

CONTRACTORS STATE LICENSE BOARD
INITIAL STATEMENT OF REASONS

Hearing Date: January 10, 2011

Subject Matter of Proposed Regulations: Blanket Performance and Payment Bond

Section(s) Affected: Title 16, California Code of Regulations (CCR), Sections 858, 858.1, 858.2, 858.3, 858.4, 858.5, 858.6, 858.7, 858.8, and 858.9

Purpose

The Contractors State License Board (CSLB) is mandated to protect the public health, safety, and welfare by ensuring that only those individuals or entities that meet the qualifications for licensure are granted contractor licenses in California. All contractors are required to have on file with CSLB a contractor's bond in the amount of \$12,500. In addition to the standard \$12,500 contractor's bond, contractors that perform home improvement work may choose to also file a bond equivalent in the form of a blanket performance and payment bond (blanket bond). A holder of a blanket bond is exempt from certain provisions of the home improvement contract requirements in exchange for full performance and payment coverage for all home improvement contracts.

Business and Professions (B&P) Code Section 7000.6 declares that the highest priority of CSLB shall be public protection. Section 7008 authorizes the Board to make rules and regulations that are reasonably necessary to carry out the provisions of the Contractors State License Law. Section 7068 establishes the qualification requirements for contractors. Section 7068.1 further delineates the qualification requirements, particularly as they relate to the qualifying individual. Section 7071.17 sets forth provisions for the posting of bonds for unsatisfied final judgments and for resultant disciplinary action and/or license suspension for noncompliance. Section 7111 sets forth provisions to make a licensee subject to disciplinary action if he or she fails to make, maintain, or produce for CSLB inspection relevant business records for not less than five years after date of construction project completion. Section 7124.6 establishes provisions for public access to complaints against licensees, including disclaimers and limitations of disclosure. Section 7151 defines "home improvement" and "home improvement goods and services." Section 7151.2 defines a "home improvement contract." Section 7159 sets forth the requirements for home improvement contracts, notably including a limitation on contractors for a down payment that is not to exceed 10% of the contract price or \$1,000, whichever is less, and a requirement to include a Mechanics' Lien Warning in the contract language. Furthermore, Section 7159 requires that a contract for home improvements contain a schedule of progress payments for the work that is to be accomplished in each phase of the project. Each progress payment must not exceed the value of the amount of work (labor and materials) that has been incorporated into each phase. Section 7159.5 further delineates the requirements for home improvement contracts, including the provision that contractors who file a performance and payment bond or a "bond equivalent... approved by the registrar" shall be exempt from certain provisions of the home improvement contract requirements

relating to down payments, progress payments, and the Mechanics' Lien Warning for home improvement work.

Civil Code Section 1427 defines an "obligation." Section 1474 sets forth criteria for determining how liability for an obligation may be extinguished. Section 3096 defines a "payment bond."

Code of Civil Procedure Section 995.020 sets forth criteria for the applicability of the Bond and Undertaking Law. Section 996.310 et seq. establishes requirements for sureties on a bond. Section 996.360 sets forth conditions for return of a bond.

CSLB initiated the proposed regulatory action for the purpose of establishing the requirements and procedures for contractors seeking approval from CSLB for a "bond equivalent" that would cover all of the contractor's home improvement obligations ("blanket performance and payment bond"), as well as requirements and procedures for related biennial reports, audits, approval rescissions, and information posting to license records. The proposed regulations would enact procedures and conditions for the approved blanket performance and payment bonds, the purpose of which are to protect the public as outlined below.

Adopt § 858. Blanket Performance and Payment Bond Defined

There is no existing CSLB regulation that defines a blanket performance and payment bond. The proposed regulatory action would add Section 858 in order to accomplish this.

Section 858 defines a "blanket performance and payment bond" (hereafter referred to as "blanket bond"); identifies the fact that, pursuant to B&P Code Section 7159.5, blanket bonds are subject to approval by the Registrar; and provides notice that the requirements for Registrar approval of blanket bonds are set forth in regulation.

This regulation is necessary to define a blanket performance and payment bond. Regulatory action is needed because without the regulatory language establishing the blanket bond definition, CSLB staff and affected contractors may not have a comparable understanding of the definition. There could be confusion about the coverage provided by a blanket bond.

Factual Basis/Rationale – § 858

Under paragraph (a)(8) of B&P Code Section 7159.5, a contractor who furnishes "a performance and payment bond, lien and completion bond, or a bond equivalent or joint control approved by the registrar covering full performance and payment" is exempt from the following:

1. Restrictions with regard to the down payment that can be charged and collected under a home improvement contract as defined under B&P Code Section 7151.2 (see B&P Code Sections 7159 (d)(8)(C) and 7159.5 (a)(3)).

2. Requirement that a schedule of payments be included in a home improvement contract (see B&P Code Section 7159.5 (a)(4)).
3. Restrictions on requesting or accepting funds that exceed the value of labor and materials for the project (see B&P Code Section 7159.5 (a)(5)).
4. Requirement that the Mechanics' Lien Warning be included in a home improvement contract (see B&P Code Section 7159 (e)(4)).

