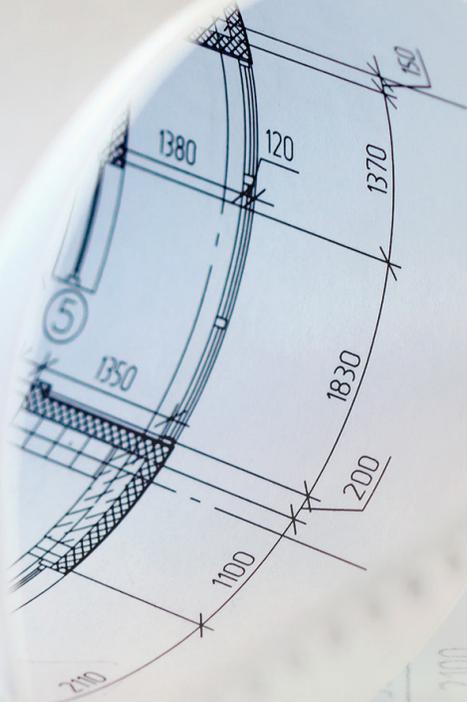


Prompt Payment and Subcontractors



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Published on www.lorman.com - June 2018

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PROMPT PAYMENT AND SUBCONTRACTORS

A. Subcontractor Substitutions

Subcontractors have many statutory protections on California public projects. The statutes governing their involvement are generally found in the Subletting and Subcontracting Fair prevent bid shopping and bid peddling in public works construction, which the Legislature has found “often result[s] in poor quality of material and workmanship to the detriment of the public, deprive[s] the public of the full benefits of fair competition among prime contractors and subcontractors, and lead[s] to insolvencies, loss of wages to employees, and other evils.”⁴³⁶

The requirements for listing subcontractors in the bid are discussed in earlier sections of this manual. Once the award has been made, a general contractor has limited authority to replace a subcontractor any may only do so with consent of the owner. The permissible grounds for substitution are:⁴³⁷

- When the subcontractor listed in the bid, after having had a reasonable opportunity to do so, fails or refuses to execute a written contract for the scope of work specified in the subcontractor’s bid and at the price specified in the subcontractor’s bid. (Provided that the written contract is based upon the general terms, conditions, plans, and specifications for the project involved or the terms of that subcontractor’s written bid);
- When the listed subcontractor becomes insolvent or the subject of an order for relief in bankruptcy;
- When the listed subcontractor fails or refuses to perform his or her subcontract;
- When the listed subcontractor fails or refuses to meet the bond requirements of the prime contractor as set forth in Section 4108;
- When the prime contractor demonstrates that the name of the subcontractor was listed as the result of an inadvertent clerical error, to the further provisions set forth in Section 4107.5;
- When the listed subcontractor is not licensed pursuant to the Contractors’ License Law;
- When the awarding authority determines that the work performed by the listed subcontractor is substantially unsatisfactory and not in substantial accordance with the plans and specifications, or that the subcontractor is substantially delaying or disrupting the progress of the work;
- When the listed subcontractor is ineligible to work on a public works project pursuant to Section 1777.1 or 1777.7 of the Labor Code; and

⁴³⁶. Public Contract Code section 4101.

⁴³⁷. Public Contract Code section 4107.

- When the awarding authority determines that a listed subcontractor is not a responsible contractor.

Subcontractor substitutions require due process. Following the prime contractor's request for substitution, the owner must give written notice (by certified or registered mail) to the subcontractor, including the reasons for the substitution request. The subcontractor then has five working days to submit written objections to the owner. Failure to submit objections in time is consent to the substitution. If the subcontractor objects in writing, it is entitled to a hearing before the owner's awarding authority.⁴³⁸

The penalties for violation of the Subletting and Subcontracting Fair Practices Act can be severe. A prime contractor found in violation violates its contract with the public owner, and the owner may choose to either (1) cancel the contract, or (2) assess a penalty of not more than ten percent of the amount of the subcontract involved.⁴³⁹

A violation of the Subletting and Subcontracting Fair Practices Act is also a violation of the Contractors' State License Law and is grounds for disciplinary action.⁴⁴⁰ The subcontractor may also sue the prime contractor (but not the public entity) for damages on a theory of statutory duty.⁴⁴¹

B. Stop Notices And Payment Bonds

1. Theory of Recovery

Subcontractors and suppliers often supply materials and labor to construction projects with the risk they will not be paid for their efforts. These parties typically have contracts with the general contractor (or a major subcontractor) and often face obstacles to payment. General contractors may refuse to pay until they are paid by the owner, may go bankrupt during the work, or may withhold payment because of disputes over work performed by the subcontractor.

