

IMPORTANT CLARIFICATIONS TO CALIFORNIA PROMPT PAYMENT LAWS

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In the 1990s numerous “prompt payment” statutes were enacted and amended in California. Two recent appellate court decisions have clarified several aspects of these laws, finding that:

1. Unpaid subcontractors are entitled to recover the 2% per month prompt payment penalty on the unpaid sums IN ADDITION TO prejudgment interest (typically 10% per year).
2. A contractor can avoid liability for prompt payment penalties and attorney’s fees, even if the subcontractor ultimately recovers money from the contractor, by showing the existence of a “bona fide dispute” with the subcontractor.
3. The “disputed amount” of withheld funds is to be determined at the time the funds are withheld, not by reference to the amount the contractor contends is in dispute at the time of trial.

In Morton Engineering & Construction, Inc. v. Stanley Douglas Patscheck (2001) 87 Cal.App.4th 712 a contractor on a public school project received the final progress payment, less retention, and then failed to pay the subcontractor the \$31,520 progress payment that was admittedly due under the subcontract within the required 10 days. The reason for non-payment is not clearly stated in the opinion, but was apparently due to problems caused by a subcontractor to the subcontractor. After the contractor was paid the retention funds, he

offered the subcontractor \$42,800 as full and final settlement of all claims on the Project. This sum represented the amount that the contractor admitted was due under the contract, but excluded extra work, interest and penalties. Apparently the contractor never issued any further payments to the subcontractor. At trial the subcontractor recovered \$111,316.73, which included the contract balance, extra work, interest, penalties, attorney’s fees and costs.

On appeal, the court focused on the provisions in Business & Professions Code section 7108.5, which provides (for both public and private projects) that upon receipt of a progress payment, the contractor must pay any subcontractor within 10 days the amount allowed the contractor for work performed by the subcontractor. The contractor may withhold up to 150% of any amount over which a “good faith” dispute exists. A violation of the statute entitles the subcontractor to recover a penalty of 2% per month on the outstanding balance payable. In the event that a legal action is brought, the prevailing party is entitled to recover attorney’s fees and costs.

The court rejected the contractor’s claim that allowing recovery of prejudgment interest (Civil Code section 3287) and the 2 per cent penalty (section 7108.5) would result in a double recovery for the subcontractor. The court, in holding that the subcontractor could recover both, noted that Public Contract Code section 7107, a prompt payment statute for retention payments to contractors and subcontractors on public projects, expressly states that the 2%

penalty is “in lieu of any interest otherwise due,” language not found in section 7108.5.

In Denver D. Darling, Inc. v. Controlled Environments Construction, Inc. (2001) 89 Cal.App.4th 1221, a contractor withheld the subcontractor’s retention in the sum of \$101,580.45 based on a dispute about the levelness tolerances of a concrete floor installed by the subcontractor in a cold storage facility. The trial court, in interpreting the different contract provisions regarding the tolerances for the concrete floor, held that

[T]here was no meeting of the minds between plaintiff and defendant as to what the contractual specification was for the suspended dock floor. Therefore, the plaintiff did not breach the contract by failing to perform to the defendant’s interpretation ... As such, it cannot be said that the plaintiff or defendant breached the contract.

The trial court found that both parties’ interpretation of the contract was reasonable, and further found that the floor met an industry standards tolerance. Ultimately the trial court awarded the subcontractor the full amount of the withheld retention, but refused to award a penalty and attorney’s fees under Civil Code section 3260 (prompt payment of retention to contractors and subcontractors on private projects).

On appeal the subcontractor argued that it was entitled to recover the penalty and attorney’s fees because section 3260 essentially allows any subcontractor who sues and recovers retention money to also recover its attorney’s fees, in other words, that section 3260 provides for an award of attorney’s fees to the party entitled to the retention without regard to whether or not a bona fide dispute existed. The court rejected this argument, stating that “attorney’s fees are to be awarded only in cases in which the retention payments are not made within the required time

periods, i.e., where a bona fide dispute does not exist,” and that “the 2 percent penalty and attorney’s fees are directed at the more egregious situation in which a contractor withholds payment of retention proceeds beyond specified time periods and without cause.”

However, the court of appeal found that the subcontractor was entitled to recover the penalty and attorney’s fees because the contractor withheld more than “150 percent of the disputed amount” as provided in section 3260. The evidence indicated that the contractor had written to the subcontractor in February 1998 and represented that it had estimated the cost of corrective work in June 1997 to be \$32,394. The contractor withheld the entire \$101,580 retention, more than 150% of the estimated cost of corrective work. At trial, the contractor contended the corrective work would cost \$200,000 to \$300,000.

The court held that the “disputed amount” in section 3260 refers to the amount in dispute at the time the retention proceeds are withheld, which in the case of payments to the subcontractors is 10 days after the contractor receives the retention payments from the owner, stating: “Any sums withheld in excess of 150 percent of the ‘estimated value of the disputed amount’ are thus not subject to a bona fide dispute, and are ‘improperly withheld’ beyond the applicable time period.” In such a case, the prevailing party is entitled to recover its attorney’s fees. The Darling court remanded to the trial court the issue of entitlement to attorney’s fees and, presumably, the 2% per month penalty.

While these cases provide important clarifications to the prompt payment laws, they also underscore the critical importance of proper and thorough documentation by the contractor when it makes a decision not to pass through a progress or retention payment to the subcontractor. The penalties if the contractor is

unable to establish its “good faith” or a “bona fide” dispute are a whopping 34% per year (2% per month plus statutory interest of 10% per annum) plus payment of the attorney’s fees and costs for both sides. On the positive side, the reasoning of the Morton and Darling decisions applies with equal force to payments by owners to contractors, making the 34% and attorney’s fees recoverable by the contractor from the owner when an owner violates the prompt payment statutes.

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