Given the impracticality of the Registrar having to review and approve a blanket bond for each project undertaken by all licensees that want to operate their businesses under the exemptions enacted by the legislature under paragraph (a)(8) of B&P Code Section 7159.5, it is reasonable to establish conditions under which a single instrument acting as security (blanket performance and payment bond) for all of the specified obligations for a contractor may be reviewed and approved by the Registrar. An approved blanket bond would serve as surety for the performance of all work and payment for all labor and materials for which a licensee is obligated under any contract that is subject to the provisions of Section 7159.

When operating with only a standard \$12,500 contractor's bond, contractors performing work under home improvement contracts pursuant to Section 7159 are limited in the amount of down payment money that they may accept from a consumer prior to the project completion date – that is, an amount not to exceed \$1,000 or 10% of the contract price, whichever is less. However, contractors who also have an approved blanket bond on file with CSLB are allowed to exceed that limit, billing and collecting up to 100% of the contract price at any time during the contract term, even before any work is performed. Existing law also allows a contractor to be exempt from the payment schedule and Mechanics' Lien Warning requirements under Section 7159 if he or she furnishes a blanket bond.

It is important to note that contractors are not required to conduct their home improvement businesses using a blanket bond; it is not a condition of licensure. Only the \$12,500 contractor's bond (or an equivalent cash deposit) is required of all licensees. Contractors must make a specific election to also use the supplemental blanket bond instrument according to the needs of their businesses.

In developing the regulatory language for the blanket bond provisions, consideration had to be given to a wide range of potential participants: (1) smaller contractors that seek to bill and collect more than a 10% down payment because of custom fabrications and (2) large publicly traded companies, such as Home Depot, Lowes, and Sears, that perform extremely large dollar volumes in home improvement services. For the smaller contractors, if the consumer will not or cannot proceed with the transaction, the contractor would otherwise lose the funds invested in the custom fabrication. For the larger contractors, the ability to bill and collect all contract funds in advance could prevent collection issues for such firms on a vast scale.

The blanket bond provides important and effective consumer protection for the public by establishing a fund from which the consumer may seek relief if necessary. Enacting the

blanket bond provisions should be beneficial for contractors and consumers alike. It will enable qualified contractors to conduct their businesses in a more cost efficient fashion while providing consumers with access to a more comprehensive source of funds in the event the contractor fails to meet contractual obligations.

However, the potential risks associated with allowing a blanket bond to be incorporated into the business model of a licensee must be minimized by ensuring that the contractors who utilize a blanket bond are qualified and remain so during the period that the blanket bond is on file. The proposed regulations accomplish this with provisions that require the financial condition of licensees to be regularly assessed through review of biennial financial reports, including authorization for the Registrar to order audits of licensee financial records and to rescind approval of the blanket bond when financial data indicates the licensee is, or is likely to become, insolvent. The proposed regulations outline the procedures to be used for these requirements and authorizations.

Additionally, to assist consumers in the filing of claims against the blanket bond, the proposed regulations provide procedures for the posting to the license records, including CSLB's website, of blanket bond information for contractors who have an approved blanket bond on file with CSLB.

Adopt § 858.1. Blanket Performance and Payment Bond Requirements

There is no existing CSLB regulation that sets forth blanket bond requirements. The proposed regulatory action would add Section 858.1 in order to accomplish this.

Section 858.1 specifies that, in order to obtain Registrar approval, a blanket bond must meet specific requirements relative to the portion of a licensee's business that is subject to B&P Code Section 7159 (home improvement contracts). It requires the dollar amount of a blanket bond to be not less than 100% of a licensee's home improvement contract obligations, thereby establishing the "100% rule," and provides criteria under which the dollar amount of the blanket bond may be capped at specified levels if the licensee is required to report annually to the United States Securities and Exchange Commission (U.S. SEC). Section 858.1 also provides the standard form with which the blanket bond must conform. Additionally, it specifies the deadline by which a licensee must increase an existing blanket bond if it does not comply with the specified minimum set by the regulation.

This regulation is necessary to specify requirements for a blanket bond. Regulatory action is needed because without the regulatory language specifying the blanket bond requirements, CSLB staff and affected contractors may not have a full understanding of the requirements. There could be confusion about whether or not a contractor should obtain or would qualify for a blanket bond.

Factual Basis/Rationale – § 858.1

Under Section 3096 of the Civil Code, a "payment bond" is "a bond with good and sufficient sureties that is conditioned for the payment in full of the claims of all claimants."

Consequently, the sum of a blanket bond must be capable of covering all claims for labor and materials that could result from a contractor's unfulfilled home improvement obligations at any given point in time. The objective of the blanket bond is to provide a financial mechanism to indemnify consumers against incomplete projects or unpaid labor and material bills. Accordingly, the amount of the bond should be not less than 100% of all unfulfilled consumer obligations for home improvement contracts at any given time – identified as “the 100% rule.”

CSLB anticipates that a wide range of licensees may be interested in operating with a blanket bond – such as small specialty contractors that do custom fabrication and large publicly traded companies that do a high volume of home improvement contracts. The 100% rule as described above would meet the needs of the smaller contractors.

