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The Joint Control Industry and State Regulation

By Lindell L. Marsh

Instances are numerous where a construction contractor, after having been paid in full, fails to disburse the funds to the proper subcontractor or materialman. As a result an owner may be faced with mechanics’ liens on his property, an unfinished house, and the prospect of paying twice for labor and material.¹

Many thousands of owners, builders, and lenders have tried to find “the key to building fund protection”² in a small service industry referred to by the State Legislature as joint control,³ by the public at large as builders’ control, and classified in the California telephone directories as Builders’ Construction Control Service.⁴

Due to incompetence and dishonesty within the joint control industry the supposed protection has turned out to be illusory in many cases. Owners, builders, related industries, and State officials have raised the question whether the State should undertake the specific regulation of the joint control industry. This comment will consider that question.

The Function of the Joint Control

Generally the joint control agent performs an escrow function.⁵ He is paid money or other property for disbursement in payment of the cost

² This phrase has often been used by joint control organizations as an advertising slogan.
³ See, e.g., CAL. FIN. CODE § 12100(d) (check sellers and cashers laws); CAL. FIN. CODE § 17006(e) (escrow law).
⁴ E.g., Oakland, Cal., Telephone Directory, May 1964, classified section, p. 161.
⁵ “They attempt to perform an escrow function disbursing funds from a lender to the contractors or subcontractors or others having claims against these funds.” Letter From Marshall Mayer, Deputy Attorney General for the State of California, to Milton Gordon, Chairman of the Board of Investment, California Department of Investment, Nov. 15, 1963. “The nature of the business was that of a pure fiduciary; the firm received funds from lending institutions and disbursed them to subcontractors upon presentation of charges on the various accounts handled.” Letter From Richard Salle, Deputy Distinct Attorney of Santa Clara County, to James Sprowls, Supervising Investigator, Investment Frauds Unit, California Department of Justice, Feb. 21, 1964.

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of labor, materials, services, permits, fees, or other items of expense incurred in the improvement of real property. Usually the joint control agent enters into an agreement with the owner or builder, and the contractor. Under the agreement the owner assigns the construction funds to the joint control agent, the lender is to pay the construction loan funds directly to the joint control agent on a pre-arranged schedule, and the joint control agent agrees to deposit funds received in a separate account established for the particular project and to disburse them on the order of the contractor, on receipt of proper lien releases, to the proper subcontractors and materialmen.

**Elements of Protection**

Proper protection of construction funds by a control begins before any disbursement is made or contract signed. It is made up of four essential elements: estimating, underwriting, disbursing, and inspecting.

An independent estimate of the cost of the proposed project is conducted before the underwriting of the proposal. It includes actual cost of construction, profit potential, and a fund for contingencies. "It may also include other applicable requirements such as construction loan fees and interest, land payments, off-site improvement costs, engineering and architectural fees, field supervision, selling expenses and overhead." This helps to insure that there are enough funds to complete the project.

Whether the control will underwrite a project depends upon

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6 See appendix I.
7 The author is aware of only one joint control agent who did not require an assignment of funds. He is no longer in business. Confidential Interview, in Oakland, Sept. 7, 1964.
whether there is enough money to cover the project cost as determined by the estimate, whether the contractor is sound, and whether the project is generally well based. If these factors are positive the control will sign the contract to disburse the funds.

Disbursal begins with a settled cost estimate of the project being developed into an overall budget containing a complete breakdown of each phase of the project. A separate bank account for the project is then established. All payments made from this account are first authorized by the contractor, who signs a voucher ordering the control to disburse the funds. Then, upon receipt of a proper lien release, the control draws a check to the order of the supplier of the materials or labor.

Inspection takes place periodically to insure that disbursement is made only for labor performed and materials supplied for the project involved.

Benefits to the Customer of a Joint Control Agent

Building fund protection means to the owner a completed house free from mechanics’ liens. The proper disbursement by a control of construction funds is important to the lender since it provides him with an improvement to which his first trust deed can attach.

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9 A major part of the control’s service is to screen out the marginal proposals. One organization takes only half the jobs offered to them to assure themselves that the project can be completed satisfactorily. Interview With Frank Wentz, Owner-Manager, Builders Disbursement Control, in Sacramento, Oct. 10, 1964.

10 “Mr. Bohan: [Counsel for the Senate Judiciary Committee]. If the building contractors themselves say that there are mysteries in building of the sub-sub and the material dealers and so forth and they can’t protect themselves with their trained business organizations, how could the average homeowner be expected to do so? Short of hiring a certified public accountant and putting somebody out to investigate who furnishes each bit of material, how could the homeowner, with full knowledge of the law, protect himself except by a bond? Mr. Zelmer: [Chairman, Legislative Committee, San Jose Chapter, Credit Managers Association, Northern and Central California] A bond is a good way, however, here in Southern California is what is called the Builders Control Incorporated, [Builders’ Control Service Co.] which has come into Northern and Central California within the last few years and I believe they’ve handled perhaps five hundred million dollars’ worth of work so they certainly have experience along that line. It is my understanding that in the course of their activities the homeowners and the lending institutions have not suffered any losses, that is one method of doing it.”

11 “We use a control because we cannot afford to employ the staff of experts necessary to make proper estimates and inspections.” Telephone Interview With Joseph Mack, Vice President and Loan Manager, Trans-Bay Federal Savings and Loan Association, in
courts have recently held that undisbursed loan proceeds are vulnerable to bonded stop notice claimants, even though the construction has not proceeded to a point where the lender is obligated to make further disbursements under his loan agreement with the borrower. In the future, the lender should be even more concerned that disbursements are properly made.

San Francisco, Sept. 14, 1964. A lender referred to the services a control was used for as follows: "First off, to determine that there is enough money in the loan to complete the job. Now controls or the majority of controls are experts of this. And where you have a good knowledge of the background of them you can lean considerably on them because they don't take the job on unless there is enough money . . . to finish the construction. . . . It is very important . . . to have our work supplemented by experts." Testimony by Carl L. Morton, Manager of Mid-Valley Savings and Loan Association, Transcript of Grand Jury Hearing, pp. 27-29, People v. Barrick, No. 40676, Super. Ct., Butte County, May 29, 1964.


