

A Recent Appellate Court Decision Significantly Impacts A Subcontractor's Means for Recovering California Prompt Payment Penalties

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On December 4, 2009 the California Third District Court of Appeals published its decision in *Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc.* This decision will impact California's prompt payment penalty statutes because it allows a prime contractor to avoid prompt payment penalties by including language in its subcontract that conditions payment on the receipt of lien release and other requirements. This decision also appears to expand the ability of prime contractors to withhold retention funds without being subject to prompt payment penalties.

As most contractors are aware, California has enacted prompt payment statutes. The statutes are intended to penalize parties that fail to pay contractors within a determined period. The statutes, however, contain certain exceptions. Generally, the non-paying party can withhold up to 150% of any disputed payment.

While the prompt payment statutes may ultimately require you to institute legal action to recover the penalties, they are significant threats to non-paying parties. It is a good practice to recite the appropriate statute in any collections demand letter. The threat of a 2% penalty and attorney's fees may be sufficient to convince a non-paying party to pay the amount owed.

In this case Martin Brothers Construction ("Martin") was a subcontractor to Thompson Pacific Construction ("TPC") on a public works project. During the project Martin submitted to TPC several change requests seeking payment for disputed items. These change orders had not yet been resolved by the time Martin completed its work in March 2004. At that time Martin submitted a pay application for the change orders it was seeking and its retention. TPC and Martin agreed in their subcontracts "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." Martin apparently did not submit conditional lien releases for these funds along with the pay application. TPC did not pay either the change orders or retention at that time. In August 2004 the owner released retention to TPC, who continued to hold Martin's retention.

Thereafter the parties continued to negotiate the changes orders and a final payment amount. In December 2004 Martin filed a lawsuit against TPC and its bond surety. In March 2005 the parties reached an agreement whereby Martin was to submit lien and bond claim releases in exchange for an agreed amount which would constitute a final payment. Thereupon Martin submitted the conditional lien releases and received the agreed funds.

However, their dispute was not concluded at that juncture. Martin continued forward in the litigation and went to trial to seek prompt payment penalties on the basis that while payment of the progress payments and retention were eventually made (by way of the March 2005 payment), they were not timely made and the funds wrongfully withheld in violation of the prompt payment statutes.

The trial court ruled that Martin was not entitled to prompt payment penalties for the reasons discussed below, and Martin appealed. The appeals court agreed with the trial court and denied Martin prompt payment penalties. In doing so the court discussed the penalty claims relative to progress payments and retention separately. Each discussion yielded a noteworthy holding.

1) Progress Payments: Subcontractor's may be "opting out" of the protections of prompt payment penalty statutes when they agree in subcontracts that progress payments are not due until conditional lien releases are submitted.

Martin sought penalties for the withholding of progress payments relative to its pay applications for the disputed change orders. Prompt payment penalties relative to progress payments are governed by Business and Professions Code §7108.5, which provides 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".

Importantly, the Court held that the language in the contract that stated "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 and thus the right to recover prompt payment penalties.

Unfortunately for Martin, it never bothered submitting conditional lien releases for the disputed amount until the March 2005 agreement for payment was reached many months after the change order disputes arose. TPC argued that no penalties should be imposed because no actual "withholding" of progress payments occurred. TPC asserted that the funds in question never actually became due until the conditional lien releases were tendered, which did not occur until the payment was made in March 2005.

In essence TPC was arguing by agreeing in the subcontract that payment was not due until conditional lien releases had been submitted Martin had "waived" its right to be paid within 10 days of TPC receiving progress payment funds as provide by Section 7108.5. TPC pointed out that Section 7108.5 appeared to allow such waiver by stating that the 10

day timeline was applicably "unless otherwise agreed in writing." TPC argued that it and Martin had effectively done so.

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 language of the subcontracts that provides for monthly progress payments of "95% of labor and materials which have been placed in final position and for which the right to payment has been properly documented pursuant to the terms of this agreement" is consistent with this expressed intent to alter the timing of progress payments. The trial court correctly interpreted the language as a waiver of the payment requirements of section 7108.5."

2) Retention: A prime contractor may withhold retention from a subcontractor in the event of any bona fide dispute, even if the dispute is unrelated to retention funds.

In addition to seeking prompt payment penalties for the withholding of progress payments, Martin sought penalties for the withholding of retention funds. Public Contract Code §7107 governs prompt payment penalties relative to retention funds on public projects. It provides that a prime contractor must pay a subcontractor retention funds within seven (7) days of receiving the same from the public entity. But, subsection (e) allows a prime contractor to withhold from retention funds up to 150% of a disputed amount in the event of a bona fide dispute. In this case TPC withheld from Martin progress payment and retention funds after the change order disputes arose.

Martin argued that it should be entitled to prompt payment penalties pursuant to Section 7107 because TPC withheld retention funds because of disputes over change orders, which it argued was unrelated to retention. Martin's argument was consistent with the customary usage of retention, which is to ensure the satisfactory completion of work. Martin was arguing that so long as its work was completed satisfactorily (as apparently it was here) that retention should be released, regardless of whether or not there were still disputes about the compensability of change orders. To wit, Martin asserted that the withholding provision in subsection (e) should only apply to disputes regarding retention funds, such as disputes over punch lists, completion of work issues, or workmanship problems. In turn, Martin asserted that a prime contractor should not be able to withhold retention when the dispute arises from only non-retention related issues, such as change orders (as was the case here).

The appeals court disagreed. It noted that while the Section 7107 itself concerned retention funds, it expressed no limit regarding the nature of a dispute which could be used justify a retention funds withholding pursuant to subsection (e). The court noted that a contrary rule would be too difficult to apply because construction disputes are often difficult to characterize. As such, the court held that a prime contractor could withhold from a subcontractor 150% of disputed amount from retention funds in the event of a

dispute of any nature, regardless of whether or not the dispute was related to the retention itself.

Conclusion

The Martin decision is a significant development in the law of prompt payment penalties, although its impact is not yet certain. One thing does seem clear though: Martin decision weakens subcontractor's hands relative to prompt payment. Prime contractors (or owners) may now seek to include expanded prompt payment "opt out" provisions in their subcontracts and use these provisions to justify payment withholdings from contractors who are not diligent in submitting lien releases and/or other conditions to payment. Likewise, prime contractors may expand the practice of withholding retention funds as a matter of course whenever any disputes remain after the project has completed.

82009, William C. Last, Jr. wrote this article. Mr. Last is an attorney who has been specializing in Construction Law for over 30 years. In addition to belonging to a number of construction trade associations, Mr. Last holds a California AA@ and AB@ license. He can be contacted at 415-764-1990 or 650-696-8350. A number of his past articles can be found on his website (lhfconstructlaw.com). This bulletin is published periodically to provide general information about current legal issues. The articles are not intended to be a substitute for the advice of an attorney as to a specific problem. If you have a specific legal question or need legal advice, you should contact an attorney.

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