In addition, CSLB needed to establish different standards for ensuring financial stability for the large publicly traded companies. The provision that authorizes a cap on the blanket bond addresses the 100% rule by establishing a net worth requirement that, given the financial dynamics applicable under the Securities and Exchange Commission rules, provides reasonable assurance that sufficient assets are available to satisfy all pertinent contractual obligations in the event the proceeds of the blanket bond of a large publicly traded company are exhausted.

A contractor that is a publicly traded company will have much more complex financials and, due to its public traded status, will be required to file reports with the U.S. SEC regarding its financial condition. According to the U.S. SEC, “The annual report to shareholders is the principal document used by most public companies to disclose corporate information to their shareholders. It is usually a state-of-the-company report, including an opening letter from the Chief Executive Officer, financial data, the results of continuing operations, market segment information, new product plans, subsidiary activities, and research and development activities of future programs. The Form 10-K, which must be filed with the U.S. SEC, typically contains more detailed information about the company's financial condition than the annual report.” Therefore, it was determined that reliance upon these U.S. SEC filings is an appropriate basis for evaluating the financial stability of such companies.

For the filing of the Form 10-K, particularly relating to filing deadlines, the U.S. SEC created categories for the publicly traded companies, including “large accelerated filers” that have a public float of \$700 million or more, “accelerated filers” that have a public float of at least \$75 million but less than \$700 million, and “non-accelerated filers” that have a public float of less than \$75 million. The U.S. SEC defines “public float” as “the aggregate market value of the issuer's outstanding voting and non-voting common stock held by non-affiliates.” It was determined that reliance upon these U.S. SEC categories is an appropriate basis for establishing levels at which the blanket bond could be capped for publicly traded companies as a feasible alternative to the 100% rule discussed above. An approved capped blanket bond held by a publicly traded company will serve as evidence of compliance with the 100% requirement.

When considering the appropriate amounts for the capped blanket bonds for publicly traded companies, CSLB looked toward existing publicly traded licensees that currently

have blanket bonds on file with CSLB. Sears, The Home Depot, and Lowe's are large accelerated filers and, for the most part, their blanket bond amounts vary between \$5 million and \$8 million. It was determined that the amount for the blanket bond for large accelerated filers should be \$10 million in order to ensure sufficient coverage of all unfulfilled consumer obligations for home improvement contracts at any given time.

Other existing blanket bond holders that are not filers with the U.S. SEC have blanket bond amounts that vary from \$20,000 to \$1 million. Taking that into consideration, the capped blanket bond amount for the lowest level of the U.S. SEC filers (non-accelerated filers) was set at \$1 million so as to be at the upper end of the amounts currently claimed by licensees that are not publicly traded companies, thereby establishing a minimum level for capped blanket bonds.

The capped blanket bond amount for the accelerated filers (the mid-range filers with the U.S. SEC) was set at an amount in between the lowest and the highest filers – \$5 million. It was determined that it was appropriate to set the amount at the midway point between the other two capped blanket bond amounts because the accelerated filers fall in between the other two filer categories financially.

To reiterate, the amounts of the capped blanket bonds for publicly traded companies are set as follows:

- U.S. SEC Large Accelerated Filers \$10 million
- U.S. SEC Accelerated Filers..... \$5 million
- U.S. SEC Non-Accelerated Filers..... \$1 million

As a means of documenting their U.S. SEC filing status and financial stability, U.S. SEC filer contractors that are seeking to obtain or maintain a capped blanket bond will be required to submit copies of their Form 10-K reports to CSLB with their application for blanket bond approval and, for subsequent reports, within 10 days of filing with the U.S. SEC. This due date ensures a timely submission of the report and is coordinated with the U.S. SEC filing dates, which should facilitate compliance with the CSLB filing requirement. Due to the thorough financial reporting with the Form 10-K submission, U.S. SEC filer contractors with blanket bonds are not required to submit financial reports required pursuant to Section 858.4.

The U.S. SEC filer provisions require that the net worth of the company be not less than 10 times the blanket bond amount. As such, a non-accelerated filer with a \$1 million blanket bond would need to have a net worth of at least \$10 million. The purpose of the 10 times requirement is to ensure that the company has enough net value to cover all unfulfilled consumer obligations for home improvement contracts in the event that the blanket bond is depleted. The concept for the 10 times multiplier was derived from existing law (B&P Code Section 7071.8) that requires a contractor who has had a license suspension or revocation that was stayed to have on file with CSLB a disciplinary bond that is not less than \$15,000 nor more than 10 times that amount. In both cases, the goal is public protection, as required under B&P Code Section 7000.6.

For any contractor that has posted a blanket bond prior to the effective date of these proposed regulations, the provisions of Section 858.1 provide a reasonable time period for compliance relative to the 100% rule. The 90 days allowed for compliance is consistent with existing law (B&P Code Section 7074) that requires a 90-day written notice when CSLB is requesting materials from or action by an applicant before the application will be voided. Failure by an existing blanket bond holder to comply with this provision would result in the rescission of the blanket bond approval pursuant to the Section 858.8.

In addition, a standardized form for the blanket bond is included under the proposed regulation to provide constructive notice as to the form and content of the blanket bond, which is signed and declared under penalty of perjury by the attorney-of-fact for the surety. The blanket bond format was reviewed and approved by the Attorney General's Office on June 3, 2008.

