

Construction Law Newsletter

SITTING ON THE SUBCONTRACTOR'S CHECK MAY RESULT IN A HUGE PAIN IN THE . . . WALLET

Winter 2004

In the past ten years, the California Legislature has stepped up its efforts to put more sting into the "prompt payment" laws to deter or, as discussed below, penalize a contractor that wrongfully withholds payments due its subcontractors.

Section 7108.5 of the Business & Professions (B&P) Code is one of the prompt payment laws that the Legislature amended to penalize contractors that carelessly withhold progress payments due their subcontractors. Until 1990, this statute allowed only for a disciplinary action by the Contractors State Licensing Board (CSLB) against a contractor that wrongfully withheld progress payments from its subcontractor. In 1990, however, the Legislature amended B&P § 7108.5 to create a monetary penalty and to provide for recovery of attorney's fees in a suit to collect the wrongfully withheld funds. In 1996, the Legislature further amended this statute to clarify that the monetary penalty was to be paid by the withholding contractor *directly* to the subcontractor.

In its present form, B&P § 7108.5 provides that the contractor shall pay all progress payments (less agreed retention, if any) due its subcontractor within ten (10) days of receipt of those funds. If the contractor disputes the amount of payment due the subcontractor, the statute allows the contractor to withhold up to 150% of the disputed amount without penalty. If, however, there is no good faith dispute over the amount due, or if the contractor

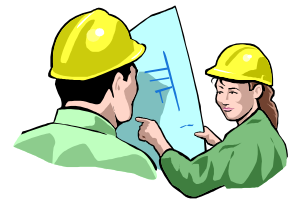
withholds more than 150% of the disputed amount, the funds wrongfully withheld are subject to a two percent (2%) penalty for each month the funds are not paid. Additionally, in a suit to collect the wrongfully withheld funds, the statute provides that the prevailing party is entitled to recover its attorney's fees and costs. B&P § 7108.5 allows the contractor and subcontractor to adjust the timing of the progress payment through their contract but the contracting parties cannot waive the protections (or penalties) provided by the statute. This statute also governs subcontractor payments to lower-tier subcontractors.

Although the primary purpose of B&P § 7108.5, like other prompt payment laws, is to deter the wrongful withholding of payments received by the contractor for the subcontractor, the sole purpose of the added 2% per month recoverable under this section is to punish the contractor for its wrongful conduct. In other words, recovery of the 2% per month penalty on the wrongfully withheld funds is in addition to an award of statutory prejudgment interest (or contractual interest, if available) or the percentage markup allowed under other prompt payment statutes (e.g., Civ. Code § 3262.5).

The *Morton Engineering & Construction, Inc. v. Patscheck*, 87 Cal. App. 4th 712 (2001) case involved a subcontractor's suit against a general contractor to collect progress payments and retention due the

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Sitting on The Subcontractor's Check ...

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subcontractor for work on a public school project. The trial court awarded the subcontractor \$111,316.73, which included an award of prejudgment interest, attorney's fees and costs, and the 2% monthly penalty under B&P § 7108.5. The general contractor appealed, arguing that recovery of B&P § 7108.5 penalties could only be through a disciplinary proceeding by the CSLB, and that allowing recovery of interest and penalties provided the subcontractor with a double recovery. The court did not agree. In affirming the judgment, the appellate court held that the 1990 and 1996 amendments to B&P § 7108.5 allow for recovery of penalties in a civil action or a disciplinary hearing before the CSLB. The court also found there was no double recovery because both statutory intent and public policy supported these separate recoveries. The court explained: "Prejudgment interest is intended to compensate the subcontractor for the loss of use of the funds. [citations]. The 2 percent penalty is intended to penalize the contractor for failing to comply with statutory requirements. To preclude recovery of both the 2 percent penalty and prejudgment interest would defeat the purpose of the statute and reduce the impact of the 2 percent penalty."

As shown in the *Morton* case, the penalties under B&P § 7108.5, when added to interest on the wrongfully withheld funds and attorney's fees, can turn a small amount held back into a handsome recovery.

Accordingly, a word of caution to contractors casual in withholding funds due their subcontractors — if there is a dispute as to the amount due a subcontractor, follow these three guidelines: (1) hold back no more than 150% of the disputed amount; (2) establish in writing that there is a good faith dispute regarding that payment; and (3) document the details of the dispute. Without these safeguards, a dispute over a small amount withheld from an early progress payment due a subcontractor may result in a large judgment down the line against the contractor.