"These decisions seem to make it clear that undisbursed loan proceedings are vulnerable to bonded stop notice claimants, even though the construction has not proceeded to a point which would obligate the lender to make further disbursements under his loan agreement to the borrower. Clearly the lender who disburses construction loan proceeds without making certain that suppliers of labor and materials have been paid to the date of disbursement of the proceeds may find himself obligated to disburse more money than is justified by the status of the construction project. The statements made by the court in these cases indicating that the lender can protect itself by securing adequate lien releases, or paying receipted bills is not very sophisticated. It isn't easy to determine what releases are needed, and receipted bills are easy to come by. In order to determine what bills will be incurred at any given progress stage, what releases are required as each payment is made, what amount should be allocated to each trade, and to material and labor involved in each trade, the lender would have to cost estimate the job on a unit cost basis, set up a control panel showing the different amounts to be allocated to each of the costs of construction, and inspect the job to determine whether the work which should normally be done at a given period has actually been done. I know of no lenders who go to these lengths to protect themselves in construction loan disbursment. That is why the joint control agency, which does these things, provides greater protection to a lender than does any of the various methods of construction loan fund disbursed by lender in the State of California." Letter From Verle N. Fry, Tustin Attorney, to the author, Oct. 15, 1964. "Due to the decision in the courts . . . [this control] has revised and refined their methods and procedures of operation so they may offer the lending institutions a safe and complete disbursing service." Response to Survey conducted by the author, Sept. 1964. Thirty-six questionnaires were sent out to all control agents listed in the classified section of the 1964 California telephone directories under Builders' Construction Control Service. Eight questionnaires were returned completed. Five were returned marked "moved no order" or similar. Four others were interviewed by the author. One is known to be out of business. Total accounted for is eighteen, leaving eighteen unknown. From location and remarks under the control's name, a general idea can be gained about its size in relation to others, etc. Items covered were mainly dealing with the size of the control, the amount of funds handled, the type of construction handled, and requests for their contracts and comments. An unpublished copy of the survey results is on file in the library of Hastings College of the Law, San Francisco. Responses to the survey are
If a seller of land takes back a purchase money trust deed and agrees to subordinate it to a construction loan encumbrance, provided the funds are used in certain ways, the proper disbursal of those funds by a control assures that the value of the seller’s encumbrance will be maintained.\textsuperscript{4}

To the provider of labor and material, proper disbursal means sure and prompt payment. The holder of a trust deed, in most cases, is given priority over mechanics’ lien holders if the trust deed is recorded prior to commencement of construction.\textsuperscript{5} If the lender forecloses on his trust deed he can satisfy his claim from the proceeds of the foreclosure sale. The mechanics’ lien claimant must rely on the proceeds left over to satisfy his claim. In 1879, when lenders would loan only 60 per cent of the value of the improvement, 40 per cent of the value might be available to meet the demands of mechanics’ lien claimants. Now, in many cases the lender will advance from 90 to 125 per cent of the value of the improvement, leaving little or nothing to satisfy the mechanics’ lien claimant after the lender has satisfied his claim.\textsuperscript{6} Proper disbursal can assure the provider of labor and material that he will not have to rely for payment on a mechanics’ lien junior to a trust deed for the whole value of the improvement.

Disbursement under a control also means faster payment. Under a conventional loan draw plan,\textsuperscript{17} the lender does not make his first disbursal of the construction loan fund until one-fifth of the work

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\textsuperscript{4} Normally the construction loan is equal to 80 per cent of the V.A. or F.H.A. appraisal. This usually exceeds the cost of construction because it includes allowance for the full value of the land, as if the land had been paid for, and it contemplates providing a fund from which the lenders’ fees and charges can be paid. Direct construction costs ordinarily do not exceed 65 to 70 per cent of the V.A. appraisal or the F.H.A. replacement value. To the extent that the amount of the construction loan exceeds the amount of money which goes into the improvement of real property, the interest of the seller of the land is subjected to a greater burden than the benefit received. The buyer may use some of the construction loan funds to pay other than construction costs, for example: (a) bills he owns on other construction projects; (b) personal obligations; (c) sales and advertising costs, or (d) general overhead expenses. If the subordination agreement requires that construction loan proceeds be handled by a joint control agency, which pays construction costs directly with its own check, the seller of the land can insist that nothing but direct building costs be paid from the construction loan, that any balance remaining be applied in reduction of the loan. Fry, \textit{Land Purchase Agreements}, 37 CAL. S.B.J. 381 (1962).


\textsuperscript{17} See Appendix II.
has been completed and does not make his last disbursement until the end of the statutory lien period, which is thirty to sixty days after the filing of a notice of completion. Under the control’s accelerated draw plan the first disbursement of the loan fund is made from the lender to the control on the recording of the loan papers, and the final disbursement is made on notice of completion. This means that under the control’s plan there are always funds available to meet the subcontractor’s bill immediately on completion of his work and authorization by the contractor. Most controls claim this is a period from one to three days.

The advantage to the subcontractor is also an advantage to the general contractor. Because of sure and prompt payment to the provider of labor and material, the general contractor is able to secure all trade discounts, lower bids, and better terms.

Secondary services are developing in the industry aimed at supplying the builder with all the specialized services that make a construction project successful. One control emphasizes its advisory capacity developed from years of experience. Other controls offer bookkeeping, data processing, contacts to arrange proper financing, insurance coverage, and reliable subcontractors.

History and Scope of Industry

Historically the control industry is reputed to have begun during the Depression when Pabco Paint Company instituted a control program for the users of their products as a means to keep sales up while protecting their investment. In 1935-1936 Builders’ Control Service Co. was founded in Los Angeles. In the past thirty years it has disbursed close to 750 million dollars. Its offspring, Builders’

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19 See Builders’ Control Service of Northern California, Inc., Brochure, p. 5, undated.
20 Ibid.
21 Ibid.
23 Interview With Executive of CAP-COM, a joint control agency, in Oakland, Sept. 11, 1964.
24 Letter From Richard Salle, Deputy District Attorney, Santa Clara County, to James Sprouls, Supervising Investigator, Investment Frauds Unit, California Department of Justice, Feb. 21, 1964.
25 Ibid.
26 Interview With F W Thrane, President of Builders’ Control Service of Northern California, Inc., in Oakland, Sept. 15, 1964.
Control Service of Northern California, Inc., was established and franchised in 1950 in Oakland. It has disbursed approximately 175 million dollars. These two giants account for close to half of the industry's total business.28

The industry is made up of twenty to twenty-eight control organizations employing approximately 100 to 120 people.29 The smallest control is a sole proprietorship which disburses over one million dollars annually. The largest control employs twenty-seven people and handles a high percentage of the 100 to 140 million dollars disbursed by the industry annually.30

Of the total number of projects handled by the industry in one year, sixty per cent are single family residences and forty per cent are tracts or commercial buildings. The great majority of controls will handle anything from swimming pools and remodeling jobs, to tracts and small commercial buildings.31

Most controls have noted a decline in their business over the past year ranging to twenty per cent and averaging ten per cent. This sharp decline in the market can be attributed to three factors. Since World War II the control industry has been supported by a tremendous boom in housing, which has only recently found itself overextended in some areas of California.32 Also cutting into the controls' market has been the lender who has established his own disbursing system, known as a voucher system.33 Finally, part of the market has been destroyed by the mismanagement and dishonesty of a few organizations.34

29 There is generally a disparity of compiled information on the joint control industry. In order to gain this essential information the author conducted the Survey described in note 13 supra. Industry figures in the text are from the Survey.
30 F. W Thrane was of the opinion that these figures were high, estimating the number of controls at less than 20, the employees at less than 100, and the total disbursements at 75,000,000 dollars. The correct figure probably lies close to the 100,000,000 dollar figure of the text. Interview With F W Thrane, President of Builders' Control Service of Northern California, Inc., in Oakland, Oct. 16, 1964.
33 E.g., Lytton Savings and Loan Association disburses all of its construction loans in this manner. Interview With Robert Wilson, Construction Fund Disbursement Officer, Lytton Savings and Loan Association, in Palo Alto, Oct. 8, 1964.
34 The largest market decline, twenty per cent, was noted in an area where there has recently been a major defalcation by a control agent. Survey.
Recent Suggestions Regarding the Industry

A factor which could bring about significant changes in the control industry is the outcome of recent investigations into the workings of the mechanics' lien laws. Three suggestions considered in these investigations are especially important to the control industry. They are: that all contractors be required to post a bond, that all construction money encumbrances be junior to all mechanics' liens unless a labor and material payment bond is posted, and that construction funds be required to be escrowed with third parties.