The legislature has recognized the risks faced by subcontractors and suppliers, and has developed several remedies. On public works projects, the primary remedies are the stop notice and the payment bond.

The statutes regarding stop notices and payment bonds are found in Part 6 of Division 4 of the California Civil Code, titled "Works of Improvement", which at the time of this writing span Civil Code sections 8000 through 9566. The statutes are divided into three titles, "Works of Improvement Generally", "Private Works of Improvement", and "Public Works of Improvement."⁴⁴²

438. Public Contract Code section 4108(a).

439. Public Contract Code section 4110. Note that the owner must hold a public hearing on five days' notice before assessing any penalty under the statute.

440. Public Contract Code section 4111.

441. *Southern Cal. Acoustics Co. v. C.V. Holder, Inc.* (1969) 71 Cal.2d 719 ("[W]e hold that [the bid award] confers the right on the listed subcontractor to perform the subcontract unless statutory grounds for a valid substitution exist. Moreover, that right may be enforced by an action for damages against the prime contractor to recover the benefit of the bargain the listed subcontractor would have realized had he not wrongfully been deprived of the subcontract.")

442. Civil Code sections 8000 to 8154; sections 8160 to 8848, and sections 9000 to 9566, respectively.

The theories of recovery are different on public and private works, and statutes governing private works are not applicable to public projects.⁴⁴³ The primary difference is that on private works, an unpaid subcontractor or supplier can enforce its claim against the owner's property through a mechanic's lien. However, public property is not subject to foreclosure and sale, but the public funds can be used for construction are subject to claims.⁴⁴⁴

Stop notice claims are therefore more aptly called "stop payment notice" claims, because they direct the public agency to stop the next payment to the general contractor and hold out of that payment enough money to satisfy the subcontractor's claim. The funds are essentially held in an escrow account until title to the money is resolved, either through negotiation between the general contractor and subcontractor, or through litigation.

2. The Stop Notice Process

The public agency's primary role when a stop notice is received is to evaluate the notice and withhold funds from the next payment due to the general contractor, if the stop notice is valid. As a general rule, the public agency need not investigate the stop notice or the circumstances surrounding the claim. This section provides an overview of the stop notice process as it relates to a public owner.

(a) Who can file a stop notice?

Civil Code section 9100 states that the following parties can file a stop notice on a public project:

- A person that provides work for a public works contract, if the work is authorized by a direct contractor, subcontractor, architect, project manager, or other person having charge of all or part of the public works contract;
- A laborer, or;
- A person described in Section 4107.7 of the Public Contract Code, that is, hazardous waste hauling subcontractors licensed under the Health and Safety Code.⁴⁴⁵

Direct contractors – a contractor that has a direct contractual relationship with an owner – cannot file a stop notice or make a claim on the payment bond.⁴⁴⁶ Unlike subcontractors and material suppliers, the direct contractor has remedies under its contract with the owner for payment disputes. Case decisions hold that suppliers to material suppliers and subcontractors who did not add value to the property do not have stop notice rights.⁴⁴⁷

443. Civil Code section 8160 ("This title applies to a work of improvement that is not governed by Title 3", i.e., the statutes governing public improvements).

444. See *Theisen v. County of Los Angeles* (1960) 54 Cal.2d 170; *Calhoun v. Huntington Park First Sav. & Loan Assn.* (1960) 186 Cal.App.2d 451; *Bates v. Santa Barbara County* (1891) 90 Cal. 543.

445. These subcontractors are entitled to file a stop notice with the public entity "within 10 days after the investigation, removal or remedial action, or disposal is completed..."

