

## **Legal Article – A December 2009 Appellate Case explains Prompt Payment Penalties in California Public Works Construction.**

On December 4, 2009 the California 3<sup>rd</sup> District Court of Appeals certified for publication its decision in Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc., Case No. C058944. This decision held that retention on public works can be withheld for any bona fide or honest dispute, and allows a general contractor to avoid prompt payment penalties by utilizing specific subcontract language which is different than the code requirements.

Martin Brothers Construction ("Martin") was a subcontractor to Thompson Pacific Construction ("Thompson") on a public works project for the Elk Grove Unified School District. Martin finished its work in 2004. The parties subcontract agreement held that payment would not be due until "Subcontractor has furnished all applicable administrative documentation required by the contract documents and the applicable releases pursuant to Civil Code section 3262." See Certified Opinion, pg. 3. Martin did not follow the subcontract procedure in its pay applications, and of course Thompson did not remit full payment, which resulted in litigation. In August 2004 the owner released retention to Thompson who continued to hold Martin's retention due to disputes over change order work. In December 2004 Martin filed a lawsuit against Thompson and its bond surety, at which time it remained unpaid both progress and retention payments. In March 2005 however, the parties negotiated a partial resolution, whereby Martin was to submit lien and bond claim releases in exchange for a final progress and retention payment.

However, despite receiving the late principal payment, Martin continued forward in the litigation and went to trial only to seek prompt payment penalties on the basis that while payment of the progress and retention payment was eventually made in March 2005, the payment was not timely and violated prompt payment statutes. The trial court ruled that Martin was not entitled to prompt payment penalties, and the court of appeals agreed. As a result, 2 rulings of note came out of this case:

### **1. Retention can be Withheld for any Bona Fide or Honest Dispute.**

Martin sought prompt payment penalties for the alleged wrongful withholding of retention funds. Public Contracts Code Section 7107 controls prompt payment penalties relative to retention funds on public construction in California. It holds a general contractor must pay a subcontractor retention funds within seven (7) days of receiving the retention from the public owner. However, Section 7107(e) allows the general contractor to withhold retention from a subcontractor up to 150% of a disputed amount, in the event of a bona fide or honest dispute. Thompson withheld both progress and retention funds due to the dispute regarding change order work.

Martin argued that it should be entitled to prompt payment penalties pursuant to Section 7107 because Thompson withheld the retention over disputes on change order work, instead of a dispute based solely on the retention itself. The courts rejected that argument. Martin essentially argued that Section 7107(e) should only apply to disputes regarding the retention funds themselves, for example disputes on completion issues or possibly punch list items.

The appeals court disagreed as Section 7107 as written, has no limit on the type or nature of the dispute which could be used to justify withholding retention funds. The court simply looked at the language of Section 7107 itself, and gave it a literal interpretation, and held that a prime contractor could withhold from a subcontractor 150% of a disputed amount from retention funds in the event of any bona fide or honest dispute, not just disputes related to retention. This is not a change in the law, just a clarification that the code means what it says. Note, it was not challenged that the dispute was dishonest. In other words, sham disputes could still be challenged to claim prompt payment penalties for the wrongful withhold of retention.

## **2. A Subcontractor could Opt Out of prompt payment statutes by Contract Language.**

Martin sought penalties for the withholding of progress payments relative to its pay applications for disputed change order work. Martin claimed in this case, that progress payments were governed by Business and Professions Code Section 7108.5, which holds that a prime contractor shall pay subcontractors progress payments not later than 10 days after receipt of funds from the owner, "unless otherwise agreed in writing." This phrase in Section 7108.5 is significant in this case.

The Court of Appeals held that the language in the contract of "Subcontractor agrees that payment is not due until Subcontractor has furnished all applicable administrative documentation required by the contract documents and the applicable releases pursuant to Civil Code section 3262" was essentially an agreement that changed the timing for payment, different than the code. This therefore changed the right to recover prompt payment penalties.

Unfortunately for Martin, it did not timely submit conditional lien releases for the disputed amount until the March 2005 negotiated settlement, instead of submitting them all as contractually required with its initial pay applications a year earlier! Thompson essentially argued successfully, that payment was not actually due until the conditional lien releases were tendered, which did not occur until the payment was made in March 2005. Accordingly, Thompson claimed Martin had basically waived its legal right by code to be paid ten (10) days of Thompson receiving progress payment funds as provide by Section 7108.5. The court agreed that Section 7108.5 expressly allowed such a waiver by stating that the 10 day time line was applicably "unless otherwise agreed in writing."

The Appellate Court in its decision stated: "Contrary to the argument of Martin Brothers, this language plainly reflects an intent of the parties to do more than simply follow the statutory guidelines for lien releases in Civil Code section 3262. The subcontractor language is a clear agreement to alter the timing of payments from Thompson Pacific to Martin Brothers...The trial court correctly interpreted the language as a waiver of the payment requirements of section 7108.5" See Certified Opinion, pg. 21-22.

## Conclusion

This decision can be viewed as an important clarification of the impact between prompt payment statutes and a written agreement. This decision can weaken a subcontractor's ability to recover prompt payment statutes, especially the unwary subcontractor. General contractors could seek to include prompt payment opt out provisions in their subcontracts by changing the timing of when payment is due, and continue to have the ability to withhold retention funds for bona fide honest disputes. Despite these important clarifications of the law, the author does not view this decision as a fundamental game changer in construction law.

Martin's cause was hindered on appeal by several factors. First, the court of appeals cited an inadequate and limited record on appeal. Notably, the vast majority of trial exhibits were not on the appellate record, which exhibits could certainly have helped explain the testimony of the parties. The lack of this critical evidence on appeal probably hindered Martin's case. Secondly, Martin apparently failed at trial, and as a result could not raise on appeal, the right to claim prompt payment penalties under both Business and Professions Code Section 7108.5 **AND** Public Contracts Code Section 10262.5. This may have been an important omission, as Section 10262.5 does not have the language of "unless otherwise agreed in writing" anywhere. So while this case held that one can opt out of Section 7108.5, it does not affect or allow one to opt out of Section 10262.5!

In summary, it is very important for your construction law counsel to claim all available remedies when pursuing these types of prompt payment penalties. If you have any questions on this case and its application in the construction industry, please consult with an experienced construction attorney.

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