Passage of a bill requiring the contractor to obtain a license bond in an adequate amount or a labor and material bond would destroy the control industry's market, since construction funds would be sufficiently protected. However, the passage of such proposals is highly unlikely since it would meet with significant opposition from contractors, for a high percentage of contractors could not meet the requirements set up by the bond companies.

As noted previously, a construction money encumbrance recorded prior to commencement of construction has priority over most mechanics' liens. If the legislature provided that the lender would lose his priority unless a labor and material bond were posted, the lender would probably establish his own voucher system, or require that a control be used to disburse the funds. The approach used by the lender would depend on how responsible the control industry proved to be.

A statute requiring that all construction funds be escrowed would increase the market immeasurably, but this proposal has met with

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35 "The Committee to Study 1958 Conference Resolution No. 70 (study of the mechanics' lien laws) was made up of lawyers throughout the state and was divided into subcommittees by subject matter and by geographic area. The committee study was conducted over four years; the committee report is contained in State Bar of California, Final Report of Committee to Study 1958 Conference Resolution No. 70, Sept. 11, 1962. (unpublished report in University of California Law School Library, Berkeley). Because the committee believed that it did not have adequate resources, it concluded that the study should be referred to an interim committee of the state legislature or to the Law Revision Commission." Comment, California Mechanics Liens, 51 Calif. L. Rev. 331 (1963).


37 Residence contractors are "an extremely hazardous class. Frequently they have little responsibility. Often they are inexperienced in interpreting plans and specifications or working with architects. As a result they are substantially inaccurate in estimating the costs for doing the work in the manner specified. Generally, if a bond is required it is because the owner or the architect lacks confidence in the contractor's responsibility and skill—thus the surety also has an adverse selection of risk to contend with. For these various reasons, bonds covering residential construction must be specifically authorized by the Home Office." Hartford Accident and Indemnity Co., Contract Bond Course, pp. 26-27, Jan. 1963.
great criticism, directed mainly at the present state of the control industry.

Criticism of the Industry

Critics of the control industry make three major points: (1) that the properly managed control does not offer the protection claimed in comparison with the protection offered by a labor and material bond, which is less expensive; (2) that in many cases the controls are mismanaged; and (3) that there have been major defalcations in the industry due to dishonest management of several controls.

Mr. Glen Behymer, prominent Los Angeles attorney and authority on the mechanics' lien laws, contends that the control misleads the public into believing that it guarantees completion of the construction project. Such a guarantee would place the control in the position of a surety and would require them to be licensed under the Insurance Commission. He argues that without such a guarantee by a control, a labor and material bond and faithful performance bond provide more effective protection for construction funds.\(^8\) The bonds provide such a guarantee and together cost only one per cent of the contract price as compared with the one and one-half per cent usually charged by a control.\(^9\)

The impression that the control does guarantee completion does exist in the minds of many of their customers, but it may be unwarranted.\(^40\) Many of the controls which this writer contacted emphasized

\(^{8}\) "It has been suggested that this protection can be obtained through what we call joint control or escrow arrangements. My own personal experience, over the years since the medium of fancied protection has become available through business custom is that even with well managed joint control operation, protection afforded by the joint control is far less effective, far less satisfactory, far more delaying than the protection afforded by a statutory labor and material bond and a faithful performance bond. The premium charged by a joint control operations is, in most instances, approximately the same as the premium that would be charged by a surety company for REAL protection. The joint control operators do not desire to make a contract which would guarantee the completion of the building free of liens, for that would subject them to the jurisdiction of the Insurance Commission." Letter from Glen Behymer, Los Angeles Attorney, to the Senate Judiciary Committee for the Interim 1957-1959, quoted in Senate Judiciary Committee for the Interim, 1957-1959, Third Progress Report to the Legislature 94.


\(^{40}\) "About [name omitted] . a business which promises to protect and guard your building funds and see that they are properly used. [Because of] . . a pamphlet [which the sender enclosed] . . and verbal assurance from [name omitted] that they would guarantee me a lien free house, I placed my funds in their hands and signed
that they did not guarantee completion, but did guarantee that all funds assigned to them for disbursal would be disbursed to the proper parties and lien releases would be obtained. These controls argued that, while their services cost more than a bond, they provided services that a surety could not. Several went further and pointed out that while they did not guarantee completion they did, as a matter of policy, complete every job even if they had to invest their own money.\footnote{41} Thus they are able to point out that their control in practice does see the job through to completion.

The control industry offers a preventative service, while a bond is remedial.\footnote{42} The control's independent estimate assures that sufficient funds are available to complete the project. The control disburses the funds properly to prevent liens. Generally, in performing its preventative function the control makes sure that the project never reaches a point where anyone has to rely on a bond. The control offers a completely different service than a bonding company, a service which, if performed properly, saves the owner money, time, and grief.

**The Charge of Incompetence**

Controls are most frequently criticized for their incompetence, both from within and from without the industry.\footnote{43} Controls point out that there are other control managers with no more than a bookkeeping background,\footnote{44} and that their own greatest problem is finding personnel to man their offices with the required knowledge of building materials, estimating, financing, and real estate.\footnote{45}
Incompetence on the part of controls shows itself in a variety of ways. Unsound projects that run short of funds are underwritten. One phase of the project is overpaid because a proper budget was never drawn up. A supply bill incurred by the contractor on a previous job is paid because the control failed to make proper inspections to see that the supplies paid for were actually delivered. Proper lien releases are not obtained. The bills of one project are paid with the funds of another. The control's own overhead is paid out of the escrowed funds.

**Criminal Conduct in the Industry**

At the point where the control begins to use the escrowed funds for its own purposes, incompetence shades into criminal misuse of funds. Misappropriation is especially made possible by the time lag between the payment of money to the control and the disbursal by the control to the subcontractor or materialman.

Problems created by a similar time lag have also occurred in the check sellers industry. It was pointed out in an investigation conducted by the legislature that the check seller in many cases would retain the money obtained from selling the money order for as long as possible, using it in his own business and then making it up out of his profits in time to make his remittance to the check service. In fact it was noted that one of the key selling points by a check service to the prospective agent (grocery or liquor store) was that the agent could extend the time between the sale of the money order and the remittance to the service. The danger of such practices is that when such "an agent gets into financial difficulties it's a little temptation for him to be slow in his remittances," and when he finally goes out of business it is usually after he has used all of the money order receipts to try to save the business.

The time lag problem, aggravated by incompetence or outright dishonesty, can reach immense proportions in the control industry, since the average control handles several million dollars each year. One case this year in San José resulted in claims totaling close to 250

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46 Suppliers usually keep a running account of the contractor's orders and do not make a distinction between one job and the next; therefore, it is common for the supplier to send a bill for material supplied to a previous job. Interview With Frank Wentz, Owner-Manager, Builders Disbursement Control, in Sacramento, Oct. 13, 1964.