446. Civil Code section 9100(b).

447. See *John A. Roebling's Sons Co. v. Humboldt Electric Light & Power Co.* (1896) 112 Cal. 288; *Primo Team, Inc. v. Blake Constr. Co.* (1992) 3 Cal.App.4th 801. Because the public agency is essentially a trustee for the stop notice funds, the agency generally need not investigate the nature of the claimant at this level, but the general contractor may raise these issues.

(b) The 20-day Preliminary Notice Requirement

Anyone asserting a stop payment notice or a claim against a payment bond must provide a preliminary notice to the public entity and the direct contractor to whom the claimant provides work.⁴⁴⁸ However, on a public project, the owner already knows which subcontractors are performing more than 1-1/2 percent of the work because they must be listed in the general contractor's bid. Those subcontractors are therefore not required to provide the preliminary notice.⁴⁴⁹ The general contractor is also not required to give notice.

The notice must contain the information required in Civil Code section 8102, but must also include a general description of the work to be provided and an estimate of the total price of the work provide and to be provided for the project.⁴⁵⁰

The preliminary notice is often referred to as a "20 day notice" because the claimant can only assert a claim for work performed "within 20 days before giving preliminary notice and at any time thereafter."⁴⁵¹ In other words, if the subcontractor or supplier provided work 21 days prior to serving the preliminary notice, it cannot include the value of that work (or any work performed before the 20th day) in its claim.

From a practical standpoint, serving a preliminary notice is straightforward, and subcontractors and suppliers must strictly comply with the statutory requirements, or their claims will be denied by the court, even if the owner had actual knowledge of the claim.⁴⁵² Preliminary notices may arrive from subcontractors and suppliers early in the project. The owner should maintain a copy in their files, but need not take any action in response.

(c) Stop Notice Requirements

The stop notice must allege that the direct contractor or a subcontractor has failed to pay the claimant a specified amount of money, must be signed and verified by the claimant, and must direct the public entity to withhold an appropriate sum of money from payments to the direct contractor to satisfy the claim.⁴⁵³ Although a claimant must strictly comply with many technical requirements to perfect its stop notice – service of a preliminary notice, timely service of a stop notice – the stop notice itself does not have any specific formal requirements beyond the basic statutory requirements. The purpose is to put the public owner on notice of the claim for payment.

The stop notice must be served on the public owner timely. Whether a stop notice is timely filed can be a complex factual issue. The statute provides that a stop payment notice is not effective unless given on the public owner before the expiration of one of the two deadlines:

- If the owner records a notice of completion, acceptance, or cessation of labor, the stop notice must be given within 30 days after the document is recorded. ⁴⁵⁴

448. Civil Code section 9300(a).

449. Civil Code section 9300(b)(2). Note that laborers are also not required to give the preliminary notice. *Id.* at (b)(1).

450. Civil Code section 9303.

451. Civil Code section 9304.

452. Civil Code section 9302; *San Joaquin Blocklite, Inc. v. Willden* (1986) 184 Cal.App.3d 361.

453. Civil Code section 9352.

454. Civil Code section 9356(a).

- If the owner does not record a notice of completion, acceptance, or cessation of labor, the stop notice must be given 90 days after cessation or completion.⁴⁵⁵

These seemingly straightforward requirements are complicated by the following issues. First, the public owner must record a notice of completion within 15 days of completion of the project, or the notice of completion is not valid.⁴⁵⁶ An invalid notice of completion has no legal effect, because the notice of completion is a benefit to the owner in the form of a shorter lien filing period, but it is not required.⁴⁵⁷

Second, if a notice of completion is not filed, the term “completion of the work” is defined as the earliest of (a) acceptance of the work of improvement by the owner, or, (b) cessation of labor for a continuous period of 60 days.⁴⁵⁸

The factual complexities of these deadlines are primarily issues for the claimant and the direct contractor. As discussed below, the public owner has little incentive to investigate the validity of the contents or timing of the stop notice filing.

