



Past Due

Appellate courts appear to be limiting the reach of construction prompt payment laws

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With private construction at its slowest pace in years and public construction wavering as government budgets are cut, contracting parties in the construction industry are learning the importance of how they label payments. A payment may look like a progress payment—which by law is required to be paid within a specified number of days—or it may seem to be a retention—which by law is required to be paid upon completion of work. California has a collection of laws known as the prompt payment statutes that are supposed to guarantee that contractors and subcontractors will be paid promptly for the work they perform. Nevertheless, California courts of appeal have news for contractors: If they do not carefully and precisely name payments and spell out when and under what circumstances payments are due, contractors may not be able to obtain the penalties and interest otherwise available when payments are late.

Payments are always an issue in construction projects, and this is especially so in tough economic times. The speed of the flow of money from lender to owner to contractor becomes slower as the ability to borrow tightens. Profit margins shrink as contractors and subcontractors cut their bids in order to compete for what work is available. Everyone in the payment chain wants to hold on to cash for as long as possible, with the result that many smaller contractors and subcontractors complain that they are being forced to wait longer and longer for payments that should have been made more promptly. They in turn cannot pay their employees or for supplies—and in today's financial climate, borrowing may not be an option. But recent state appellate decisions have cut back on the protections that the prompt payment statutes were meant to provide.

The current economic downturn in the construction industry is similar to the losses it endured in the 1980s, with smaller contractors and subcontractors bearing the brunt of the pain. The industry had fallen into the practice of slow payments in both public and private construction arenas. Prior to the 1990s contractors and subcontractors had limited remedies at their disposal when progress payments or retentions were withheld. Contractors complained that owners would hold retentions for open-ended periods of time. Subcontractors complained that they did not receive progress payments on time.

Generally the terms of payment to contractors and subcontractors in California were determined by the contract or subcontract documents. The party with the greatest leverage—generally an owner vis-à-vis a contractor or a contractor vis-à-vis subcontractors—was able to draft contractual provisions providing for slow progress payments and large retentions. During lean times with tight credit, subcontractors were forced to obtain loans in order to manage cash flow, especially when retentions were held for a long time and, as is often the case in depressed markets, when the retention equaled or exceeded their profits. It had become commonplace for owners to withhold money from general contractors and general contractors to withhold money from subcontractors—and then dare the other party to sue.

Legislative Response

In 1990, following a period of losses and bankruptcies, the California Legislature took action and passed Senate Bill 2515, the first of a series of prompt payment statutes designed to provide meaningful protection to contractors and subcontractors. The legislative history of Senate Bill 2515 makes clear that the lawmakers recognized a problem in need of a remedy: “Slow payment or nonpayment to subcontractors is one of the more serious problems facing the construction industry.”ⁱ Senate Bill 2515, codified as Civil Code Section 3260, requires prompt payment of retentions by owners and general contractors on private works construction. Two years later, the legislature established Public Contracts Code Section 7107 to extend the protections of the prompt payment requirements to public works construction. The section requires a public entity to pay retention to the original contractor within 60 days after the date of completion. Further, original contractors must pay subcontractors their retention within seven days from the receipt of funds from a public entity.

The legislature followed these enactments with a number of other statutes:

- Civil Code Section 3260.1 requires owners to pay prime contractors progress payments within 30 days of a contractor’s request for payment.
- Business and Professions Code Section 7108.5 requires prime contractors or subcontractors to pay all tiers of subcontractors within 10 days of receipt of funds by contractors for private projects. Public Contract Code Section 10262.5 makes the requirement applicable to contractors and subcontractors in public works construction.
- Public Contract Code Section 10261.5 requires that state agencies pay the prime contractors within 30 days after a payment request or engineer submittal.
- Civil Code Section 3320 requires any public entity to pay a design professional within 30 days of the design professional’s demand if it is for a progress payment and within 45 days if retention is due. Civil Code Section 3321 requires a design professional to pay both progress and retention payments to the design professional’s subconsultants within 15 days after receipt from the public agency.
- Public Contract Code Section 7200 limits the amount of retentions that may be withheld in public works construction.