48 Id. at 39.

49 Survey.
thousand dollars and the conviction of the proprietor of the control on charges of grand theft.\textsuperscript{59}

The control agent in \textit{People v. Sage}\textsuperscript{51} began by commingling the funds paid in. Then he proceeded to misappropriate them for a down payment on his own home and for payments to builders on other projects handled by the control whose money had run out. As the misappropriation of funds mounted, the control made its disbursements slower, thus extending the time lag. At one point, when the control was 60,000 to 70,000 dollars behind in his disbursements, he attempted to recoup his losses by investing more of the escrowed funds in the building of apartment buildings. The investment failed. Finally the control could no longer put off the subcontractors. Liens were filed. The owners began to ask questions and the whole case of theft came to light.\textsuperscript{52}

It was not the control's intent from the beginning to deprive the victims of their money permanently. But through incompetence and greed he became hopelessly involved, crossing the line from dishonesty to crime.\textsuperscript{58}

A control can be intentionally used as a tool to defraud the lender and land owner. In \textit{People v. Barrick}\textsuperscript{54} a control was working together with a contractor who was able to obtain land for dubious buyers for a very low down payment by falsifying their financial statements. Then, by giving its own false financial statement, overestimating the


\textsuperscript{51} \textit{Ibid.}

\textsuperscript{52} Interview With Richard Salle, Deputy District Attorney, Santa Clara County, in Sunnyvale, Oct. 8, 1964. As to the distribution of losses Mr. Salle writes: "Some of the land purchased by Sage-White [White was a contractor-builder who was later working with Sage trying to recoup his losses] was not paid for and monies owed on it were subordinated to the construction money. It is indeed possible that some of the former owners of the land may not recover all of which is owed them. Many, but not all of the subcontractors on the Sage-White jobs have filed liens. Those who have not will certainly not recover anything; those who have valid liens may or may not recover some part of that which is owed them. Although I have little confidence in their chances, it would be unsafe to speculate as to eventual results. Presently, a bankruptcy proceeding is contemplated and an aggressive trustee may accumulate some funds by sales of the properties of Sage and White and by other means. The unsuccessful attempts over a period of five months to unload these properties to willing buyers, however, would indicate that little if anything will be recovered." Letter From Richard Salle, Deputy District Attorney, Santa Clara County, to James Sprowls, Supervising Investigator, Investment Frauds Unit, California Department of Justice, Feb. 21, 1964.

\textsuperscript{53} Robert Sage advanced money to contractors who had run out of funds on other projects handled by the control, which is not the act of a criminal who means to use the funds for his own benefit. Telephone Interview With Robert Sage, Former Proprietor, Empire Builders' Control, in San Jose, Oct. 12, 1964.

\textsuperscript{54} No. 40676, Super. Ct., Butte County, May 29, 1964.
cost of construction, and agreeing that the funds would be disbursed by a control, the contractor was able to obtain a construction loan sufficient to cover not only the total cost of construction but also the original down payment on the land.\textsuperscript{55} The reliance placed by the lender on disbursement is evident from the lender's testimony before the grand jury. He stated that had there been no control to disburse the funds he would not have made the loan.\textsuperscript{56}

The control agreed with the lender that it would establish a separate trust account, hold back the contractor's profit until the job was complete, make proper inspections, and generally disburse the funds properly. However, immediately upon receipt of the funds the control disbursed them to the contractor and to creditors of the contractor under various pretexts, breaching the control agreement and the fiduciary obligations established thereunder.\textsuperscript{57}

When the deception finally came to light, houses were left in various stages of substandard construction and subcontractors were not paid, although the lender had transferred enough money to the control to cover construction to that point. The sellers of the land had subordinated their interest to the lender, who held the first trust deed, and would probably not be able to recover much after the lender had satisfied his claim. The suppliers of labor and material would recover behind the second trust deed, but there is small chance that they will see any of their deserved pay.

These are not isolated instances. They are outstanding because they involved over 300,000 dollars and were decided within the last year. Other instances can be obtained from complaints received by the Consumer Counsel to the Governor,\textsuperscript{58} reports from the Justice Department of the State,\textsuperscript{59} and several investigations presently being conducted concerning major criminal defalcations.\textsuperscript{60} A State legislative committee showed great concern when losses due to defalcations in the collection industry were estimated at 100,000 to 500,000 dollars over a period of years.\textsuperscript{61} This indicates the seriousness of the problem in the control in-

\textsuperscript{56} \textit{Id.} at 27.
\textsuperscript{57} \textit{Id.} at 27-29, 85, 161, 165-66, 170-71.
\textsuperscript{58} Interview With Helen Nelson, Consumer Counsel to the Governor of California, and Vincent V Mackenzie, Attorney-Administrative Advisor to the Consumer Counsel to the Governor, in Sacramento, Oct. 9, 1964.
\textsuperscript{59} Letter From Marshall Mayer, Deputy Attorney General, to Milton Gordon, Chairman, Board of Investment, California Department of Investment, Nov. 15, 1963.
\textsuperscript{60} Confidential Interview, in San Francisco, Oct. 1964.
\textsuperscript{61} "Business and professional firms have lost large sums due them because of em-
Industry, where 300,000 dollars was lost in just two defalcations which occurred in one year. This history of criminal defalcation and dishonesty adds urgency to the argument of those advocating State regulation of the control industry.

Arguments For and Against State Regulation

Opponents of State regulation advance several arguments. They contend that the individual can protect himself sufficiently by inquiring into the regulation of the control that he deals with, that licensing misleads the public into a false sense of security, and that licensing of the control industry would be ineffective and inefficient.

The first argument fails to take into account that the majority of the users of a control are inexperienced homeowners, many in the process of building their first house. In People v. Sage the control "received considerable business by referral from the lending institutions." In another instance, an allegedly dishonest control was made up of the officers of a lender. Can an inexperienced homeowner be expected to do more than rely on the representations of his lender? If a lender is not aware of the incompetency or dishonesty of a control, how can such a homeowner be? The individual, in most cases, cannot adequately protect himself from incompetent or dishonest controls.

A license may carry an implication to the public of State approval of the character and competence of the licensee as well as authorization to engage in the licensed activity, thus misleading the public into a false sense of security. In order to counteract this impression, statutes regulating industries similar to the control industry usually contain a provision prohibiting false statements to the effect that such

References:
62 Interview With F W Thrane, President of Northern California Builders' Control Service, Inc. H. A. Dutcher, President of Builders' Control Service Co. and Verle Fry, Tustin Attorney, in Oakland, Sept. 16, 1964.
64 Letter From Richard Salle, Deputy District Attorney, Santa Clara County, to James Sprowls, Supervising Investigator, Investment Frauds Unit, California Department of Justice, Feb. 21, 1964.
65 Confidential Interview, in San Francisco, Oct. 1964.
66 Clarkson, Practice Before California Licensing Agencies, 44 CALIF. L. REV. 197, 199 (1956).
licensees are supervised by the State. It is doubtful that these provisions are effective. Probably licensing does, to some extent mislead the public, but any adverse effect of licensing must be weighed against its benefits.

Some proponents of State regulation of the control industry tend to be satisfied to rest their argument for regulation on proof of a problem without ever considering if regulation will solve the problem. They present the Sage case and conclude that the State ought to step in and regulate the situation. Opponents, on the other hand, tend to discount such instances as Sage as rare, caused by criminals or incompetent businessmen who will soon weed themselves out of business. At the same time they attack State regulation as being inefficient and ineffective.