Adopt § 858.2. Application for Approval of Blanket Performance and Payment Bond

There is no existing CSLB regulation that sets forth application procedures for the blanket bond approval. The proposed regulatory action would add Section 858.2 in order to accomplish this.

Section 858.2 outlines the process for making application for approval of a blanket bond, specifies the information to be included in the application, establishes the eligibility qualifications including the financial reporting requirements, and creates a standard certification form to be used by the licensee's qualifier in the application and biennial submission processes.

This regulation is necessary to specify the procedures and qualifications required for the application, by which approval of a blanket bond can be considered. Regulatory action is needed because without the regulatory language specifying the blanket bond application and approval procedures, CSLB staff and affected contractors may not have a full understanding of the application qualifications and approval process. There could be confusion about how a contractor should apply for a blanket bond and about the eligibility qualifications and approval process.

Factual Basis/Rationale – § 858.2

Standardized application filing procedures are established for the sake of consistency and clarity relative to the requirements for approval of the blanket bond.

Contractors who are not U.S. SEC filers with predetermined dollar amounts based on their filing status must apply for amounts based on financial information that must be verified in a specific manner and provided to CSLB. The dollar amount of the blanket bond for which the licensee initially requested approval might not be sufficient to cover all circumstances into the future. This is particularly plausible if there is a shift in market conditions between the date the blanket bond is originally approved and the subsequent date of approval at license renewal (two years later).

Section 858.2 accounts for such circumstances through two provisions: 1) the certification statement, which is designed to reasonably ensure that the sum of the bond preserves the 100% rule relative to the ongoing obligations of the licensee; and 2) the financial statements, which are intended to ensure that the licensee's business is financially sound, as evidenced by sufficient and liquid assets that could be used to satisfy claims if circumstances inadvertently render the proceeds of the blanket bond insufficient for all home improvement obligations. The rationale for each provision is as follows:

1) Certification by the license qualifying individual or qualifier: Under Section 7068.1 of the code, the qualifier for the license is responsible for exercising the direct supervision and control of the construction operations that is necessary to secure the licensee's full compliance with the Contractors State License Law and the associated regulations. The qualifier's certification requirement under Section 858.2 is reflective of this duty, and to reinforce its significance in relation to the blanket bond, the qualifier must expressly acknowledge a fiduciary responsibility relative to the 100% rule, which he or she must sign and declare under penalty of perjury.

2) The reviewed year-end financial statements and a report prepared by a duly licensed certified public accountant (CPA): In reviewing these financial statements, an accountant using the specified standards will generate liquidity ratios. Most notably, the financial statements and liquidity ratios are used in evaluating a firm's ability to pay its short-term debt obligations, such as accounts payable (payments to suppliers), accrued taxes, and wages. Use of a duly licensed CPA is required for the completion of the financial documents in order to help ensure the reliability of the provided information. At least two years' worth of statements is needed to more precisely assess the financial position of the firm being reviewed. Two of the most common ratios used for this purpose are the current ratio and the quick ratio.

The current ratio is probably the best known and most often used of the liquidity ratios. On the balance sheet, the current portions of the assets and liabilities are ones that convert to cash within one year. Current assets and current liabilities make up the current ratio. Current assets include: the sum of a firm's cash, accounts and notes receivable, inventory, prepaid expenses, and marketable securities which can be converted to cash within a single operating cycle. Current liabilities include: measurable debt owed within one year, including accounts, loans, and notes payable; accrued liabilities; and taxes due.

Calculation of the Current Ratio

The current ratio is calculated from balance sheet data as current assets divided by current liabilities. For example, if a business firm has \$200 in current assets and \$100 in current liabilities, the calculation is $\$200/\$100 = 2.00X$. The "X" (times) part at the end is important. It means that the firm can pay its current liabilities from its current assets two times over. The current ratio in this hypothetical scenario would be 2:1 (two-to-one ratio). Therefore, there would be \$2 of assets for every \$1 of liabilities, which would be sufficient to pay short-term obligations. The firm would be considered solvent if it had a current ratio of 2:1.

It is important to note that inventory is the least liquid of all the current assets. Finding a ready buyer, whether through contracts for additional business and/or through outright liquidation, is not an assured event. Therefore, the more reliable test of a firm's financial soundness is its ability to meet short-term debt obligations without having to rely on selling inventory, which is what the quick ratio projects.

Calculation of the Quick Ratio

The quick ratio, sometimes called the "acid-test," is a more stringent test of liquidity than the current ratio, because it removes inventory from the equation. For example, if a business firm has \$200 in current assets, \$50 in inventory, and \$100 in current liabilities, the calculation is $\$200 - \$50 / \$100 = 1.50X$. Again, the "X" (times) means that the firm can pay its current liabilities from its current assets (minus inventory) one and one-half times over. Therefore, in this scenario, the quick ratio would be 1.5:1, and there would be \$1.50 of current assets minus inventory for every \$1 of liabilities – sufficient to pay debt obligations. In fact, the firm would be considered solvent if it had a quick ratio of 1:1.

