Recent California Appeals Court opinions that have held a surety can be liable for attorney fees in an amount in excess of the surety bond

This bill is being brought in response to the holding in *Karton v. Ari Design and Construction* (2021) 61 Cal.App.5th 734. In *Karton*, plaintiff sued his contractor (Ari Design and Construction) and was awarded damages, costs of litigation, and \$90,000 in attorney's fees. Wesco Insurance Company was the surety for the contractor, who had a contractor's bond of \$12,500 (which was the statutory dollar amount at the time).¹ The trial court held that Wesco was not liable to the plaintiff for the \$90,000 in attorney's fees as that sum exceed the amount of the surety bond Wesco issued to Ari Design. (*Id.* at 751.) *Karton* argued on appeal that Wesco was liable for the \$90,000 attorney fees, even though it exceed the amount of the surety bond. The appellate court concurred with *Karton's* argument, noting that Section 2808 of the Civil Code makes a surety's liability commensurate with that of the surety's principal, the contractor in this case. (*Ibid.*) The court cited to a prior decision, *Pierce v. Western Surety Co.* (2012) 207 Cal.App.4th 83 to support its conclusion, noting that the "surety's obligation to pay costs under Code of Civil Procedure [S]ection 1032 was based on its status as a litigant and was not for breach of the condition of the bond." (*Karton* at p. 752 (citing to *Pierce* at p. 92).) In the *Pierce* case, the trial court awarded attorney fees to the plaintiff "in an amount not to exceed the remaining balance on the bond." (*Pierce* at 82.)

Wesco argued to the court that its ruling was against public policy, stating that public policy "favors low insurance premiums, and that to increase its liability would mean higher insurance rates." (*Ibid.*) The court responded that Wesco could have negotiated a settlement for its own liability or used interpleader procedures to deposit the amount of the surety bond with the court, but that Wesco instead decided to avoid liability based on the merits of the case and therefore is not in a position to protest liability for the costs of going to court. (*Ibid.*) The court further noted that if "a surety decides to fight a lawsuit, it can make itself liable for the costs of that litigation in excess of the face value of its bond" and noted that Wesco had already paid the *Kartons* \$38,768.49 after the trial court proceeding for the sum of the \$12,500 bond, post judgment interest, and costs. (*Karton* at 753.) Wesco's petition for a rehearing by the appellate court was denied on

¹ The statutory dollar amount for a contractor license bond was increased to \$25,000 as of January 1, 2023. (SB 607 (Min, Ch. 367, Stats. 2021).)

March 29, 2021, and review by the California Supreme Court was denied on June 23, 2021.

A 2024 unpublished opinion from the California Fourth District Court of Appeal upheld the trial court's finding that a surety of an auto dealer bond was liable for \$264,440 in attorney fees, which was greatly in excess of the value of the \$50,000 auto dealer bond issued by Hudson and the underlying damages award of \$8,748.28 in compensatory damages and \$5,000 in punitive damages. (*Gonzalez v. Hudson Insurance Co.* (2024) 2024 WL 566058.) The attorney fees were incurred in both arbitration and then the subsequent trial and were awarded to the plaintiff by the court because she prevailed on her claim under the California Consumer Legal Remedies Act, which requires that court costs and attorney fees be awarded to a prevailing plaintiff. (§ 1750 et. seq. of the Civil Code.) In this case, the plaintiff was unable to collect from the auto dealer (principal on the bond) as they "disappeared" after they lost in arbitration, and therefore sought to collect from the surety Hudson Insurance. (*Id.* at 2.)

3. Author and sponsors arguments for why this bill is needed

The author and sponsor state that the two above described cases have "thrown the once-stable [surety bond] market into turmoil" because if sureties cannot rely on the bond amount to limit their aggregate liability, "they will have to reconsider how they underwrite and price such bonds, which is likely to significantly impact licensed contractors in particular." As evidence to this proposition, they point to the fact that second largest writer of contractor license bonds – Suretec Insurance/Markel Surety – has left the California market. They argue that if this bill is not enacted, premiums for surety bonds will have to increase, tighten their underwriting requirements, and potentially require collateral. They posit that consumers are the ones who will be negatively impacted because: (1) there will be fewer licensed contractors due to the higher cost of bonds; (2) the higher costs of the bonds will be passed on to the consumers; and (3) this will result in more unlicensed contractors being hired, which will pose risks to consumers.