These opponents do not give sufficient weight to the fact that when a criminal or incompetent control weeds himself out of the business he usually takes along the funds of a number of individual builders. On the other hand, the proponents fail to realize that while there has been a widespread trend toward State regulation of businesses similar to the control industry, the agencies resulting from the trend have come under heavy criticism for being grossly ineffective. One attorney for a regulatory agency has said that the agency could exercise little control over the licensee who set out from the beginning to steal the funds of his principal. In the check seller industry, a check service was able to use funds for its own purposes, finally embezzling many thousands of dollars, while under the supposed regulation of the State. It is alleged that in San Francisco there has not been one hearing to revoke a check seller’s license in the last ten years. In recent years the legislature has established committees and conducted hearings in response to charges of ineffectiveness in the regulation of collection agents and check sellers and cashers.

The Justice Department’s Proposal

The simplest and most practical solution advanced by the proponents of regulation has been drawn up by the State Department of

67 E.g., CAL. FIN. CODE §§ 12311 (check sellers and cashers law), 17210.2 (escrow law).
68 Confidential Interview, in San Francisco, Oct. 1964.
69 Ibid. An investigation is presently being conducted.
71 E.g., Assembly Committee on Finance and Insurance for the Interm 1955-1957, and Senate Committee on Collection Agencies, Private Detectives, and Debt Liquidators, for the Interm 1957-1959.
Justice and is to be submitted to the legislature at the next session. The present time transactions involving joint control agents are specifically exempted from the Escrow Law and the Check Sellers and Cashers Law. The Justice Department's proposal is to omit the exemption under the Escrow Law, which would make the control agent subject to the provisions of that division. Another provision would allow the Commissioner of Corporations, who is in charge of the regulatory agency administering the Escrow Law and the Check Sellers and Cashers Law, to adopt such rules and regulations as are appropriate to the activities of a joint control agent. The opponents argue

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that such regulation would be ineffective and, in application to such a small industry, inefficient.

Any effective regulation must rest on license requirements and the regulation of the licensee. License requirements would include four major provisions: incorporation, capitalization, bonding, and qualification of the individual participants.

Incorporation

The requirement that a licensee be a corporation has a threefold purpose. First, since a corporation for profit is required to have three directors, "the Commissioner of Corporation can be expected to disallow the use of directors not especially qualified for the purpose upon the initial application for a license." This discretionary power will continue throughout the entire period of operation by reason of the Commissioner's authority to order the discontinuance of unsafe practices. Second, "the corporate device lends itself to increased control under existing bonding requirements," since a fidelity bond cannot be obtained by the principal unless a corporation has been formed. Third, the corporate framework provides a complete and separate package of assets and liabilities which can be audited by the State more efficiently and effectively than a sole proprietorship, where personal assets and liabilities are often intermingled with those of the business.

Capitalization

The escrow agent is required to maintain a net worth of 10,000 dollars. Similar requirements are established for check sellers and cashers, model bill, the proposed text of Assembly Bill 2319 as finally amended in Assembly May 27, 1955, No. 608, providing for the regulation of the prorater under the Check Sellers and Cashers Law in, Assembly Committee on Finance and Insurance for the Interim 1955-1957, Preliminary Report on Fiscal Agencies 62 (Mar. 1956).

76 CAL. FIN. CODE § 17200.
77 CAL. CORP. CODE § 301(d).
78 Comment, 27 So. Cal. L. Rev. 70, 85 (1953); See CAL. FIN. CODE § 17209.3(b).
79 CAL. FIN. CODE § 17602. See also Comment, 27 So. Cal. L. Rev. 70, 85 (1953).
83 CAL. FIN. CODE § 17210.
Opponents argue that this requirement is illusory. This argument has been echoed in an investigation held by the State legislature on collection agents. Testimony was given pointing out instances “where the applicant borrowed money, or had inflated the value of a used automobile, furniture or other possessions to attain the required figure.” However, provisions in the Escrow Law providing for incorporation and auditing were not included in the Collection Agency Act at the time of the hearings. These provisions provide a stricter control of the capitalization requirement but do not completely eliminate the problem. Even if the capitalization requirement could be strictly enforced, it is questionable whether it provides any protection to the public. F. W. Thrane, president of Builders’ Control Service of Northern California, Inc., points out that a capitalization of $75,000 dollars was necessary to establish his control. In hearings conducted on the activities of proraters, testimony was given that a successful prorater could not establish himself on a total capitalization of $10,000 dollars. Therefore, even if the capitalization requirement could be enforced, which is doubtful, it is insufficient to guarantee that the license applicant will have the funds which make success possible.

84 CAL. FIN. CODE § 12205.
85 CAL. BUS. & PROF. CODE § 6880.
86 Interview With F W Thrane, President of Builders’ Control Service of Northern California, Inc., H. A. Dutcher, President of Builders’ Control Service Co., and Verle Fry, Tustin Attorney, in Oakland, Sept. 16, 1964.
87 Senate Committee on Collection Agencies, Private Detectives, and Debt Liquidators for the Interim 1957-1959.
88 The result of this deception by the applicant was that “a large number of State-licensed collection agencies in California are insolvent, yet continue operating. These insolvencies result not only from misappropriation of trust funds but from falsification of assets which goes undetected through lack of auditing and supervision. SENATE COMMITTEE ON COLLECTION AGENCIES, PRIVATE DETECTIVES, AND DEBT LIQUIDATORS FOR THE INTERIM 1957-1959, FINDINGS, REPORT ON SENATE RESOLUTION No. 155, at 7 (1957).
90 “A ‘prorater’ or ‘debt adjuster’ is a person engaged in the business, for compensation, or receiving money from a debtor for the purpose of entering into an arrangement with the creditors of the debtor to distribute the money between the creditors and pay off the debts of the debtor.” Testimony by Herbert A. Smith, Assistant Commissioner of Corporations, ASSEMBLY COMMITTEE ON FINANCE AND INSURANCE FOR THE INTERIM 1955-1957, PRELIMINARY REPORT OF THE SUBCOMMITTEE ON FISCAL AGENCIES 10 (Mar. 1956).
91 “[I]t would take anywhere from fifteen to twenty-five thousand dollars or more of hard cash to get into the prorating business.” Testimony by Harry A. Edwards, Chief of the Division of Collection Agencies, ASSEMBLY COMMITTEE ON FINANCE AND INSURANCE FOR THE INTERIM 1955-1957, PRELIMINARY REPORT OF THE SUBCOMMITTEE ON FISCAL AGENCIES 37 (Mar. 1956).
Bonding

Bonding is the most widely discussed regulation. Most statutory regulations require a license bond in the amount of 5,000 to 10,000 dollars running to the State for the benefit of those injured by the failure of the licensee to abide by the code provisions. Major criticisms of license bonds such as the bond required in the Escrow Law are that the amount is inadequate, that practically, bonds in any greater amount cannot be obtained, and that it is difficult for the individual to recover on such a bond.