These prompt payment statutes, among others, prescribe remedies for late payment in the form of penalties in addition to interest in some cases, penalties in lieu of interest in other instances, and often costs of suit and attorney's fees to the prevailing party. California's contractors and subcontractors would seem quite well protected when it comes to being paid promptly.

Prompt payment statutes are common around the country. Also, in 1982 Congress passed a federal prompt payment actⁱⁱ partly as a result of a General Accounting Office report finding that government agencies were late in paying 30 percent of their bills. All states, with the exception of New Hampshire, have some form of prompt payment legislation applicable to government contracts; many states also have prompt payment laws that apply to private construction. California seems to have more prompt payment statutes in place than any other jurisdiction. However, at a time when contractors and subcontractors need them the most, the protections of these statutes are proving illusory in many cases.

Recent Appellate Decisions

The California Legislature enacted prompt payment statutes to ensure that contractors and subcontractors will be paid promptly for the work they perform. Three recent state appellate court decisions, however, have interpreted the prompt payment statutes in a manner that restricts the applicability of their provisions.³ⁱⁱⁱ In each case, the court's interpretation, while arguably defensible in terms of strict statutory construction without reference to legislative history, is at odds with the original intention of the prompt payment legislation.

In *Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc.*, the Third District Court of Appeal dealt a blow to two of the statutory protections encompassed under the prompt payment statutes.^{iv} First, the court held that the statutory exception allowing a contractor to withhold retention when there is a "bona fide dispute" did not apply only to a bona fide dispute relating to the contract payments. Rather, the court held that a contractor could withhold retention after the subcontractor raised a dispute relating to change orders outside the contract, even though the contractor had no dispute regarding the work performed under the contract.^v Second, the court affirmed the right of contractors to include language in the subcontract that amounted to a waiver of certain protections of the prompt payment provisions.^{vi}

In that case, the plaintiff subcontractor, Martin Brothers Construction, brought an action against a general contractor, Thompson Pacific Construction, and against the general contractor's surety and bonding companies. Martin Brothers sought penalties, interest, and attorney's fees for late progress and retention payments for work on a public works project. The subcontract provided that Thompson would make monthly progress payments to Martin Brothers, minus a retention. Also, the subcontract contained a provision that neither the progress payments nor the withheld retention would be paid until Martin Brothers had furnished specified documentation, including lien releases, certified payroll, union letters, and proof of insurance. For final payment of the previously withheld contract retention, the subcontract required additional releases.

Martin Brothers did not provide the specified documentation promptly, and Thompson Pacific accordingly did not pay Martin Brothers within the statutory time limits. Moreover, at the conclusion of the project, the contractor withheld the retention amounts—even though it acknowledged that all the contracted work had been performed—based on disputes between the parties involving change orders for additional work. Martin Brothers made claims under both Business and Professions Code Section 7108.5 (progress payments) and Public Contract Code Section 7107 (retention payments).

Under Public Contract Code Section 7107, the failure of a contractor to pay a subcontractor within seven days of a contractor being paid by the public entity allows the subcontractor to receive a penalty payment of 2 percent per month on the amount withheld. The subcontractor also is entitled to attorney's fees.^{vii} The section expressly states that any waiver of this requirement is void as against public policy.^{viii} Nevertheless, Section 7107(e) contains an exception: "The original contractor may withhold from a subcontractor its portion of the retention proceeds if a bona fide dispute exists between the subcontractor and the original contractor. The amount withheld from the retention payment shall not exceed 150 percent of the estimated value of the disputed amount."^{ix}

The court in Martin Brothers Construction recognized that Section 7107 "serves a remedial purpose: to encourage general contractors to pay timely their subcontractors and to provide the subcontractor with a remedy in the event that the contractor violates the statute."^x Nonetheless, the court refused to construe Section 7107 liberally in light of this remedial purpose and limit withholding of contract retention proceeds due to a bona fide dispute related to the contract work. The court held instead that the word "dispute" in Section 7107 was not limited to any particular kind of disputes other than those that are bona fide. Accordingly, the court deprived the subcontractor of the right to prompt payment of the contract retention, notwithstanding the fact that the contractor had no dispute regarding the subcontractor's performance on the contract.