Under the proposed provisions of Section 858.2, a five-year licensing requirement is necessary to reasonably ensure that a licensee has been able to sustain a solid business performance within the law and without a history of consumer harm for a period that sufficiently evidences the potential for continued success. This five-year minimum is based on a similar provision of existing law (B&P Code Section 7001) that establishes minimum standards for potential contractor Board members of CSLB.

The personnel of record of any licensee applying for blanket bond approval, or any home improvement salesperson registered to the licensee, must not have been found to be culpable for any act or omission that resulted in a license suspension or revocation required to be disclosed under B&P Code Sections 7124.6 (e)(2) or 7124.6 (e)(3), or be named on a license that is suspended for an unsatisfied construction-related judgment pursuant to B&P Code Section 7071.17. A person who has committed acts that have warranted suspension or revocation of a license has demonstrated a disregard for the public welfare, and the financial harm sustained by the public as a result of such behavior is frequently considerable. Accordingly, persons who have been disciplined by CSLB should not be permitted to be in a position of control or influence of a contracting business that is exempt from some of the consumer protection provisions of the Contractors State License Law. As previously stated and mandated by B&P Code Section 7000.6, public protection is paramount to CSLB.

An applicant who previously had a license suspended or revoked but who subsequently is named on a license and remains in good standing for not less than three years may be party to an application for blanket bond approval. The three-year provision for those with previous disciplinary action is comparable to the California Code of Regulations Section 869 that establishes criteria of three years after a misdemeanor criminal conviction for an applicant to demonstrate sufficient rehabilitation before CSLB would issue a license to the applicant. To provide reasonable assurance that a blanket bond and its economic advantages are not used as a means to exploit consumers, it is prudent that a similar discipline-free period of licensure be applicable.

Adopt § 858.3. Minimum Standards for Blanket Performance and Payment Bond Approval – Cause for Denial

There is no existing CSLB regulation that sets forth minimum standards or causes for denial or rescission of blanket bond approval. The proposed regulatory action would add Section 858.3 in order to accomplish this.

Utilizing the current and quick ratios as the baseline metrics, Section 858.3 specifies the minimum standards that a licensee must demonstrate relative to the financial health of his or her business in order to qualify for approval of a blanket bond. It also provides the Registrar with the authority to deny blanket bond approval if the information in the required financial reports indicates that the licensee's business will not be able to meet current liabilities.

This regulation is necessary to specify the minimum standards required for initial and ongoing approval of the blanket bond. Regulatory action is needed because without the regulatory language specifying the minimum standards required for approval and maintenance of blanket bonds, CSLB staff and affected contractors may not have a full understanding of the approval process. There could be confusion about the eligibility qualifications and approval process.

Factual Basis/Rationale – § 858.3

Taken together, the current ratio and the quick ratio are a good measure of the financial health of a business and, more particularly, a reliable standard for determining whether or not a business is solvent. If the financial data indicates that the licensee's business cannot meet its short-term obligations, or is unlikely to do so, the Registrar's authority to deny blanket bond approval based on this information is critical for protection of the public. To do otherwise would unnecessarily expose consumers to an unacceptable level of risk. Therefore, to qualify for blanket bond approval, either initially or at the time of biennial renewal as required under Section 858.4, the licensee must demonstrate that the applicant firm has remained solvent (1:1 ratio) under the quick ratio method during the two fiscal years preceding application. In other words, the financial data submitted with the application must show that the firm has, after subtracting out inventory figures, maintained \$1 of current assets for every \$1 of current liabilities.

In lieu of demonstrating solvency under the quick ratio method, a firm may still obtain blanket bond approval if the firm's financial data shows that, utilizing the current ratio method for the two fiscal years preceding application, the firm maintained a ratio of 2:1. In other words, the financial data submitted with the application must show that the firm has, including inventory figures, maintained \$2 of current assets for every \$1 of current liabilities. Justification for this ratio requirement lies in the fact that, to meet short-term obligations, the firm's inventory must first be sold in order to obtain the necessary cash. Although it may be plausible that, for the construction industry, a 1.5:1 ratio could generally be considered to be the upper end of the norm, it would not be prudent to ignore the fact that inventory is required to maintain an ongoing business. In other words, a company should not have to liquidate all inventories in order to meet current obligations, as it would leave nothing in stock for future sales in the business cycle.

Adopt § 858.4. Blanket Performance and Payment Bond Biennial Certification and Financial Reporting Requirements

There is no existing CSLB regulation that sets forth procedures for filing a biennial report by a licensee that maintains a blanket bond. The proposed regulatory action would add Section 858.4 in order to accomplish this.

Section 858.4 specifies that, in order to maintain a blanket bond, a licensee must biennially file a certification statement as specified in Section 858.2 and a financial report relative to the licensee's contracting activity. It also specifies the deadline by which the certification statement and report must be submitted to the Registrar and provides circumstances under which the Registrar's approval may be rescinded.

This regulation is necessary to specify requirements for blanket bond biennial reports. Regulatory action is needed because without the regulatory language specifying the blanket bond biennial report requirements, CSLB staff and affected contractors may not have a comparable understanding of the biennial reporting requirements. There could be confusion about what must be submitted for the blanket bond biennial report and when it must be filed with CSLB.