(d) Public Agency’s Duty Upon Receipt of a Stop Notice

The public entity “shall, on receipt of a stop payment notice, withhold from the direct contractor sufficient funds due or to become due to the direct contractor to pay the claim stated in the stop payment notice and to provide for the public entity’s reasonable cost of any litigation pursuant to the stop payment notice.”⁴⁵⁹ As a practical matter, the public agency generally withholds 125% of the stop notice amount out of the next payment due to the general contractor.

This ‘rule of thumb’ for withholding is based both on the measure of likely costs the public owner might incur and because that is the amount the contractor must post through a stop notice release bond to “bond around” the stop notice.⁴⁶⁰ A public owner is not entitled to recover its attorneys’ fees incurred in litigation, because of the interpleader remedy (discussed below), but in limited circumstances may be entitled to recover attorneys’ fees that would be available as costs of suit.⁴⁶¹

The public owner has no discretion in the amount to withhold and, upon receipt of a valid stop notice, becomes a trustee, or stakeholder, of the funds.⁴⁶²

Failure to withhold presents significant risks. Cases hold that a wrongful failure to withhold exposes the public entity and the disbursing officer to liability.⁴⁶³ In addition, by paying funds that should have been withheld under a stop notice, the public agency allows the

455. Civil Code section 9356(b).

456. Civil Code section 9204.

457. See *Fontana Paving, Inc. v. Hedley Bros., Inc.* (1995) 38 Cal.App.4th146. *Fontana Paving, Inc.* is a mechanic’s lien case, but the principles are the same for public owners.

458. Civil Code section 9200.

459. Civil Code section 9358.

460. See Civil Code section 9364.

461. See *Tri-State, Inc. v. Long Beach Comm. College Dist.* (2012) 204 Cal.App.4th 224 (“...[A] public entity upon receipt of a stop notice must withhold an amount sufficient to answer the claim and to provide for the public entity’s reasonable litigation costs, not including attorney fees.”); see also Code of Civil Procedure section 1033.5, which sets forth the items available as costs under Code of Civil Procedure section 1032.

462. See *Jasper Construction, Inc. v. University Casework Systems, Inc.* (1974) 39 Cal.App.3d 582.

463. See *L.W. Blinn Lumber Co. v. Pioneer Drainage Dist.* (1920) 50 Cal.App.364.

payment bond surety to escape liability for the claim, because the public agency's failure to withhold exonerates the payment bond surety.⁴⁶⁴

As a result, the public agency has little to gain from disputing or challenging an apparently valid stop notice and will usually elect to withhold the funds. Many times the stop notice is a symptom of a dispute between the general contractor and its subcontractor that has nothing to do with the public owner.

(e) Exception to the Duty to Withhold – No Money Due to the Contractor

A stop notice functions like a garnishment on funds owed to the direct contractor. If there are no funds due, then the stop notice is of no effect.

Civil Code section 9358(a) provides “[t]he public entity shall, on receipt of a stop payment notice, withhold from the direct contractor sufficient funds due or to become due to the direct contractor to pay the claim stated in the stop payment notice and to provide for the public entity’s reasonable cost of any litigation pursuant to the stop payment notice.” The key language here is “due or to become due.”

There are two situations where this becomes an issue. First is when all of the contract funds have been paid out to the direct contractor, and there is no money left owing. In that situation, the claimant is out of luck.

The second situation is where the public agency has costs or damages that it has assessed against the direct contractor, and is holding that money to compensate it for those damages. If the public entity has authority under a statute to withhold funds, those funds are not ‘due or to become due’ to the general contractor.⁴⁶⁵

When a general contractor is terminated for cause on a public works project, the subcontractors often immediately file stop notices to try and protect their rights to payment. However, the general rule in California is that, following a termination, there may be no money ‘due or to become due’ to the general contractor, and that retention proceeds can be used to fund project completion. If there is money remaining when the work is complete, it must be paid out to the general contractor. If there is a deficit, the County can seek to recover that deficit from the contractor. If the County prevails in its positions, then the retention will never be due and the stop notices will never have valid effect.