The court also addressed the meaning of the phrase "unless otherwise agreed to in writing" as a qualification to the rule in Business and Professions Code Section 7108.5 requiring prompt payment of progress payments. Section 7108.5 provides that a "prime contractor or subcontractor shall pay to any subcontractor, not later than 10 days of receipt of each progress payment, unless otherwise agreed to in writing, the respective amounts allowed the contractor on account of the work performed by the subcontractors, to the extent of each subcontractor's interest therein." The trial court and court of appeal found that Thompson Pacific and Martin Brothers had "otherwise agreed" to a different time of payment. Thus the parties had "opted out" of Section 7108.5 by the provision in the subcontract 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."^{xi} The court interpreted the language of Section 7108.5 to permit contractors and subcontractors to waive the payment requirements otherwise provided for in that statute, perhaps even indefinitely.

It is true that Section 7108.5 permits parties to “otherwise agree[] in writing.” The parties may wish to agree to lump sum payments upon conclusion of certain construction milestones, for example. However, the court of appeal’s holding in *Martin Brothers Construction* has now opened the door for contractors to incorporate language into subcontracts under Section 7108.5 that authorizes indefinite delay. Although several of the prompt payment statutes expressly prohibit waiver of the protections as against public policy, Section 7108.5 does not contain such an express prohibition.

Final Payment or Progress Payment

In *Murray’s Iron Works, Inc. v. Boyce*,^{xii} the Sixth District Court of Appeal dealt with the question of whether a final payment, due at the conclusion of the work, was covered by Civil Code Section 3260.1, which provides for prompt payment of progress payments. According to Section 3260.1(b), “Except as otherwise agreed in writing, the owner shall pay to the 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.” Civil Code Section 3260(g) further provides that the remedy for failing to make a progress payment when due is the same remedy as provided under Section 3260 covering retentions—namely, a charge of 2 percent per month on the improperly withheld amount, in lieu of any other interest, as well as attorney’s fees and costs to the prevailing party.^{xiii}

The contract in *Murray’s Iron Works* provided that payment would be made “50% Deposit/Net upon Satisfactory Completion of Project.” Upon completion, the owner paid less than half of the outstanding amount (\$50,000 of \$116,222) and raised a claim of breach of contract as a result of the contractor providing decorative ironwork containing imitation gold leaf rather than 22-carat gold leaf. Contending that imitation gold leaf was agreeable to the parties as an acceptable finish, the contractor sued under Civil Code Section 3260.1 for the remainder of the final payment.

In construing Section 3260.1, the court stated, “Since the payment was not due until the project was completed, it is considered a final payment and not a progress payment.”^{xiv} While the term “progress payment” is not defined anywhere in the Civil Code, the Business and Professions Code defines “progress payments” as “any payments, other than the down payment,...made before the project is completed.”^{xv} Sections 10853(e)(1) and 20104.50 of the Public Contracts Code define “progress payments” as “all payments due contractors, except that portion of the final payment designated by the contract as retention earnings.” From these analogous sources, the court of appeal in *Murray’s Iron Works* reasoned that at least part of a final payment could be deemed a progress payment.