4. Potential concerns raised by this bill

a. *Bill likely abrogates other existing court cases*

California Appellate Court decisions have held as far back as 1992 that a surety can be liable for an amount in excess of a surety bond. In *Harris v. Northwestern National Ins. Co.* (1992) 6 Cal.App.4th 1061, the court held that a surety could be liable for court costs in excess of the bond that were incurred for the surety's "own conduct unsuccessfully litigating respondents' amended complaint and amended cross-complaint" under Sections 1032 and 1033.5 of the Code of Civil Procedure. (*Harris* at 1067.) The court in *Harris* noted that three prior California Supreme Court Cases from the late 1800s provided that the judgment in a successful action against a surety on a bond should be

against the surety for the full amount that the defendant is liable on the bond and for costs. (*People v. Rooney* (1886) 29 Cal.643, 644; *People v. Love* (1864) 25 Cal. 521, 522-23 & 531; *Heppe v. Johnson* (1887) 73 Cal.265, 266.) Additionally, the court stated that Section 996.470 of the Code of Civil Procedure, which this bill is amending, limits liability up to the amount of the bond for breach on the *condition of the bond*, not liability imposed by statute. (*Harris* at 1065.) To further bolster the court's view, they pointed to Section 996.475 of the Code of Civil procedure, which was enacted in 1984, and provides that "nothing in this chapter is intended to limit the liability of a surety pursuant to any other statute. This section is declaratory of, and not a change in, existing law." The court in *Harris* explained:

To avoid the costs and risks of litigation, appellant could have negotiated settlements of its own liability or used interpleader procedures to deposit the amount of its bond in court. [citations omitted] Here appellant elected to gamble that appellant and its principal, the notary, might avoid liability altogether on the merits. Having lost that gamble, appellant is not in a position to complain about liability for court costs contemplated by Code of Civil Procedure [S]ection 1032.

This bill defines "aggregate liability" as including all liability for damages, costs, or attorney's fees, if recoverable. Section 996.470 of the Code of Civil Procedure, as proposed to be amended by this bill, states that the *aggregate liability* of a surety to all persons for breaches of the condition of a bond, including any attorney's fees that may be assessed as costs pursuant to paragraph (10) of subdivision (a) of Section 1033.5 of the Code of Civil Procedure or similar statute, is limited to the amount of the bond. If the definition of aggregate liability includes recoverable costs, then the bond limits recovery to the amount of the bond for costs as well, which would abrogate the holding in *Harris*, above.

b. Burden will be on consumers to recoup attorney's fees and other costs from principal

If this bill is enacted, the burden of recouping attorney fees and other costs awarded by the court will fall completely on the consumer or homeowner as the contractor or principal would remain liable for those fees or costs. As the sponsor and support coalition of this bill note in their letter, attorney fees can be substantial – \$90,000 in the *Karton* case – and it is likely that many contractors will be forced into bankruptcy to pay the surety back. They note that if the contractor files for bankruptcy or cannot pay, the surety would have to pay the fees. However, under this bill a contractor or principal is still liable for the fees or costs and the only recourse the homeowner or consumer will have as is to seek judgment against the contractor or principal on the surety bond. If the contractor or principal either goes bankrupt or disappears, as was the situation in the *Gonzalez* case discussed above, the homeowner or consumer will likely not be able to recoup any of the fees or costs.

- c. *Opposition fears this bill will make the security surety bonds are supposed to provide to consumers illusory*

The opposition fears that if this bill were to pass, the consumer protection that surety bond requirements are supposed to provide to consumers would be illusory. As the Consumers for Auto Reliability and Safety note:

By allowing surety companies to evade potentially having to pay defrauded victims' attorneys fees when the sureties fail to honor legitimate claims and force victims to litigate in order to prove they were defrauded, and in order to receive any compensation under the bond, AB 2677 would make any protections afforded consumers by the existence of the bond largely illusory.

Only the very wealthy, who can afford to pay for legal counsel out of pocket, would be able to afford to access the bonds, rendering their supposed protections virtually useless for most Californians.