In *Dorris v. Altruas School District of Modoc County*,⁴⁶⁶ the general contractor abandoned construction of a school. There was a balance remaining under the contract. A brick supplier filed a stop notice after the abandonment. The court held that, at the time of termination, there was no money due to the general contractor, because no further payments were due until the building was completed. The District had no obligation to withhold funds for the stop notice. The District’s contract with the general contractor did not require the District to

464. See *United States Fidelity & Guarantee Co. v. Oak Grove Union School Dist.* (1962) Cal.App.2d 226.

465. See *Harsco Corp. v. Department of Public Works* (1971) 21 Cal. App. 3d 272; *East Quincy Services Dist. v. General Accident Ins. Co. of America* (2001) 88 Cal. App. 4th 239, 246-47.

466. *Dorris v. Altruas School District of Modoc County* (1914) 25 Cal. App. 30.

make another payment until the work was complete. The court held that if funds are not due to the general contractor under the terms of the contract at the time the stop notice is filed, then no funds are ‘due or to become due’ to the contractor, and are not subject to the stop notice.

In *Harsco Corp. v. Department of Public Works*,⁴⁶⁷ the Department contracted with Ashby Construction for the construction of a bridge in Riverside County. Ashby used scaffolding provided by Harsco for the project; Harsco was not paid and filed a stop notice. At the time of the stop notice, the District had paid all of Ashby’s outstanding progress payments for work in place, and was holding retention. The District did not withhold funds. Ashby then defaulted, and the Department terminated its control over the project. The project was completed by a different contractor. The final cost was more than the contract price between Ashby and the Department. The court held that: (a) retention is not ‘earned’ by the subcontractors until the project is complete; (b) funds withheld as liquidated damages are not ‘earned’ by the general contractor and therefore not subject to a stop notice, and (c) retention proceeds would only become due to a stop notice claimant after the project is complete if there is money remaining. If the cost to complete exceeds the original contract balance, the retention proceeds do not belong to the stop notice claimants.

Note that even if the subcontractors and suppliers have no stop notice remedy, they can still proceed against the public works payment bond.

(f) Stop Notice Release Bonds

The public owner may permit the direct contractor to provide a surety release bond to take the place of the withheld funds. These bonds, commonly titled stop notice release bonds, obligate a third party surety to stand in the place of the public owner and allow the owner to release withheld funds to the general contractor. This process is often referred to as “bonding around” the stop notice.

The stop notice release bond must be executed by an admitted surety insurer, in an amount equal to 125 percent of the claim stated in the stop notice, and must be conditioned on the payment of any amount the claimant recovers in an action for its claim, together with court costs.⁴⁶⁸ Upon receipt of the bond, the public entity “shall not withhold funds from the direct contractor pursuant to the stop payment notice.”⁴⁶⁹

(g) Stop Notice Litigation

A public owner may be drawn into payment dispute litigation after a stop notice has been served. The claimant has a short statute of limitations to file suit after serving a stop notice: 10 days after the date the stop notice was given and 90 days after the period in which a stop notice may be given.⁴⁷⁰

As discussed above, the period in which stop notices may be given is often uncertain, but it is a short window of time following project completion or extended cessation of work. The claimant will typically advance theories of breach of contract against the direct contractor (or

467. *Harsco Corp. v. Department of Public Works* (1971) 21 Cal. App. 3d 272.

468. Civil Code section 9364(a).

469. Civil Code section 9364(b).

470. Civil Code section 9502.

subcontractor, as the case may be), recovery on the stop notice claim, and recovery on the payment bond. In response to the lawsuit, the public entity's response should be to interplead the withheld funds. Filing an interpleader allows the public agency to cut off its liability in excess of the withheld funds.⁴⁷¹

There is also a process for summary declaration of the parties rights to the stop notice funds.⁴⁷² In general, these procedures require the direct contractor to file an affidavit on the public owner demanding release of the withheld funds and the facts supporting the demand. The public owner then serves this affidavit with a notice on the claimant that the funds will be released unless the claimant serves a counter-affidavit within a short period of time as required in the statute. If a counter-affidavit is filed, either the direct contractor or the claimant can commence a declaratory relief action.⁴⁷³ If no counter-affidavit is filed, the public agency can release the funds.⁴⁷⁴