On the other hand, subcontractors should note that the application of the statutory penalty (24% per year) on the withheld funds, plus interest and the prospect of recovery of attorney's fees, should provide the needed incentive to sue to recover even the most modest amounts wrongfully withheld by a contractor. ♦

— *J. Michael Matthews and
Robert M. Osier*



DISPUTE REVIEW BOARDS: GOOD FOR OWNERS AND GENERAL CONTRACTORS BUT NOT SO GOOD FOR SUBCONTRACTORS?

Disagreements are inevitable in large-scale construction projects and come in all shapes and sizes. For example, a disagreement may arise between the project owner and the general contractor regarding a fundamental change to the entire project. At the other end of the spectrum, disagreements with a more limited impact frequently arise between lower-tiered subcontractors.

Beginning in the 1970s, Dispute Review Boards (DRBs) have been utilized on large-scale construction projects to resolve disagreements that could not be worked out by the parties on their own. CALTRANS began requiring DRBs for all contracts greater than \$10 million in January 1998. For the most part, DRBs have worked well for owners and general contractors alike on projects including the Los Angeles MTA Subway and the Boston Central Artery project.

The DRB process is similar to other forms of alternative dispute resolution (ADR) in that it is designed to resolve disagreements without forcing the parties to endure costly, time-consuming and unpredictable litigation. There is, however, one critical difference between the DRB process and other types of ADR: the DRB is established at the outset of the project and so is involved in the project before any disputes arise.

Although the composition of DRBs varies from contract to contract, a typical DRB is comprised of three neutral panelists with technical rather than legal backgrounds. The formation process may differ in a number of ways. Frequently, each party to the general contract appoints one board member, and those two board members agree on the third board member. A deviation to that approach is where each party to the contract submits a list of nominees, and the other party chooses one from that list. Alternatively, the parties may agree to appoint all members of the DRB by consensus.

Like DRB composition, DRB procedures vary from contract to contract. In general, as described above, the DRB becomes involved in the project at the outset. For instance, the DRB might meet for the first time shortly after the owner has given the contractor notice to proceed. The DRB then spends some time learning about the project and the various parties involved in the project. Most DRBs meet on a regular basis throughout the life of the project. In this way, when the first dispute arises, the DRB is steeped in the workings of the project and does not need to spend a great deal of time learning about the underlying facts. Thus, the DRB is able to resolve disputes

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Dispute Review Boards ...

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expeditiously, allowing the entire project to remain on track.

An important aspect of the DRB is that its rulings are non-binding. Although parties are required by the contract to bring their disputes to the DRB, if a party disagrees with the findings or recommendations of the DRB, litigation can be pursued. The fact that DRB decisions are non-binding makes DRB formation and DRB procedures critical; if the parties do not trust the DRB members and the process, the DRB will not accomplish its purpose of resolving disputes prior to litigation.

Although the DRB is an excellent mechanism for resolving disputes between the owner and the general contractor on a construction project, the recent decision of *Sehulster Tunnels v. Traylor Brothers, Inc.*, 111 Cal. App. 4th 1328 (2003), highlights an important limitation on the DRB with respect to disputes involving subcontractors. In that case, the court held that a subcontractor was not required to go through the DRB because the DRB process set forth in the general contract was unfair to the subcontractor.

In *Sehulster*, the City of San Diego hired Traylor Brothers, Inc./Obayashi Corporation ("TBO") to build a sewage tunnel. In turn, TBO subcontracted part of the project to Sehulster Tunnels ("Sehulster"). TBO's contract with the City provided for a DRB to resolve project disputes. While the subcontract issued by TBO to Sehulster did not specifically provide for a DRB, it did incorporate by reference the provisions of the general contract. After the dispute arose, Sehulster refused to submit its claim to the DRB because the parties to the general contract would not permit Sehulster to appoint a panel member.

After a jury found in favor of Sehulster at trial, TBO asked the court to set aside the verdict on the grounds that Sehulster was required to submit its claim to the DRB before pursuing litigation. The trial court denied the motion, and TBO appealed.