Factual Basis/Rationale – § 858.4

Biennial reporting requirements are necessary to ensure that the financial position of the contractor is maintained at a level that sufficiently ensures continued solvency in the event claims against the blanket bond deplete the bond amount. Certification signed under penalty of perjury is required as acknowledgement and verification by the person charged to be responsible for the licensee's construction operations (the qualifier) that the licensee's blanket bond, pursuant to the information contained the financial reports, conforms to the minimum requirement (not less than 100% of all contracts for which an obligation remains).

Certification on an ongoing basis updates the qualifier's acknowledgement and verification of his or her fiduciary duty relative to the 100% rule. From a legal perspective, the qualifier specifically is held responsible for compliance, and any charges of culpability that might ensue should not be based on the execution of an acknowledgement that is outdated. Furthermore, if a qualifier fails or refuses to update the certification, he or she is effectively failing to continue the fiduciary responsibility specific to the blanket bond, and the Registrar must be authorized to rescind approval of the blanket bond for lack of assurance that it will be maintained in compliance with the regulations.

Since the use of two (2) reviewed year-end financial statements is a more certain method of determining the financial capacity of a business and active contractor's licenses must be renewed every two (2) years, submission of biennial reports (including the updated qualifier's certification statement) is best accomplished at the time of license renewal.

This proposed section contains provisions under (a)(2) for financial reporting for shorter

time periods when the first license renewal following the blanket bond approval comes about less than two (2) years after the approval date.

Once a blanket bond is issued, there is nothing that compels the surety companies to advise the Registrar as to whether or not there are any ongoing financial reporting requirements that they have subsequent to the underwriting. Such financial reporting may be presumed to occur, but protection of the public must involve due consideration of the most current facts available. If the financial reports indicate that, given the level of business reported, a licensee is or will be unable to meet current liabilities, the Registrar's authority to rescind approval of the bond is critical to protecting the public.

Adopt § 858.5. Blanket Performance and Payment Bond Audit Authorization and Procedures

There is no existing CSLB regulation that establishes authorization and sets forth procedures for the Registrar to order an audit of a licensee that has an approved blanket bond on file with the Board. The proposed regulatory action would add Section 858.5 in order to accomplish this.

Section 858.5 outlines the conditions under which the Registrar may order an audit of a licensee's business activities that are germane to the purpose for which the blanket bond has been filed by the licensee and specifies that the Registrar is to have free access to the licensee's records in order to complete the audit for the purpose of ensuring compliance with the 100% rule.

This regulation is necessary to establish authorization and procedures for the audit of a blanket bond. Regulatory action is needed because without the regulatory language specifying the blanket bond audit authorizations and procedures, the Registrar may not have the tools necessary to conduct a complete audit, and CSLB staff and affected contractors may not have a comparable understanding of the audit procedures. There could be confusion about the Registrar's authority to conduct a comprehensive audit of a blanket bond and the procedures for such audits.

Factual Basis/Rationale – § 858.5

To ensure reasonable public protection as required under B&P Code Section 7000.6, the Registrar must be authorized, under specific conditions, to investigate (by audit) a licensee's business activities and financial condition to ascertain whether or not the sum of the blanket bond complies with the regulatory requirements. The proposed regulation reiterates the licensee's existing obligation regarding the inspection of books and records as set forth under B&P Code Section 7111.

The underlying need for this provision is based on the possibility that a contractor could become overextended at any time in the business cycle. The manifestation of such situation could come about as the result of complaints from multiple homeowners. The worst case scenario would be where a contractor with an approved blanket bond has numerous projects for which mechanics' liens have been filed against the homeowners' properties because material suppliers and subcontractors have not been paid by the

contractor. Such circumstances warrant special attention, and the ability to order an audit to ensure that the level of business has not outstripped the blanket bond amount is a necessary element for the protection of the public. In order to provide licensees with sufficient opportunity to respond to the audit request, a written notification will be sent out by certified mail not less than 30 days before the audit. If the licensee claims that that time is not sufficient, the Registrar may grant an additional 30 days for the licensee to prepare. Based on the audit findings, the Registrar will make a decision about the licensee's compliance with the 100% rule.

Adopt § 858.6. Authorization and Procedures for Ordering the Amount of Blanket Performance and Payment to Be Increased

There is no existing CSLB regulation that establishes authorization and sets forth procedures for ordering the amount of a blanket bond to be increased. The proposed regulatory action would add Section 858.6 in order to accomplish this.

Section 858.6 authorizes the Registrar to order an increase in the amount of a blanket bond based on the results of an audit, outlines the reasons for which the order may be prescribed and the procedures for delivering the order, and specifies that the approval of the licensee's blanket bond shall be rescinded if the licensee fails to comply with the order by the specified deadline.

This regulation is necessary to establish authorization and procedures for ordering an increase in the amount of a blanket bond. Regulatory action is needed because without the regulatory language specifying the authorizations and procedures for ordering an increase in the amount of a blanket bond, the Registrar may not have the tools necessary to ensure that all blanket bonds are for amounts that are sufficient to cover all of the contractor's outstanding contracts based on the results of an audit. In addition, CSLB staff and affected contractors may not have a comparable understanding of the procedures for ordering an increase in the amount of a blanket bond. There could be confusion about the Registrar's authority to order an increase in the amount of a blanket bond and the procedures for such orders.