C. Payment Bonds

Payment bonds are required on all public works contracts in excess of \$25,000, except where the contract is with a state entity.⁴⁷⁵ The direct contractor must secure and provide the bond, and the call for bids must state that a payment bond is required.⁴⁷⁶ The bond must be equal to not less than 100 percent of the total amount payable under the contract.⁴⁷⁷

The payment bond is required because it is a substitute for the mechanics' lien, which is not available on public projects. The bond provides subcontractors and suppliers with an additional means of compensation for unpaid labor or materials, and places the duty to make payment on a third party surety.⁴⁷⁸

1. Public Agency Has a Duty to Investigate the Bond Surety

Payment bonds must be issued by an admitted surety insurer,⁴⁷⁹ which is defined as a "a corporate insurer or a reciprocal or inter-insurance exchange to which the Insurance Commissioner has issued a certificate of authority to transact surety insurance in" California.⁴⁸⁰ The public agency has a duty to verify that the bond is, in fact, executed by an admitted surety insurer, which it can verify in one of two ways. The first is to print out information from the California Department of Insurance confirming the surety is admitted and attaching the printout to the bond. The second is to obtain a certificate from the county clerk confirming the surety is admitted, and attaching that certificate to the bond.⁴⁸¹

471. See Civil Code section 9506(c). *See also Leatherby Ins. Co. v. City of Tustin* (1977) 76 Cal.App.3d 678, a cautionary tale for a public agency that intends to litigate when it is merely a stakeholder of the stop notice funds.

472. Civil Code sections 9400 to 9414.

473. Civil Code section 9408.

474. *Id.*

475. Civil Code section 9550.

476. *Id.*

477. Civil Code section 9554(a).

478. See *Capital Steel Fabricators, Inc. v. Mega Constr. Co.* (1997) 58 Cal.App.4th 1049, 1060-61.

479. Civil Code section 9554.

480. Code of Civil Proc. section 995.120.

481. Code of Civil Proc. section 995.311. This statute was added in 2001 in response to the holding in *Walt Rankin & Assocs. v. City of Murietta* (2000) 84 Cal.App.4th 271 to clarify the scope of the public agency's duty to investigate.

A bond claimant may have a tort cause of action against a public entity that fails to investigate the surety.⁴⁸²

2. Who is Protected by the Bond?

The payment bond protects the same parties that are authorized by statute to file a stop notice on a public project:

- A person that provides work for a public works contract, if the work is authorized by a direct contractor, subcontractor, architect, project manager, or other person having charge of all or part of the public works contract;
- A laborer, or;
- A person described in Section 4107.7 of the Public Contract Code, that is, hazardous waste hauling subcontractors licensed under the Health and Safety Code.⁴⁸³

The payment bond also ensures payment of:

- Amounts due under the Unemployment Insurance Code with respect to work or labor performed pursuant to the public works contract, and;
- Amounts required to be deducted, withheld, and paid over to the Employment Development Department from the wages of employees of the contractor and subcontractors under the Unemployment Insurance Code with respect to the work and labor.⁴⁸⁴

The bond must be conditioned on the full payment of claims or all claimants, and must by its express terms, be for the benefit of the persons listed in Civil Code section 9100.⁴⁸⁵ The bond must state that if the direct contractor (or a subcontractor, as the case may be) fails to pay, the surety will pay the obligation and, if an action is brought to enforce the liability on the bond, a reasonable attorney's fee, to be fixed by the court.⁴⁸⁶

Recovery on the payment bond is independent from recovery on the stop notice, and a claimant does not need to have served a stop notice before filing suit to recover on the bond.⁴⁸⁷

3. Consequences of Having No Payment Bond

If no payment bond is in place on a public works project, the public agency effectively becomes the payment bond surety and may be liable to bond claimants on the legal theory that the public agency breached a statutory duty to protect the bond claimants.⁴⁸⁸ Such liability exposes the public agency to potentially paying twice for the same work – first to the general

482. *Walt Rankin & Assocs. v. City of Murietta* (2000) 84 Cal.App.4th 271.

483. Civil Code section 9100.

484. Civil Code section 9554(b)(2); (b)(3).

485. Civil Code section 9554(c).

486. Civil Code section 9554(b).

487. Civil Code section 9564(a).

488. *N.V. Heathorn, Inc. v. City of San Mateo* (2005) 126 Cal.App.4th 1526.

contractor, and a second time to the subcontractor or supplier who was not paid by the general.