Nevertheless, the court came to the “logical conclusion” that inasmuch as a final payment is to be made after all work is completed, that payment cannot be a progress payment because “there is nothing left on which to stop work.”^{xvi} The contractor may have thought that its final progress payment was protected under the

prompt payment provisions of Section 3260.1, but by failing clearly to name that payment a progress payment, the contractor lost its remedy.^{xvii}

The Second District Court of Appeal also addressed the final payment issue in *Yassin v. Solis*.^{xviii} Following *Murray's Iron Works*, the *Yassin* court agreed that a final payment was not a progress payment. Moreover, the court held that the final payment also was not a retention payment under Section 3260: "The remedy for the failure to pay a last installment payment upon completion of the services is simply damages for a breach of contract."^{xix}

Yassin, a contractor, was hired by the Solises to do improvement work on their home. The contract for \$75,000 provided for a down payment and additional payments at various stages of construction, including \$15,000 after the final inspection and a final payment of \$7,500 due upon the issuance of the certificate of occupancy. The trial court awarded *Yassin* nothing on his claim and awarded the Solises \$50,000 on their cross-complaint for deficient work. In addition, the trial court awarded the Solises attorney's fees on the theory that they had prevailed on *Yassin's* claim for the final \$7,500 payment—which the trial court deemed to be a retention under Section 3260. The court of appeal reversed the award of attorney's fees on the ground that the final payment was not a retention payment, and thus Section 3260 was not applicable.

In reaching this result, the *Yassin* court reasoned that the last payment did not constitute "retention proceeds withheld from any payment" but was instead merely a final payment. The court stated, "Retention amounts are a form of security generally retained by the owner from prior payments due for work previously performed."^{xx} The final payment is just that, a final payment, and not an amount that has been previously withheld, unless the contract specifies that sums were being withheld during the course of the work. The trial court had recognized that the final payment of \$7,500 was 10 percent of the total contract price, which is the amount usually withheld by the owner, and had deemed the final payment to be a retention because it was not to be paid until the work was approved. While noting that this position was "tenable," the court of appeal rejected it, apparently because the contract did not name the final payment a retention.

As if to confirm the confusion and inconsistencies inherent in the collection of prompt payment statutes, the Second District followed its decision in *Yassin* with another (and rather complicated) analysis of Civil Code Sections 3260 and 3260.1 in *Heinerfeld-Ward, Inc. v. Lipian*.^{xxi} At issue in that case was whether the contractor was entitled to an award of attorney's fees under Section 3260.1 as a result of the owner's withholding of progress payments.

The court's analysis demonstrates the tangled thicket that the prompt payment statutes have become:

As we have seen, section 3260.1, subdivision (b) provides for recovery of the "penalty" specified in section 3260, subdivision (g), but that statute does not use the term "penalty." In contrast, other prompt pay statutes cited by the parties expressly characterize a monthly charge imposed on withheld amounts as a "penalty." The characterization of the monthly two percent charge in section 3260, subdivision (g) as "in lieu of interest" rather than as a "penalty" reflects a legislative choice to distinguish that statute from other prompt pay statutes. Had the Legislature

employed the term “penalty” in section 3260, subdivision (g) to describe the two percent charge, the statute would not be ambiguous and no resort to other interpretive aids would have been required.

The court despaired of finding clarity in the statutes and turned to legislative history for support for its conclusion that both the 2 percent monthly interest payment and the prevailing party attorney’s fees were intended to be the “penalty” within the meaning of Section 3260.1.

Naming Payments

What is evident from these cases is that judges are reading the prompt payment statutes narrowly and cautiously. Construction disputes traditionally are more apt to find their way into arbitration, and as a result the published case law on payment issues is relatively slim. The court in *Martin Brothers Construction* refused to take judicial notice of the legislative history that would have explained the purpose of the prompt payment laws, stating that the language of the statutes was clear enough for the court to interpret without the need for outside resources.^{xxii} Likewise the courts in *Yassin* and *Murray’s Iron Works* relied upon a careful parsing of the statutory language and compared that to the contract provisions at issue.