Factual Basis/Rationale – § 858.6

The Registrar must have the authority to issue an order requiring the licensee to increase the sum of the blanket bond whenever an audit review reveals that the sum for which the blanket bond has been filed is insufficient to comply with the 100% rule. Any coverage that is less fails to meet the blanket bond requirements and to protect the public in accordance with the regulatory requirements and pursuant to CSLB's mandate for public protection under B&P Code Section 7000.6. Failure by the licensee to comply with the order within the 30-day period specified would result in rescission of the approval of the blanket bond in accordance with the regulatory provisions. Procedures for mailing of the order are outlined in the proposed regulations for the sake of clarity, consistency, and evidence of mailing.

Adopt § 858.7. Maintenance of Blanket Performance and Payment Bond

There is no existing CSLB regulation that sets forth requirements and procedures for

maintaining a blanket bond. The proposed regulatory action would add Section 858.7 in order to accomplish this.

Section 858.7 specifies that blanket bond approval is subject to rescission if any member of the licensee's personnel of record, or any salesperson registered to the licensee, is found to be culpable for any acts or omissions resulting in the suspension or revocation of licensure that is subject to public disclosure or named on any license that is subject to bond suspension. It directs the Registrar to provide due consideration to the protection of the public in determining whether or not a blanket bond approval should be rescinded. In addition, Section 858.7 specifies the maintenance procedures for a blanket bond in relation to the replacement of a qualifying individual.

This regulation is necessary to establish requirements and procedures for the maintenance of a blanket bond. Regulatory action is needed because without the regulatory language specifying the blanket bond maintenance requirements and procedures, CSLB staff and affected contractors may not have a comparable understanding of the maintenance requirements and procedures. There could be confusion about the requirements and procedures for maintenance of a blanket bond.

Factual Basis/Rationale – § 858.7

The Contractors State License Law provides for the discipline of licensees that, through their acts or omissions, have demonstrated a disregard for the law and the welfare of the public. Licensees (including their personnel of record and registered home improvement salespersons) that have been disciplined subsequent to the approval of a blanket bond represent a risk to the public that was not contemplated when approval of the blanket bond was originally granted. Since the blanket bond permits the acceptance of the full contract price for home improvements in advance of the performance of any work or services under the contract, allowing individuals who have received the most severe discipline (license suspension or revocation) to maintain a blanket bond without the opportunity for reconsideration is not consistent with the Board's duty to protect the public pursuant to B&P Code Section 7000.6. For cases where the licensee has been disciplined subsequent to blanket bond approval, the approval should be subject to rescission by the Registrar in accordance with the regulatory provisions. The decision to rescind the approval should be rendered subsequent to review of the facts underlying the disciplinary action and with due consideration to the protection of the public.

In addition, the Contractors State License Law provides for the suspension of the licenses of contractors who have an unsatisfied construction-related judgment (B&P Code Section 7017.17). Licensees can prevent this judgment suspension and possible rescission of a blanket bond by notifying the Registrar of the unsatisfied judgment within 90 days and posting a bond to cover the amount of the judgment. Licensees who fail to comply represent a risk to the public. Since the blanket bond permits the acceptance of all funds for home improvements in advance of the performance of any work or services under the contract, allowing licensees that are under judgment suspension to maintain a blanket bond without providing the Registrar with the opportunity for reconsideration is not consistent with the Board's duty to protect the public pursuant to B&P Code Section 7000.6. For cases where the licensee has received the judgment suspension

subsequent to blanket bond approval, the approval should be subject to rescission by the Registrar in accordance with the regulatory provisions. The decision to rescind the approval should be rendered only after due consideration of the facts underlying the judgment suspension and their relevance with regard to protection of the public.

When the blanket bond is originally approved, the qualifying individual completes, signs, and submits a certification statement pursuant to Section 858.2. If that qualifier subsequently disassociates and is replaced, the new qualifier must show his or her responsibility for the blanket bond by completing, signing, and submitting a new certification statement for the blanket bond. The provisions give the licensee 90 days after the disassociation date in which to file a replacement certification statement for the new qualifier. The 90-day timeframe is consistent with existing law (B&P Code Section 7068.2) that allows 90 days for the replacement of disassociated qualifying individuals.

Adopt § 858.8. Rescission of Blanket Performance and Payment Bond Approval

There is no existing CSLB regulation that sets forth procedures for rescission of a blanket bond approval. The proposed regulatory action would add Section 858.8 in order to accomplish this.

Section 858.8 specifies the conditions under which the Registrar is authorized to rescind approval of a blanket bond and outlines the rescission procedures and the process by which the licensee may appeal the Registrar's decision. It also provides for the automatic rescission of the Registrar's approval in the event that the blanket bond is cancelled.