If a payment bond is not provided to the public owner and approved by the owner, the public agency cannot “audit, allow, or pay a claim of the direct contractor.”⁴⁸⁹

D. Progress Payments and Retention / Prompt Payment Issues

There are several statutes requiring prompt payment to contractors on both private and public works.⁴⁹⁰ This manual focuses on the main prompt payment statutes for public agencies regarding progress payments and retention.

1. Progress Payments under Public Contract Code section 20104.50

For local agencies, Public Contract Code section 20104.50 governs progress payments, that is, all payments due a contractor except for that portion of the final payment classified as retention earnings.⁴⁹¹ With respect to progress payments on a construction project, the Legislature has expressly stated its intent “to require all local governments to pay their contractors on time so that these contractors can meet their own obligations.”⁴⁹² The Legislature has also determined that prompt payment of progress payments is an issue of statewide concern, pre-empting Charter City ordinances that would deviate from the statute.⁴⁹³

Any local agency which fails to make any progress payment within 30 days after receipt of an undisputed and properly submitted payment request from a contractor on a construction contract must pay interest to the contractor at the legal rate. As of this writing, the legal rate is 10% per year.⁴⁹⁴

The public agency is also required to review the payment request as soon as practicable after receipt to determine if the request is proper. If the agency determines the request is not proper, it must return the request to the contractor as soon as practicable, but not more than seven days after receipt. A returned payment request must include a document listing the problems with the payment request.⁴⁹⁵ If the agency takes longer than seven days to return the payment request, the 30 day time period for which it can avoid interest is reduced by a day for each day over the seven days.⁴⁹⁶

Each local agency must include the text or a summary of the statute in the terms of any contract.⁴⁹⁷

489. Civil Code section 95552(a).

490. See, e.g., Civil Code sections 3260, 3260.1 (private works); Business & Professions Code section 7108.5; Public Contract code sections 7107, 20104.50, 10853, and 10261.5.

491. Public Contract Code section 20104.50(e)(2).

492. Public Contract Code section 20104.50(a)(1). The statute further provides that “[t]he Legislature finds and declares that all government officials, including those in local government, must set a standard of prompt payment that any business in the private sector which may contract for services should look towards for guidance.” See *id.* at (a)(2).

493. Public Contract Code section 20104.50(a)(1); (a)(2).

494. Public Contract Code section 20104.50(b); Code of Civil Procedure section 685.010.

495. *Id.* at 20104.50(c).

496. *Id.* at 20104.50(d).

497. *Id.* at 20104.50(f).

2. Retention Under Public Contract Code section 7107

Public Contract code section 7107 applies to all contracts relating to the construction of any public work of improvement.⁴⁹⁸ It specifies how public owners and general contractors must disburse retention on a public project.⁴⁹⁹ It is not subject to waiver.⁵⁰⁰

The rule is that, within 60 days after completion of the work, retention must be released by the owner to the general contractor. Then, within 7 days from the date the general contractor is paid the retention, it must pay each of its subcontractors any withheld retention.⁵⁰¹

Under the statute, the project is complete upon any of the following:

- The occupation, beneficial use, and enjoyment of a work of improvement, excluding any operation only for testing, startup, or commissioning, by the public agency, or its agent, accompanied by cessation of labor on the work of improvement;
- The acceptance by the public agency, or its agent, of the work of improvement;
- After the commencement of a work of improvement, a cessation of labor on the work of improvement for a continuous period of 100 days or more, due to factors beyond the control of the contractor;
- After the commencement of a work of improvement, a cessation of labor on the work of improvement for a continuous period of 30 days or more, if the public agency files for record a notice of cessation or a notice of completion.⁵⁰²

In the event of a dispute between the general contractor and the owner, the owner may withhold retention from the general contractor in “an amount not to exceed 150 percent of the disputed amount.”⁵⁰³ The general contractor may similarly withhold from a subcontractor, again up to 150 percent of the disputed amount, provided the dispute is bona fide.⁵⁰⁴

If retention payments are not made within the time periods in the statute, the entity withholding faces penalties of 2% per month of the withheld amount, which is in lieu of any interest that would otherwise be due by statute. The 2% charge is not compounded.⁵⁰⁵ The public owner (or contractor when withholding from a subcontractor) is exposed to attorney’s fees and costs in any action to recover the funds.⁵⁰⁶

The statute is remedial in nature and intended to deter public entities from improperly withholding retention payments.⁵⁰⁷ Therefore “Section 7107’s purpose of ensuring the prompt

498. Public Contract Code section 7107(a).

499. *Id.* at 7107(b).