For counsel drafting construction contracts, the lessons from these recent cases is the importance of carefully naming payments. This includes not only defining what each payment is but also denoting the preconditions to payment and when payment is due. Progress payments and retention payments have specific statutory protections, but these payments must be clearly specified. If a payment due at the end of construction is one last “progress payment” (albeit at the end of the progress), it should be identified clearly as a “progress payment” or the “final progress payment.” If the final payment is payment of the retention, it should be named “payment of the retention.” Cats may have three names, as T.S. Eliot has written,^{xxiii} but payments under construction contracts are better off having only one name—and a very specific one at that.

Owners have the greater bargaining power in the current economic climate, but counsel for contractors should be able to specify and clarify the conditions that must be met before payments are made. If lien releases or other documentation are required, the contract should specify that payments are to be made within a certain number of days after the documentation has been provided, in order to avoid an indefinite delay. With regard to retention against disputes, the contract should clarify the disputes against which the retention is being withheld. Owners and contractors both benefit from contract terms that are clear and explicit.

California’s prompt payments statutes reflect a legislative determination that contractors and subcontractors should be paid promptly for their work. In scaling back these protections in *Martin Brothers Construction*, *Murray’s Iron Works*, and *Yassin*, the courts of appeal did not dispute this remedial statutory purpose but nonetheless applied rules of strict statutory construction. Assuming that the construction industry believes that prompt payment statutes are still needed, the time is now for all parties involved in the industry to propose that the legislature create a uniform statutory scheme. This would replace the current disparate and

inconsistent statutes and directly address the issues presented by the recent appellate opinions as well as future decisions that may further restrict California's prompt payment remedies.

ⁱ Enrolled Bill Report, SB 2512, at 2 (1990).

ⁱⁱ 31 U.S.C.A. §§3901 et seq. (amended 1988).

ⁱⁱⁱ Yassin v. Solis, 2010 Daily J. D.A.R. 6720 (2d. Dist., May 6, 2010); Martin Bros. Constr., Inc. v. Thompson Pac. Constr., Inc., 179 Cal. App. 4th 1401 (2009); Murray's Iron Works, Inc. v. Boyce, 158 Cal. App. 4th 1279 (2008).

^{iv} Martin Bros. Constr., 179 Cal. App. 4th at 1414, 1416-17.

^v Id. at 1414.

^{vi} Id. at 1416-17.

^{vii} Pub. Cont. Code §7107(f).

^{viii} Pub. Cont. Code §7107(h).

^{ix} Pub. Cont. Code §7107(e) (emphasis added).

^x Martin Bros. Constr., 179 Cal. App. 4th at 1410 (citations omitted).

^{xi} Id. at 1415.

^{xii} Murray's Iron Works, Inc. v. Boyce, 158 Cal. App. 4th 1279 (2008).

^{xiii} Civ. Code §3260(g).

^{xiv} Murray's Iron Works, 158 Cal. App. 4th at 1294.

^{xv} Bus. & Prof. Code §7159.

^{xvi} Murray's Iron Works, 158 Cal. App. 4th at 1298.

^{xvii} The contractor still has its breach of contract remedy, but it lost the right to collect interest of 2 percent per month plus costs and attorney's fees.

^{xviii} Yassin v. Solis, 2010 Daily J. D.A.R. 6720 (2d. Dist., May 6, 2010).

^{xix} Id. at 6725.

^{xx} Id. at 6723.

^{xxi} Heinerfeld-Ward, Inc. v. Lipian, 2010 WL 3431831 (Sept. 1, 2010).

^{xxii} Martin Bros. Constr., Inc. v. Thompson Pac. Constr., Inc., 179 Cal. App. 4th 1401, 1410 n.4 (2009).

^{xxiii} "The Naming of Cats is a difficult matter,/ It isn't just one of your holiday games;/ You may think at first I'm as mad as a hatter/ When I tell you, a cat must have THREE DIFFERENT NAMES." T.S. Eliot, "The Naming of Cats," Old Possum's Book of Practical Cats (1939).