On appeal, the court concluded that Sehulster was not required to go through the DRB. In particular, the court held that the DRB was presumptively aligned with the City and with TBO because they had formed the DRB and because Sehulster was not permitted to appoint a member to address its claim. The court regarded the DRB process as biased since it excluded Sehulster from having a "voice in the selection of the 'neutrals'" accordingly, the court did not require Sehulster to submit its claim to it.

In spite of the court's decision in *Sehulster* allowing the subcontractor to avoid the DRB process, DRBs remain an excellent mechanism for efficiently resolving construction project disputes without re-

sorting to litigation. However, if the owner and the general contractor hope to require subcontractors on the project to use the DRB process, they must ensure that the DRB process is fair to subcontractors. In practice, this means either having a separate DRB for each subcontract (which may not be practical) or having a procedure by which the subcontractor can appoint someone to the DRB for the limited purpose of addressing the particular subcontractor's issues. ■

— Mark A. Kahn

AS OF JANUARY 1, 2004, employees may sue their employers for California Labor Code violations.

The "Labor Code Private Attorneys General Act of 2004" (Labor Code §§ 2698-2699) establishes civil penalties for violations of any provision of the Labor Code and provides that an "aggrieved employee" may sue his or her employer for those civil penalties. Before this year, only the State could bring an action for civil penalties for a Labor Code violation. An employee who prevails in a lawsuit under this new law will be entitled to recover 25% of the civil penalties assessed (with the remainder going to the State) and reasonable attorneys' fees and costs.

CONTRACTOR LIABILITY UNDER FEDERAL AND STATE DISABLED ACCESS LAWS

The American with Disabilities Act ("ADA") prohibits discrimination against persons with disabilities in the design and construction of certain facilities. While the ADA makes clear that owners and operators of inaccessible facilities are liable, it is less clear whether liability under the ADA also extends to construction contractors.

Fortunately for California contractors, the federal Court of Appeals has concluded that individuals or firms that neither *own* nor *operate* inaccessible facilities, such as construction contractors, are *not* liable under the ADA. *Lonberg v. Sanborn Theaters, Inc.*, 259 F.3d 1029, 1035-6 (9th Cir. 2001). Because this ruling differs from a prior decision by another federal Court of Appeals (*United States v. Days Inns of America, Inc.*, 151 F.2d 822 (8th Cir. 1998), *cert. denied*, 119 S. Ct. 1249), the issue of contractor liability under the ADA might eventually be decided by the United States Supreme Court. At the present time, however, contractors in California cannot be held li-

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able for inaccessible facilities under the ADA.

Notwithstanding the protection afforded by the court's ruling, California contractors need to be aware of liability issues relating to disabled access. This is so because although protected from federal liability, a California contractor can be *directly* liable under state law, and *indirectly* liable through indemnity obligations.

First, California contractors that construct inaccessible facilities may be liable under the State's Unruh Act concerning disabled access. This law is less specific than the federal ADA and most importantly does not contain any language limiting liability to owners and operators. Thus, there is a risk that under State law, contractors could be required to correct inaccessible facilities, regardless of whether they would be entitled to or could obtain compensation for that work. Contractors could also be subject to monetary damages and civil penalties for violation of the State's disabled access law. Fortunately, no California contractor has yet been held liable under the Unruh Act.

Second, even if a contractor escapes statutory liability, it may find itself responsible under the terms and conditions of its contract for constructing an inaccessible facility. There is nothing in the federal ADA or the State's Unruh Act that prevents an owner or lessee held liable from seeking indemnity from its contractor for the costs of correcting violations and paying damages and penalties. Accordingly, contractors must carefully review all of the terms of a proposed contractual agreement, including the indemnification provision, to assess whether it could be found liable, on a contractual rather than statutory basis, to an owner or lessee of the facility found in violation of federal or State disabled access law. If such a provision is proposed, the contractor should object to the inclusion of the provision or at a minimum attempt to negotiate more equitable language. If this effort fails, the contractor must then decide whether to (1) decline the work or (2) accept the provision with an understanding of the risk and hopefully adjust the price for the work accordingly. •

— Aaron P. Silberman



RJOP in the News

Patricia Meagher was elected to the Executive Board of Women Construction Owners and Executives at its Annual Meeting in Washington, D.C. in January 2004. She will represent that Western Region. For more information on this organization, go to www.wcoeusa.org.

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