Statements are frequently heard that "statutory bonds are almost all inadequate," or that "in a great many cases the application bond is entirely inadequate to protect the amount of escrow funds involved at any given time by an escrow agent." A 5,000 dollar license bond is grossly inadequate to meet the possible defalcation of an average size control, which may handle several million dollars in one year. Single defalcations have amounted to several hundred thousand dollars as in the Sage case.

It is conceded that license bonds in amounts greater than 10,000 dollars cannot be required. If a larger bond was required a large portion of the control industry would be disqualified, because of the underwriting policies of the surety industry, and for those left, larger bonds would be extremely expensive.

License bonds have also been difficult to collect on. Usually the surety company waits until suit is brought to pay the claimant. A

92 CAL. FIN. CODE §§ 12206 ($10,000 bond required for check sellers and cashers), 17202 ($5,000 bond required for escrow agent), CAL. BUS. & PROF. CODE § 6895 ($5,000 bond required for collection agency with less than 6 employees).


94 Comment, 27 So. CAL. L. REV. 70, 86 (1953).


96 Interview With Wilson Taylor, Attorney for Hartford Accident and Indemnity Company, in San Francisco, Oct. 6, 1964; Telephone Interview With J. Wells, Manager of the Bond Underwriting Department, Fireman's Fund American Insurance Companies, in Oakland, Oct. 12, 1984. On the difficulty of a check seller to get a license bond: "Licensees have difficulty obtaining surety bonds [$10,000] and consequently, when a loss occurs, typically the licensee will absorb the loss rather than file a claim on the bond and run the risk of having the bond cancelled and his license revoked." Testimony by John G. Sobieski, Corporation Commissioner, ASSEMBLY COMMITTEE ON FINANCE AND INSURANCE FOR THE INTERIM 1961-1963, FINAL REPORT 42 (Jan. 1963).

97 "A procedure against a bonding company is a long and arduous task," Mr. Mulvany [Vice President of United States National Bank which handles money orders of Check Service Corporation] told the committee. He cited a three-year law suit his bank has had pending against a bonding company and contrasted that span of time.
possible reason for this was explained in hearings on the collection industry. Under present statutes there is no machinery for determining the liability of the bonding company short of suit. Mr. Wilson Taylor, attorney for the Hartford Accident and Indemnity Company, pointed out that some bond provisions do establish such a procedure. While it might be possible to make the remedy more simple, it would remain grossly inadequate as protection for the public from incompetence and defalcation by controls.

Escrow agents are required also to obtain a fidelity bond in an amount established by the Commissioner. A fidelity bond which guarantees the personal honesty of an officer, is inexpensive. The cost is approximately 400 dollars for a 100,000 dollar bond. They are obtainable by almost all control organizations. Presently the great majority of controls have such fidelity bonds ranging in coverage to 800,000 dollars. Coverage is limited, though, to funds lost due to dishonest misappropriation, and there is no coverage for funds lost due to incompetence.

Qualifying

Qualifying the individual participant in the control industry would be done in a very general manner under the provisions of the Escrow against the exigencies of the average person who buys a money order for the purpose of paying a premium on an insurance policy or an installment on a car. The officers of Check Service Corporation stated that their company now pays a $5,000 premium for bonding 'for nothing.'

The present bond provision for the escrow agent requires that a claimant bring suit to recover on the bond. "In addition to any other remedy, any person who sustains an injury covered by an escrow agent's bond may bring an action in his own name upon the bond for the recovery of any damages sustained by him. No action may be brought on the bond by any person after expiration of two years from the time when the act or default complained of occurs." CAL. FIN. CODE § 17205. The bond provision for a commission merchant provides for a cause of action on the bond for an injured party; but also, provides that in case of failure of a commission merchant to pay producers, the director (State) shall ascertain all creditors of the merchant and can then make a demand on the bond on behalf of those creditors, or settle or compromise the claim, or discharge the bonding company completely. CAL. AGRIC. CODE § 1265. The advantage of this provision is twofold. It does allow the bonding company to settle a claim before going to suit. Second, it notifies the commissioner of a claim which he is obligated to investigate, giving him a chance to stop cases such as Sage before they get started.

CAL. FIN. CODE § 17203.1 provides that an escrow agent with access to money, etc., will post an indemnity bond in an amount to be determined by the commissioner.

Telephone Interview With J. Wells, Manager of the Bond Underwriting Department, Fireman's Fund American Insurance Companies, in Oakland, Oct. 12, 1964. The premium is dependent on the amount of the bond and the number of employees.
Law. Presently an applicant is required to be of good moral character, to present evidence that he is capable of running an escrow agency, and to provide assurances that a person with five years of responsible escrow experience will be on duty during business hours. These provisions might help to keep the criminal and perhaps the flagrant incompetent out of the control industry. The requirement of experience, or a criterion by which the Commissioner could judge the applicant to be competent, has to take into consideration that, unlike the escrow agencies, the control industry is too small and too new to boast many really experienced employees. Most established controls consider that the successful control agent must have a working knowledge of bookkeeping, construction, building materials, estimating, financing, and real estate. The control applicant might be required to demonstrate that there would be employees or officers of the control with previous experience in the several specialized areas. It has been suggested that written examinations should be used to test the competence of the prospective agent. In view of the size of the industry and the probably small number of new applicants each year, the cost of administering examinations would be high in relation to the benefit.

Regulation of the licensee would be handled under the provision of the Justice Department's proposal allowing the Corporation Commissioner to adopt rules and regulations appropriate to the activities of the joint control agent.

The control should be required to establish separate bank accounts for customers' funds, which are not to be commingled with his own. Unlike escrow agents and check sellers and cashers, the control agent should be required to establish a separate fund for each project. This provision, more than any other, would help keep the control honest. It would help to prevent from the beginning the use of funds during the time lag either for the control's benefit, or for the benefit of other projects which have run short of funds. Provision would also be made that the control is to apply all monies received as promptly

103 Grounds for refusal to issue license. CAL. FIN. CODE § 17209.3.
104 Most control agents have less than five years experience. Survey. 
105 Ibid.
106 Compare CAL. FIN. CODE § 17200.8, which requires that an applicant for an escrow license have a person with five years responsible escrow experience in the organization and on duty during business hours.
107 "Such legislation should also provide for the examination of applicants, and the licensing of only those who prove capable of discharging the responsibility incident to the business." CALIFORNIA STATE BAR ASSOCIATION, FINAL REPORT OF THE COMMITTEE TO STUDY 1958 CONFERENCE RESOLUTION NO. 70, REPORT OF SUBCOMMITTEE NO. 4, at G-2, Sept. 11, 1962.
108 CAL. FIN. CODE § 17409.
109 CAL. FIN. CODE §§ 12300.3-00.6.
as is reasonably possible, by check, directly to the person or persons providing the service, labor, or materials and not to other third persons except as expressly provided in the control agreement. This would prompt proper disbursement of funds and supply an accounting trail to facilitate State audits.

While all businesses maintain records, the control should be required to keep books that would clearly demonstrate whether or not the control was conforming to the code. For instance records should be kept for a specified period of time showing that the funds were deposited promptly into the particular project account and were promptly disbursed to the proper persons.

**Enforcement**

Enforcement of these regulations would be by means of annual financial statements filed with the Corporation Commission and by means of audits conducted by the Commission auditors.