500. *Id.* at 7107(h).

501. *Id.* at 7107(c), (d).

502. *Id.* at 7107(c).

503. *Id.*

504. *Id.* at 7107(e).

505. *S&S Cummins Corp. v. West Bay Builders, Inc.* (2008) 159 Cal.App.4th 765.

506. *Id.* at 7107(f).

507. See *FEI Enterprises, Inc. v. Yoon* (2011) 194 Cal.App.4th 790, 804-05); *S&S Cummins Corp. v. West Bay Builders, Inc.* (2008) 159 Cal.App.4th 765, 777).

release of retention funds would not be served if any dispute justified retaining the funds. There is no reason to allow a public entity to retain the funds once their purpose of providing security against mechanics liens and deficiencies in the contractor's performance has been served. Unless the dispute relates to one of those purposes, the public entity will not be protected from the statutory penalty."⁵⁰⁸

At present, an open question exists: can a contractor withhold retention payments when there is a good faith dispute of any kind, or does the dispute need to relate only to the retention itself?⁵⁰⁹ This issue is currently pending before the California Supreme Court for resolution.

In *Martin Brothers Construction v. Thompson Pacific Construction, Inc.*,⁵¹⁰ the third appellate district held a general contractor *could* withhold retention even if the only dispute was over outstanding change orders. In that case, the subcontractor submitted numerous contract change requests during the work and sought money for work it claimed was beyond the scope of the contract. The subcontractor and general contractor did not agree on the amounts for the extra work, and the general contractor withheld retention because of the dispute.

The subcontractor argued that the general subcontractor should only be allowed to hold retention if there was a dispute related to the performance of the work within the contract scope – for example, defective or incomplete work, or a contract interpretation dispute. The court disagreed, and held the text of Section 7107 did not qualify the term “dispute”: “[t]he statute contains no language restricting the word “dispute” to any particular kind of dispute other than it must be “bona fide.” The ordinary meaning of “dispute” is a “verbal controversy,” a “debate,” or “quarrel.”⁵¹¹ Thus, any bona fide dispute would trigger a right to withhold.⁵¹²

By contrast, the second appellate district held in *East West Bank v. Rio School Districts*⁵¹³ that a dispute over the contract price does not entitle a public agency to withhold funds due to a contractor.⁵¹⁴ The court stated “Section 7107’s purpose of ensuring the prompt release of retention funds would not be served if any dispute justified retaining the funds. There is no reason to allow a public entity to retain the funds once their purpose of providing security against mechanics liens and deficiencies in the contractor’s performance has been served.”⁵¹⁵

Although the California Supreme Court has not yet resolved this appellate district split, public agencies may face risks if they withhold retention in the face of disputes over extra work with a general contractor.

508. *East West Bank v. Rio School Dist.* (2015) 235 Cal.App.4th 742.

509. *United Riggers & Erectors v. Coast Iron & Steel*, review granted March 16, 2016, S231549. The case was fully briefed as of July 5, 2016 and amicus briefs were filed as of August 12, 2016. The case has not been set for oral argument as of October 31, 2017.

510. *Martin Brothers Constr. v. Thompson Pacific Constr., Inc.* (2009) 179 Cal.App.4th 1401

511. *Martin Brothers Constr. v. Thompson Pacific Constr., Inc.* (2009) 179 Cal.App.4th 1401, 1412.

512. *Id.*

513. *East West Bank v. Rio School Dist.* (2015) 235 Cal.App.4th 742.

514. *Id.* at 745.

515. *Id.* at 748-49.

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