

## Public Entities and Contractors Take Note: A Word of Caution When Withholding Retention Proceeds

A recent decision from the California Court of Appeals Second Appellate District, *East West Bank v. Rio School District*, attempts to clarify confusion about a public entity's ability to retain funds from a contractor, under the "prompt pay laws" outlined in Public Contract Code 7107. Namely, the holding in *East West Bank* signified a split in the California appellate courts regarding what type of "dispute" justifies the withholding of retained funds.

In this case, the contractor, FTR, was awarded the contract on a \$7.345 million bid for construction of a school in the Rio District. During the project, FTR submitted requests for approximately 150 change orders. The District denied most of the change order requests. Construction was completed in 2001, but the District retained \$676,436.49, which was subject to withholding for multiple stop notice claims filed by FTR subcontractors. By 2004, the last of the stop notices had been released, but the District did not release the retained funds. FTR sued the District for, among other things, wrongfully withholding retention funds under Public Contract Code Section 7107. The trial court held that the District had improperly withheld the retention payments, and FTR was awarded interest penalties in the amount of \$1,537,404.96 under Section 7107.

On appeal, the School District relied on the holding in *Martin Brothers v. Thompson* (where the Court of Appeals Third Appellate District held that a California contractor could withhold funds when there was a bona fide dispute between the parties), to support the argument that it properly withheld the full amount of retention because the District and FTR had a good faith dispute over the change orders. The Second District Appeals Court rejected the argument, declining to follow the holding in *Martin Brothers*. The Court stated that the "purpose of a retention is to provide security against potential mechanics liens and to insure the contractor will complete the work properly and repair defects. The retained funds must be paid to the contractor when the security is no longer required." When the security is no longer needed, the public entity cannot rely on an unrelated dispute to justify the retention of funds.

While it is not clear how the discrepancy between the *Martin Brothers* and *East West Bank* holdings will be resolved, one thing was made clear by the *East West Bank* holding-- both public

entities and general contractors must take caution when deciding to retain funds past the deadline under prompt payment laws. As seen with the District in this case, deciding to withhold money for reasons unrelated to completion of the work or unpaid stop payment notice claims could result in harsh penalties.

Based on the split between the holdings in *Martin Brothers* and *East West Bank*, this issue is ripe for adjudication by the California Supreme Court.

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