Auditing is considered to be the prime tool for enforcing the code provisions dealing with trust account and escrow functions. The effectiveness of audit procedures has been demonstrated in the collection industry. In 1959, following an investigation of the collection agencies in which widespread commingling of funds was found, a system of audits to be performed by the Collection Agency Licensing Board and paid for out of the annual license fee by each collection agency was established. Since that time there have been extensive audits, with accusations of code violations brought against one third of all those agencies audited. As a result of these accusations there were fifty hearings to revoke the agent's license, ten receiverships, and ten convictions of theft. Then in 1963, legislation was passed to fade out the State audit by June 1, 1965, and replace it with the audit of a CPA and an annual financial statement. The argument used for the

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113 "As one of the means of putting 'teeth' in the commissioner's power to control agent irregularities, the law should categorically state his right to conduct audits of agents." Assembly Committee on Finance and Insurance for the Interim 1961-1963, Conclusion, Final Report 45 (Jan. 1963).
114 Senate Committee on Collection Agencies, Private Detectives, and Debt Liquidators for the Interim 1957-1959, Report on Senate Resolution No. 155 (1957).
116 Interview, supra note 115.
actions was that the cost of the audit was prohibitive. Others contend that the action was the result of industry pressure. This year the license fees ranged to 450 dollars, which include the provision for the State audit. The fee in 1965, which will not include the State audit, will range to 200 dollars. In relation to the effectiveness of the auditing program the extra fee seems a small price to pay. In response to the elimination of the audit, George Soloff, Deputy Chief of the Collection Agency Licensing Bureau, said, "This agency has never taken the position that an independent audit or a financial statement can begin to do the job that a State audit does."

The high cost of an audit may be explained by the lack of knowledge on the part of many accountants of the proper method of conducting an audit of a business handling escrowed funds. In the collection industry the high cost of a State audit can be accounted for by lack of records kept by licensees, the number of mismanaged agencies which required a more thorough investigation, and the preparation of indictments against the criminally managed agency. F. W. Thrane pointed out that with the establishment of an outside audit for their control organization they were paying a great deal of money for time which the auditors spent in learning how to audit escrowed funds. Under the Corporation Commission, which conducts numerous audits of escrow and trust funds, the cost of auditing can be expected to be at a minimum.

A question was raised recently in the check sellers' and cashers' industry as to whether an audit was able to stop the dishonest agent from carrying out a calculated program of theft. A check seller was able to embezzle large amounts of funds while he was supposedly regulated by the State. In response to this case Mr. Richard Albright, Supervising Auditor for the Corporation Commission, stated that the value of an audit is in stopping the quasi-honest agent from ever getting into a position where he would turn to wholesale embezzle-

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119 Confidential Interview, in San Francisco, Nov. 10, 1964.
122 Barker, Functions of the Accountant in Auditing Businesses Handling Escrow Agreements, 95 J. Accountancy 324 (1953).
There is a possibility that, had Robert Sage been under State regulation, his incompetence and first misuse of funds would have been discouraged or detected long before he was irretrievably involved. The State audit is an essential element of any regulatory program.

Remedies available to the Corporation Commissioner include revocation or suspension of the license,\textsuperscript{128} taking possession of the agency,\textsuperscript{127} applying to the superior court to have the agency placed in receivership,\textsuperscript{128} and prosecuting the agent for violation of the code provisions.\textsuperscript{129}

**Conclusion**

The need for some type of effective regulation in the joint control industry is convincing and imperative. Including the joint control agent in the Escrow Law would seem to be an effective and efficient solution. While present license requirements may provide something less than perfect regulation, they will keep the known criminal out of the industry, provide some criterion for competence and skill, provide some remedy in the form of a license and fidelity bond for those injured as a result of misconduct on the part of the control, and provide that a control maintain a minimum of capital.

Regulation of the licensee can further this protection by assuring that the control will follow proper principles of disbursement. The main tool in this effort is the audit, which allows the Commissioner to investigate so that he may later take action.

The regulation of the control industry under the Escrow Law would be efficient since it will merely increase the number of agents already under the Corporation Commissioner, allowing the adoption of an even more efficient organization. The cost will be far less than the thousands of dollars lost in recent months and years due to incompetent and dishonest controls.

Such a proposal for the regulation of the joint control industry can expect support from the Attorney General, the Consumer Counsel to the Governor, the California State Bar Association,\textsuperscript{130} the savings and


\textsuperscript{126} CAL. FIN. CODE §§ 17602-03, 17606, 17608.

\textsuperscript{127} CAL. FIN. CODE § 17621.

\textsuperscript{128} CAL. FIN. CODE §§ 17635-36.

\textsuperscript{129} CAL. FIN. CODE § 17414.

\textsuperscript{130} "The licensing and probably the bonding of builders' control organizations in California would be in harmony with a prevailing trend today. Escrow companies, real estate brokers, collection agencies, commission merchants, and in fact, about all businesses
loan industry, and a segment of the joint control industry Opposition to such regulation is centered within several of the larger joint control organizations.

Such regulation, while it cannot stop all defalcations within the industry, will certainly pay for itself in view of the large amounts of money, time, and mental anguish expended as a result of but a short history of losses due to incompetent and dishonest joint control agents. Such a result will certainly mean greater markets for the joint control industry based upon its function as "the key to building fund protection."

APPENDIX I

Below are some provisions of a typical joint control contract. The parties are Owner, Contractor, and Service (joint control).

I. Immediately upon the execution of these presents there shall be deposited with Service two copies of the plans, specifications, building contract and one copy of the cost breakdown between Owner and Contractor, and it is agreed there shall be paid to Service a fee equal to \(\text{a}\) of the contract price of \(\text{b}\), plus any and all bank charges which may be legitimately assessed by a banking institution as nominated by Service to maintain the account of Owner. It shall be understood that this agreement shall not be construed as completed until all valid bills for said work of improvement have been paid.

2. In exchange for the fees charged by Service under and by virtue of the terms of this agreement, and of the execution of these presents by Owner and Contractor, Service agrees that it will, immediately upon receipt of the building funds as hereinbefore provided, place said funds in a trust account in a banking institution to be selected by Service and will deposit therein any and all moneys received from Lender, Owner and/or Contractor upon the execution of these presents or during the construction of the building or buildings as hereinabove provided, less the fees and charges of Service as herein set forth. Thereafter, Service will apply the moneys so received by it that collect, disburse or handle the funds of its customers are required by law to be licensed and bonded."

181 "The savings and loan industry would certainly support reasonable legislation to require proper regulation of builders' control companies, to include some bonding requirements for individuals operating the companies." Letter From W Dean Cannon, Senior Vice-President of the California Savings and Loan League, to the author, Oct. 20, 1964.

182 Survey.

183 Interview With F. W. Thrane, President of Builders' Control Service of Northern California, Inc., H. A. Dutcher, President of Builders' Control Service Co., and Verle Fry, Tustin Attorney, in Oakland, Sept. 16, 1964.

184 "If there was some way, and there may be since full consideration is being given to this problem currently, to shift the responsibility from the lender to a supervised, regulated, and examined builders' control company, then, and only then, this type of service would be in greater demand by our lenders." Letter From W Dean Cannon, Senior Vice-President of the California Savings and Loan League, to the author, Oct. 20, 1964.
Service guarantees the application of all money received by it hereunder, solely and exclusively to the purposes set out in this agreement. It does not guarantee that the construction work mentioned shall proceed, nor be completed, nor that the cost thereof shall be paid.

