

THERE BETTER BE A GOOD REASON FOR WITHHOLDING THAT MONEY

By Scott R Omohundro
Procopio, Cory, Hargreaves & Savitch LLP

Withholding money based upon a dispute on a project. All contractors have either done it or had it done to them. The question is always the same: What about the prompt payment penalties? A recent Second District Court of Appeal decision, *FEI Enterprises, Inc. v. Kee Man Yoon, et al.* (2011) 194 Cal.App.4th 790 (“*FEI*”), attempts to shed some light on the proper standard for evaluating whether the prompt payment penalties are appropriate. The end result is that it is more important than ever for a contractor to have a good reason for withholding payment.

As a matter of background, California has a number of “prompt payment” statutes that require general contractors to pay their subcontractors within specified short time periods and that impose monetary penalties for violations. These statutes serve 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.” The statute at issue in *FEI* is Business and Professions Code section 7108.5, which requires a contractor pay its subcontractors their share of a progress payment within ten (10) days of receiving that payment from the project’s owner. Failure to make timely payment will subject the contractor to a two percent (2%) monthly penalty on the outstanding amount plus potential disciplinary action and liability for attorneys’ fees and costs. However, if a “good faith dispute” exists over any amount due on the progress



SCOTT R. OMOHUNDRO

payment, the contractor may withhold up to 150% of the disputed amount. Similar language is found in Public Contract Code sections 7107(e) (“bona fide dispute”) and 10262.5 (“good faith dispute”) and Civil Code section 3260 (“bona fide dispute”).

The problem has always been that the statutes do not define these terms. The question for contractors is how to determine whether a good faith dispute actually exists. In a prior case, *Alpha Mechanical, Heating & Air Conditioning, Inc. v. Travelers Casualty & Surety Co. of America* (2005) 133 Cal.App.4th 1319 (“*Alpha Mechanical*”), the Fourth District Court of Appeal held that courts should use a subjective standard when answering the question. In doing so, the *Alpha Mechanical* Court basically converted the Legislature’s “good faith **dispute**” language into a “good faith **belief**” in the dispute. The problem is that a “subjective state of mind” is rarely susceptible of direct proof, as it is highly unlikely a contractor is going to admit it is acting in bad faith. The end result under *Alpha Mechanical* is that a contractor could make an entirely

unreasonable decision but avoid the imposition of penalties if he simply showed he believed he was acting in good faith. In other words, a contractor could avoid penalties simply by believing, either by delusion, ignorance, negligence of counsel, or otherwise, that the money is not owed.

The Second District Court of Appeal in *FEI* strongly criticizes the use of the arbitrary subjective standard, pointing out that in the absence of a specific expression in the contract or one implied from the subject matter of a dispute (i.e., matters of personal taste), the preference of the law is for the objective, i.e., reasonable person, standard. The *FEI* Court points to the legislative history of Business and Professions Code section 7108.5(c) as further support for the objective standard. The analysis of the Senate Committee on the Judiciary specifically notes that the statute provided “some leeway” for a general contractor where there was a dispute as to the amount due. The intent behind Section 7108.5(c) was to “establish a clear standard for amounts that a prime contractor could retain in cases of disputes, while also ensuring that litigation does not ensue over de minimis amounts.”

Given the goals of the Legislature in enacting these remedial statutes, the *FEI* Court held that a non-paying party would have a defense to the imposition of penalties only if there is a bona fide actual legal dispute. Whether the non-paying party might ultimately be vindicated at trial is not the issue. The critical question should be the legal tenability of the justification for non-payment that was asserted. “A *legal dispute* between two parties exists, is

‘legitimate,’ ‘genuine,’ ‘bona fide,’ or in ‘good faith’ where the arguments asserted or positions taken have *objective* legal tenability.”

In *FEI*, the trial court determined there was a good faith dispute as to (i) what the terms of the subcontracts required and (ii) whether the subcontractor fully performed its obligations. With regard to the subcontract language, both parties litigated their understanding of the meaning of specific phrases and both interpretations were found to be reasonable. With regard to performance, the trial court found persuasive the fact that the general contractor went so far as to retain and pay another company to complete the work it believed the subcontractor did not complete. Applying an objective standard, the *FEI* Court of Appeal agreed with the trial court that there was a good faith dispute and confirmed the denial of

the subcontractor’s request for penalties.

Under *FEI*, the critical question is no longer the contractor’s state of mind (i.e., a good faith belief, even if mistaken or ludicrous, that money should be withheld), but rather the legal tenability of the reason for non-payment. Is there an objectively reasonable basis for the delay or denial of a promised progress payment? It is important to note that *Alpha Mechanical*, while strongly criticized, has not been expressly overruled. That being said, the prudent course for contractors is to follow the Second District’s lead in *FEI* and make sure they have a valid legal basis for withholding money that is strong enough to withstand the scrutiny of a judge. *FEI*’s more in-depth analysis is sound, based on the Legislature’s intent in enacting the prompt payment statutes, and provides a much clearer, less

arbitrary standard. It is important to remember that the “good faith dispute” provision is an exception to the legal obligation of contractors to timely pay their subcontractors. If a contractor withholds money from a subcontractor, it better be prepared to prove it falls within the exception.

Scott R. Omohundro’s practice emphasizes business and civil litigation including construction dispute and breach of contract. He is experienced in representing owners and contractors in disputes arising on public and private works of improvement, including contractual disputes, stop notice and payment bond claims, and delay, disruption and inefficiency claims. Reach him at scott.omohundro@procopio.com or 619.525.381