- d. *Bill affects all surety bonds, not just license bonds*

Though the author and sponsor focus largely on contractor license bonds, this bill would affect all surety bonds. There are numerous instances of surety bonds required by statute including, license bonds for auto dealers, mortgage brokers and lenders, notaries, immigration consultants, and cannabis-related businesses (*see Veh. Code § 11710; Fin. Code § 50141; Gov. Code § 8213; & 4 C.C.R. Div. 19, § 15002(c)(22).*) Additionally, surety bonds can be required to pay employees of a business such as for car washes, which are required to obtain a surety bond of \$150,000 to ensure that their employees are paid in accordance with existing law (i.e. tip and wage laws). (*see Lab. Code § 2055.*) Other surety bonds are required for public works projects that cost greater than \$25,000. (*Civ. Code § 3247.*)

5. Statements in support

The Contractors State License Board writes in support, stating:

The Contractors State License Board (CSLB) supports Assembly Bill (AB) 2677. This bill would provide that a surety writing a bond is not liable for an award of attorney's fees (as costs in a civil action) unless a statute requiring a bond expressly authorizes the recovery of them.

The CSLB requires a license bond for every licensed contractor. It is the Board's understanding that this bill will address concerns about an increase in the costs of bonds that arose after a recent court opinion, *Karton v. Ari Design & Construction*, 61 Cal.App.5th 734 (2021).

An increase in the cost of the license bond is a barrier to licensure for applicants that may not have the financial resources to pay the increased costs. It is further the Board's understanding that the bill as amended April 17, 2024, ensures the entire amount of a license bond is available for consumers.

6. Statements in opposition

The California Low-Income Consumer Coalition and Consumer Federation of California write in opposition, stating:

There is a reason that California law requires certain types of business to have surety bonds: because the Legislature has found that fly-by-night members of those industries are likely to defraud their customers and then close up shop before consumers can get their money back. Surety bonds perform an essential function: even if the business and its proprietors are gone, the bond remains as a source of funds to make defrauded consumers whole.

The reality is that without the help of an attorney very few people would be able to access those bonds – or even to know of their existence. A bill that precludes the payment of attorneys' fees would essentially shut down consumers' access to surety bonds. We agree that making consumers whole, rather than paying attorneys, must be the first priority. But if there is no realistic prospect for paying attorneys, then consumers won't get paid either, because the bond proceeds will never be accessed.

A wide array of business enterprises are required by California law to obtain surety bonds in order to protect consumers in the event of the business going under – or disappearing – and leaving its customers with no other recourse. Auctioneers, credit service organizations, dance studios, discount buying organizations, employment agencies, foreclosure consultants, health studios, immigration consultants (notarios), job listing services, sellers of travel, home contractors, auto dealers, mortgage brokers -- all must maintain a surety bond to protect against consumer harm.

AB 2677 would make those bonds illusory as a practical matter. It would undermine the purpose of the bonds that are maintained by hundreds of thousands of businesses for the benefit of millions of consumers. Only those few consumers who could afford to pay for a lawyer out of pocket would be able to access the bonds. That is the opposite of what surety bonds were designed for, and it is certainly not what this Legislature had in mind when it required them.

SUPPORT

Flasher Barricade Association (sponsor)
American Property Casualty Insurance Association
Associated Builders and Contractors of California

Associated General Contractors
Associated General Contractors San Diego Chapter
Associated Roofing Contractors of Bay Area Counties, Inc.
American Subcontractors Association of California
California Builders Alliance
California Building Industry Association
Civil Justice Association of California
Contractors State License Board
Masonry Contractors Association of California, Inc.
Painting & Decorating Contractors of California, Inc.
Roofing Contractors Association of California
Sacramento Regional Builders Exchange
Southern California Contractors Association
Union Roofing Contractors Association
United Contractors
Western Electrical Contractors Association Inc.

OPPOSITION

California Low-Income Consumer Coalition
Consumer Federation of California
Consumers for Auto Reliability and Safety

RELATED LEGISLATION

Pending Legislation: None known.

Prior Legislation: SB 607 (Min, Ch. 367, Stats. 2021), among other things, increased the required limit for a contractor license bond to \$25,000.

PRIOR VOTES

Assembly Floor (Ayes 75, Noes 0)
Assembly Judiciary Committee (Ayes 12, Noes 0)