4. Any payment made by Service hereunder shall be deemed a payment to Contractor and shall reduce the amount owing to Owner by Owner by the amount thereof. Owner and contractor shall each jointly and severally, hold Service free and harmless from any liability in connection with any payments hereinafter made by Service. There shall be no segregation between money derived from Lender, from Owner, from Contractor, or from any other source.

5. Upon disbursement of any portion of said funds, it shall be the obligation of Service to obtain such mechanic's lien releases as are necessary to assure that said property will not be subjected to mechanic's liens for labor or materials which it is the legal obligation of the recipient of such disbursement to pay.

6. Service shall, if it seems advisable, inspect the said job at reasonable intervals to determine the amount of such inspection, and shall be deemed the equivalent of nor a substitute for architectural or engineering supervision nor Lender's inspection. Service shall not be liable for any disbursements made by it for costs of improvements located wholly or partially off the real property described above, nor shall it be liable for the event that the job of construction is in accordance with plans and specifications, nor shall Service at any time be called upon to pass upon the quality of the work of improvement, nor shall Service be liable for any corrections which may need to be made in the plans or specifications, nor for any defects in materials and/or workmanship, whether such defects be patent or latent.

7. Service shall give satisfactory receipts for and shall maintain complete and adequate records of all sums received by it, and shall permit the inspection of said records by the Lender and Contractor at any and all times during reasonable business hours. Service further guarantees that it will not commingle such funds with its own funds, and that all sums so received and disbursed by Service do not include the right to remove from the premises of Service any of the records of such funds. The right of inspection of the records of all sums so received and disbursed by Service, including, but not limited to the bankruptcy of Owner and/or Contractor, refusal of Lender to disburse, insolvency of Owner and/or Contractor, or any other entity which has agreed to contribute funds to the said work of improvement, to deliver any and all such funds as may have been agreed upon between Owner and Contractor, either jointly or severally, and Lender title company, or any other person, firm, corporation, or entity which has agreed to contribute funds to the said work of improvement, to deliver any and all such funds as may have been agreed upon between Owner and Contractor, either jointly or severally, and Lender title company, or any other person or firm or corporation, to deliver such funds to Service. Wherein a Lender is involved, Service is hereby granted the sole right to negotiate with such Lender as to the manner in which the available funds shall be delivered to Service and such distribution of funds shall be acceptable to all parties to this agreement and assignment.

10. Neither Contractor nor Owner shall have any right, title or interest in or to the said funds, nor shall the disbursement thereof, except as specifically provided herein. The powers in this contract given Service are irrevocable and no set of circumstances, including, but not limited to the bankruptcy of Owner and/or Contractor, refusal of Lender to disburse further funds, insolvency or default of Owner and/or Contractor that this agreement terminates, shall deprive Service of its option to proceed and complete the construction herein referred to using therefor all funds from all sources provided by this agreement.

11. No assignment to Service of all of Contractor's agreements or contracts with subcontractors and material men or laborers in connection with the construction of said improvements, but this assignment shall become effective only if Service elects to take possession of the premises affected by or completion of the said improvements, pursuant to the provisions hereof, but Service shall not be obligated under any circumstances to exercise any right or to perform any obligations contained in the said agreements or contracts, in its opinion, and that of the Lender, it is to the advantage of the interested parties to do so.

12. No alterations, deviations, additions, omissions, or extras to or in relation to said plans, specifications or building contract as submitted to Service shall be made without first obtaining the written approval of Service.

13. In the event it is determined by Service that the funds deposited for the payment of costs and expenses of construction of the said improvements have been exhausted before payment in full of such costs and expenses, or if in the opinion of Service the unused balance of such funds will not be adequate to pay the estimated costs and expenses of said construction and also provide a reasonable reserve as determined by Service, then on demand of Service Owner and/or Contractor shall pay to Service for use by it hereunder the sum so requested by Service. In any contingencies not covered above the parties shall pay such amounts as they are severally liable for under the terms of the building contract. Such additional sums may be requested by Service immediately or from time to time as, in the sole discretion of Service, seems best. The obligation to deposit any and all sums when so requested by Service shall be enforceable by court action, attachment and sale for the benefit of Service, as the enforcing party hereof.

14. In consideration of the execution of this agreement by Service and the assumption by Service of the obligations it undertakes herein, it is agreed that if Contractor at any time, (a) abandons the construction work, or (b) permits work to cease, or (c) causes or permits work on said improvement for a period of seven days, or more, or (d) secures from Service money in excess of the then actual cost of the said improvement, or (e) fails to apply money paid to Contractor for
a specific purpose in connection with said construction promptly to such purpose, or (e) attempts to secure from Service money for use other than as provided herein, or (f) makes any false statement to Service with the intent to induce Service to rely and act upon such statement, or (g) violates any provisions of Chapter 9, Division 3, of the Business and Professions Code of the State of California or Amendments thereto, or (h) is unable to demonstrate that the remaining available construction funds are sufficient to pay the cost of everything necessary to complete the improvement, in addition to providing a reasonable reserve fund for contingencies, or (i) requests, or receives any rebates, cutbacks, or secret commissions from or on any labor or materials used on such construction, or (j) if Contractor dies or becomes physically or mentally incapacitated or unable to carry on his business or if a voluntary or involuntary petition of bankruptcy is filed, by or against Contractor, or if Contractor becomes insolvent or makes an assignment for the benefit of creditors, or if a receiver is appointed for any of Contractor's assets, or (k) if Contractor uses or attempts to use materials secured for said construction on any other construction job, or (l) if Contractor violates any provision of this agreement or of the building contract between Owner and Contractor, then Service may, in its discretion, immediately enter upon the premises on which said improvements are being constructed, and using any necessary force, take possession thereof, including tools, materials and equipment located on the premises or being used by Contractor in the construction of the aforementioned improvements; and Service may proceed with the completion of the said improvement, or let contract for completing said improvement, either in Contractor's name or otherwise, at the discretion of Service; and Service may pay from the funds provided to be deposited with it hereunder, all cost of such completion, including the reasonable value of the services rendered by Service, and on demand any shortage of moneys necessary for said completion purposes shall be paid by Contractor and/or Owner, and in the event there remains on hand any surplus funds, such funds shall be disbursed by Service in accordance with the provisions hereinafter set forth. Provided, however, that Service shall not be obligated, by any provisions herein contained, to take over such construction, nor to advance any funds of its own therefor, whether or not it takes over such construction. In the event that Service elects not to proceed with the completion of the said improvements, Service shall disburse to Lender the funds available to it hereunder.

APPENDIX II

A construction loan draw plan is a schedule for the disbursement of construction loan proceeds from the lender to the borrower, his agent, or assignee. Under the conventional "five pay" plan, the construction loan is disbursed to the borrower in five equal payments beginning with the laying of the subfloor. Under the control's accelerated draw plan the construction loan proceeds are disbursed directly to the control. The first disbursement from the lender is upon the recordation of the loan papers. The following figure comparing the two draw plans is reproduced from Builders' Control Service of Northern California, Inc., Brochure, p. 5, undated.
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