

# Construction Newsletter

[Presented by the Law Offices of Ashley A. Baron]

## Legal News for the Construction Industry

### Penalties Under Prompt Pay Statutes

Most owners and contractors in California know that there are prompt pay statutes in place in Private and Public Works. There are multiple statutes for progress payments and final payments. This Newsletter will focus on the Private works.

With regard to Private Works progress payments *Civil Code* Section 3260.1 is applicable. It states in relevant part: "Except as otherwise agreed in writing, the owner shall pay to contractor, within 30 days following receipt of a demand for payment in accordance with the contract, any progress payment due thereunder as to which there is no good faith dispute between the parties. In the event of a dispute between the owner and the contractor, the owner may withhold from the progress payment an amount not to exceed 150 percent of the disputed amount. If any amount is wrongfully withheld in violation of this subdivision, the contractor shall be entitled to the penalty specified in subdivision (g) of Section 3260." The penalty provided in *Civil Code* Section 3260(g) is "the owner or original contractor withholding the unpaid amounts shall be subject to a charge of 2 percent per month on the improperly withheld amount, in lieu of any interest otherwise due. Additionally, in any action for collection of funds wrongfully withheld, the prevailing party shall be entitled to his or her attorney's fees and costs." Likewise,

with regard to retention, *Civil Code* Section 3260 provides: "Within 45 days after the date of completion, the retention withheld by the owner shall be released. 'Date of completion,' for purposes of this section, means any of the following: (1) The date of issuance of any certificate of occupancy covering the work by the public agency issuing the building permit. (2) The date of completion indicated on a valid notice of completion recorded pursuant to Section 3093. (3) The date of completion as defined in Section 3086."

However, as with retention payments, there is a provision, *Civil Code* Section 3260(e), for dispute which provides: "If a bona fide dispute exists between the owner and the original contractor, the owner may withhold from the final payment an amount not to exceed 150% of the disputed amount." There is a similar provision as to withholding as between the original contractor and subcontractors. It should also be noted that these penalty statutes are not applicable to material suppliers, laborers or rental equipment suppliers.

While these 2% penalty and attorney's fees statutes appear to be a huge incentive to owners and original contractors to make prompt payment, in reality they are not as effective to induce payment as they appear.

First, the statute requires that the contractor must demand payment in accordance with the contract in order for the statute to be applicable. Many savvy owners and their attorneys are incorporating more elaborate

conditions for payment in the terms of the contract. These include, but are not limited to, the requirement that contractors provide: mechanics' lien releases, stop notice releases, conditional releases, unconditional releases, certified payroll, union letters regarding payment of prevailing wages, proof of insurance, proof of licensing during the work performed (and all of these for subcontractors as well), roof certifications, core certifications, government permits and the turn over of all documents necessary for an audit of the contractor. Because contractors are notorious for not keeping paperwork, the demand for such items only frustrates a contractor who looks at the completed project and says it is built, you are occupying it, so pay me.

A contractor is well advised to make sure they comply with all reasonable demands made by the owner for documentation which is required for

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payment pursuant to the terms of the contract.

The next impediment to the use of the prompt pay statute is the statute specifically reads that the payment must be made "except as otherwise agreed in writing."

Thus, the owner can contract around the prompt pay statute and often an innocuous term that is passed over by the original contractor in the verbiage of the contract contains such a provision. It behooves the contractor to look closely at all the terms of the general contract and make sure they are not waiving this important right. Although original and subcontractors often review their own contracts, the necessity of having an attorney do a through review prior to signing a new contract is clear when such terms could affect when you will be paid and whether you can obtain a penalty for failure to promptly pay.

The statutes themselves provide another exception to enforcement of the penalty, the owner's right to withhold from the payment, if a bonafide dispute exists, an amount not to exceed 150% of the disputed amount. The trouble arises two fold with the language used by the statute. First, what is a "bonafide dispute?" If the owner claims the contractor did not supply the paperwork required under the terms of the contract to receive payment can it withhold the entire amount owed and claim it was a "bonafide dispute?" Also, what if there are change orders, does the bonafide dispute provision apply to them?

"Bonafide dispute" is not defined in the statute itself and there has been very little court interpretation of the term. Recently in *Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc.* (2009) 179 Cal. App. 4<sup>th</sup> 1401, a case dealing with the Public Works failure to pay statute, *Civil Code* Section 7101, (which closely parallels the language of the Private Works statute, the Court did

not agree with Martin Brothers argument that the statute only applies to "honest disputes" such as where there is a belief that the work was substandard or where the work was not completed or improperly completed. Nor did the Court agree with Martin's contention that the withholding could not take place when there was a dispute over change order work. The Court broadened the interpretation of what a "Bonafide Dispute" is to include disputes over change orders and additional work.

The Court stated: "The statute contains no language restricting the word 'dispute' to any particular kind of dispute other than it must be 'bona fide.' ... The subject is immaterial to its nature as a dispute. Indeed, in the context of construction litigation, a dispute may arise between a general contractor and a subcontractor concerning any number of subjects, including, but not limited to, nonperformance, improper or substandard performance, the timing of performance, or additional performance of work. ... There may be questions over double billing, excessive billing, or allocation of billing. Thus, the nature or subject of a dispute in construction litigation is open to many possibilities. There is nothing in the language of section 7107(e) that evinces a legislative intent to limit the type of honest dispute that will justify the withholding of retentions." *Id.* at 412.

The *Martin* Court also specifically held that the statute could be altered by contractual terms agreed to by the parties. While *Martin Brothers* dealt with the public works version of the penalty provisions, *Civil Code* Section 7101, it is safe to say that it will be used to address upcoming cases that deal with the same terminology in the private sector code sections.

The prompt pay statutes call for a penalty of 2% per month, however, in *S&S Cummins Corp. V. West Bay Builders, Inc.* (2008) 159 Cal. App.4<sup>th</sup>

765, the Court in an analogous situation dealing with *Civil Code* section 7107(e) held that the penalty is not compounded on a monthly basis but rather on an annual basis.

Further, the Court in *Wm. R. Clarke Corp. V. Safeco Ins. Co.* (1997) 15 Cal 4<sup>th</sup> 882, held that a "pay if paid" clause is unenforceable as contrary to public policy. Thus, an original contractor is left in a rather precarious position whereby a subcontractor could claim entitlement to penalties even though the original contractor has not been paid by the owner. The original contractor should have a provision incorporating all the terms of the contract between the owner and the original contractor into its contracts with subcontractors. Also, the original contractor should always have a contract provision in its contracts with subcontractors that the subcontractors agree to be joined to any lawsuit filed by the original contractor against the owner and any arbitration between the original contractor and owner. Likewise, the original contractor needs to have a provision in its contract with the owner that allows the subcontractors to be joined to any litigation or arbitration between them, so that an inconsistent result does not occur.

We now have both Orange County and Park City Offices. Ashley Baron, a U.S.C. undergraduate and law school graduate, has been a lawyer for the past 29 years. Ms Baron has tried over 100 cases. The firm performs construction, business, labor law and litigation support for developers, prime contractors, material suppliers, subcontractors, banks, title companies and other businesses in Orange, Riverside, San Bernardino and Los Angeles Counties. For further information contact us at (714) 974-1400 or e-mail us at [ashleybaronesq@yahoo.com](mailto:ashleybaronesq@yahoo.com). You can now also go to our web site [www.ashleybaron.com](http://www.ashleybaron.com) to read more about our firm or view our newsletters.