This regulation is necessary to establish authorization and procedures for the rescission of a blanket bond approval. Regulatory action is needed because without the regulatory language specifying the blanket bond approval rescission authorization and procedures, the Registrar may not have the tools necessary to rescind a blanket bond approval as needed, and CSLB staff and affected contractors may not have a comparable understanding of the approval rescission procedures. There could be confusion about the Registrar's authority to rescind the approval of a blanket bond and the procedures for such rescissions.

Factual Basis/Rationale – § 858.8

In order to fulfill the duty to protect the public pursuant to B&P Code Section 7000.6, the Registrar must be authorized to rescind the approval of the blanket bond whenever the licensee or the blanket bond is not in compliance with the conditions that are prerequisite to approval or required for continued maintenance of the blanket bond. Procedures for mailing of the order are outlined in the proposed regulations for the sake of clarity, consistency, and evidence of mailing.

The proposed regulation establishes procedures for effectuating the rescission and, likewise, establishes the procedures by which the licensee may appeal. Since the rescission of the blanket bond approval would have a major impact on the licensee's business practices (in relation to down payments, payment schedules, and Mechanics' Lien Warnings), licensees should have a right to appeal and present information that

may not have been available to the Registrar for consideration. The minimum 30-day notice prior to the rescission is consistent with existing provisions of law that relates to pending license suspensions (e.g., B&P Code Sections 7085.6 relating to arbitration award suspensions and 7090.1 relating to civil penalty suspensions). If appealed, the rescission would be delayed until the appeal is reviewed and decided, which is also consistent with existing law provisions.

If the blanket bond is cancelled for any reason, the public protection is no longer in place. Therefore, the Registrar's blanket bond approval must be automatically rescinded effective on the date of the cancellation.

Once a rescission is final, the home improvement contract exemptions that previously applied to that licensee are no longer in place. Like all other licensees who are operating with only the standard \$12,500 contractor's bond, the licensee must comply with all provisions of B&P Code Section 7159.5, specifically including subsections (a)(3), (4), and (5) relating to down payments, payment schedules, Mechanics' Lien Warnings.

Adopt § 858.9. Posting of Blanket Performance and Payment Bond Information to License Records

There is no existing CSLB regulation that sets forth procedures for posting of blanket bond information to the license record. The proposed regulatory action would add Section 858.9 in order to accomplish this.

Section 858.9 specifies the information that is to be posted to the license record when a blanket bond has been approved and when there is a pending rescission of a blanket bond approval. It also specifies the time period during which this information is to be posted and the time period for which blanket bond information must remain on the license record subsequent to cancellation of the blanket bond or rescission of approval by the Registrar.

This regulation is necessary to establish procedures for posting of blanket bond information to the license record and to specify the content of the posted information. Regulatory action is needed because without the regulatory language specifying the blanket bond information posting procedures and content, CSLB staff may not have a complete understanding of what blanket bond information should be posted and when and for how long it should be posted. In addition, the public may not have complete information regarding a contractor they are seeking to hire. Without this regulation, there could be confusion by the public about whether or not a contractor is exempt from certain provisions of the home improvement contract requirements because of an approved blanket bond on file with CSLB.

Factual Basis/Rationale – § 858.9

As with the current posting of information on CSLB's website for a standard \$12,500 contractor's bond, with regard to the Registrar's approval or rescission of blanket bonds, the public cannot be fully served unless the relevant information is posted to the license record of the licensee, including the approval date, bond number, surety company

information, and blanket bond dollar amount. Approved blanket bonds should be posted to the public license record so that the public can determine whether or not contractors they are seeking to hire are exempt from certain provisions of the home improvement contract requirements, including down payments and payment schedules.

Notice of rescission of a blanket bond, as well as notice of a pending rescission, should be posted timely so that the information is readily available to the public to use in making consumer decisions. However, a pending rescission notice should not be posted to the public license record without ample opportunity for the licensee to receive notice of the rescission in advance of the public. A licensee whose blanket bond approval is being rescinded by the Registrar should not learn of the event from a consumer who refuses to sign a contract after reviewing the CSLB website. If a licensee appeals the rescission of a blanket bond, a notation of that appeal would be posted on CSLB's website as notice to the public that the effective date of the rescission is delayed pending the appeal decision.

Additionally, all information regarding the blanket bond should remain available on the public license record subsequent to rescission or cancellation for an ample period (specified as five years) in the event the information is required for civil proceedings.

Underlying Data

Excerpt from April 29, 2010 Board Meeting Minutes

June 3, 2008 Department of Justice Letter Regarding Bond Form Approval by the Attorney General

Excerpt from U.S. SEC's Exchange Act Rules – Compliance and Disclosure Interpretations (Last Updated August 11, 2010)

Business Impact

CSLB is not aware of any significant adverse economic impact that the proposed regulatory action will have directly affecting business, including the ability of California businesses to compete with businesses in other states, because the proposed regulatory action does not impose a new mandate that is being required of all contractors. It defines and outlines procedures for a supplement to an existing requirement that is available on a voluntary basis for those contractors who choose to apply for approval of a blanket bond for business purposes.

Specific Technologies or Equipment

This proposed regulatory action does not mandate the use of specific technologies or equipment.

Consideration of Alternatives

No alternative which was considered would be either more effective than or equally as effective as and less burdensome to affected private persons than the proposed regulation.