



Education Law Alert

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California 2nd Appellate District Court Interprets Public Contract Code Section 7107 to Limit Public Agency's Right to Withhold Retention Only as Security for Stop Notice Claims and Deficiencies in Contract Performance

The California Court of Appeal in *East West Bank v. Rio School District* (2015) (2015 DJDAR 3677) recently ruled that the grounds for public agencies to withhold retention funds under Public Contract Code section 7107 prompt payment requirements are limited. The Court held in part, "Public Contract Code section 7107 allows a public entity to withhold funds due to a contractor when there are liens on the property or a good faith dispute concerning whether the work was properly performed."

Statute at Issue

Public Contract Code section 7107(c) requires payment of retention within sixty days of project completion unless there is a "dispute between the public entity and the original contractor," in which case "the public entity may withhold from the final payment an amount not to exceed 150 percent of the disputed amount." Subdivision (f) provides a two percent per month penalty on any amount improperly withheld, plus attorney fees and costs.

Entitlement to Section 7107 Penalties

The Rio School District withheld retention even after all stop notice claims had been released, because of a contract price dispute. Notably, the District did not assert that there were (1) any further liens or (2) any defective work by the contractor [as the basis for withholding retention]. Rather, the dispute related to the contractor's claim for a contract price adjustment for extra work. The court found the District's grounds for

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withholding retention funds, i.e., a contract price dispute for extra work, was not an allowable basis under section 7107.

In so holding, the court declined to follow *Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc.* (2009) 179 Cal.App.4th 1401, which involved a dispute between a contractor and a subcontractor that asserted claims under section 7107(d). In *Martin Brothers*, the subcontractor asserted claims for additional monies owed due to change orders. The subcontractor sought the section 7107(f) two percent per month penalty against the contractor, for its failure to timely release retention funds. Holding the subcontractor was not entitled to the penalty, the *Martin Brothers* court concluded the section 7107(e) "bona fide dispute" exception "applies to any good faith dispute between a general contractor and subcontractor." (*Martin Brothers, supra*, 179 Cal.App.4th at 1414 (emphasis added).)

The *East West Bank* court declined to follow *Martin Brothers*. The court reasoned, "the purpose of section 7107 is to deter public entities from improperly withholding retention payments," and "section 7107's purpose of ensuring the prompt release of retention funds would not be served if any dispute justified retaining the funds." The Court of Appeal further pronounced, "[t]here is no reason to allow the public entity to retain funds once their purpose of providing security against [stop notices] 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." project.

Attorney Fees

Because of the wrongful withhold, the trial court awarded the contractor \$3.85 million in attorney's fees, which included a 10% lodestar factor. The trial court justified the award because the District had raised the unclean hands defense to the contractor's claims, including its section 7107 claim, and the trial court agreed with the contractor the claims had become "inextricably intertwined." The Court of Appeal disagreed, explaining that because "section 7107 is intended to protect one class of persons (public works contractors) from the activities of another (public entities)," the unclean hands doctrine did not apply as a matter of law. As a result, the Court of Appeal found the section 7107 claims were not inextricably intertwined with the other issues and claims in the case and rejected the contractor's contention that "no apportionment is required for fees incurred for representation on an issue common to a cause of action in which fees are appropriate and one in which fees are not allowed." (Citing *Thompson Pacific, Inc. v. City of Sunnyvale* (2007) 155 Cal.App.4th 525, 555.) Accordingly, the Court of Appeal remanded the case directing the trial court to reduce the attorney fee award to those fees relating solely to the section 7107 prompt payment cause of action.

Contractual Notice Provisions

The *East West Bank* decision also validates and reinforces the need for contractors to comply with contractual claims procedures and written notice provisions. The two contract claims notice provisions at issue required written notice within the specified time, and provided that untimely notice would forfeit those claims. The trial court held that the contract notice

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provisions applied only when the untimely notice prejudiced the District, reasoning, "the law abhors a forfeiture ... the forfeiture clauses are so one-sided as to be unconscionable, and the contract is one of adhesion."

Overturing the trial court's refusal to enforce these "material provisions of the contract," the *East West Bank* Court explained: "The problem with the trial court's reasoning is that the contract clauses are authorized by statute." (Citing Government Code section 930.2.) "Far from being unconscionable, contractual claims procedures contained in public works contracts serve the same purpose of government claims statutes." (Citing *Arntz Builders v. City of Berkeley* (2008) 166 Cal.App.4th 276, 289.) The Court of Appeal ruled: "The trial court erred in adding the requirement of a showing of prejudice to the contractual claims provisions. The contract must be enforced according to its terms."

Impact

The holdings in this case provide a cautionary tale for both public agencies and contractors:

1. Public agencies must comply with prompt payment requirements, and be cautious to withhold retention funds solely on the two grounds authorized in section 7107: liens and/or deficiencies in a contractor's performance, and not for disputes over contract price or contractor claims for extra time or money.
2. Contractors must strictly adhere to contract claim provisions, including providing timely written notice of claims, when necessary, or else risk waiving those claims.
3. All litigants should understand that attorney fee awards to the prevailing party, pursuant to section 7107, are limited to those fees associated with the section 7107 claims, unless they can demonstrate that the section 7107 claims share common issues of fact and law and are "inextricably intertwined" with the other disputed claims.