

CLIENT NEWS BRIEF

Public Agencies May Not Withhold Retention Without A Dispute Regarding Contractor Performance

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In light of a recent court of appeal decision, all public agencies are cautioned to examine carefully their retention practices at project closeout. The court in *FTR International, Inc. v. Rio School Dist.* (Jan. 27, 2015) 2015 Cal.App.Lexis 68, concluded that a dispute over the contract price does not entitle a public agency to withhold funds due to the prime contractor. In the event of a dispute, a public entity may only withhold funds from retention as security against existing mechanics liens or stop notices and to provide reasonable assurance that the contractor will properly complete the work or repair defects.

The *FTR International* court refused to follow the conclusions reached by another appellate court in *Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc.* (2009) 179 Cal.App.4th 1401, which dealt with a different, but related, subsection of Public Contract Code section 7107. In *Martin Brothers*, the court blessed a prime contractor's aggressive withholding of funds from a subcontractor on a public works project. As predicted in our [2010 CNB](#), the *FTR International* court has reached a different conclusion as to permissibility of a public agency's retained payment amounts during a contract dispute.

In *FTR International*, the Rio School District (District) in 1999 engaged the contractor firm FTR International, Inc. (FTR) to construct a school for the District. During construction, FTR submitted approximately 150 change orders, claiming that the plans provided by the District were misleading or inadequate. For the most part, the District denied the change orders. The school was completed in 2001, and a notice of completion was filed by the District in August of that year. As provided in the construction contract, the District retained 10 percent of each progress payment, aggregating to over \$675,000 in retention. The District held the retained amount because of stop notices that had been filed by FTR's subcontractors and FTR's dispute over change orders and contract price. After the stop notices were released, the District refused to pay the retention to FTR. Unable to reach agreement on the amounts owed under the contract, FTR filed suit against the District.

Under subdivision (c) of Public Contract Code section 7107, prompt payment of retention is required, although the public agency is permitted to withhold retention from a prime contractor in the event of a dispute. Subdivision (f) of section 7107 also permits the assessment of a two percent per month penalty against a public agency for amounts improperly withheld from the contractor, and an award of attorney's fees and costs to the prevailing party.

The trial court found that the District had no justification for retaining the funds after the stop notices were released. The trial court awarded FTR over \$9 million, which included, among other things, the 10 percent retention amount, the section 7107 two percent penalty (totaling more than \$1.5 million), and attorney fees of \$3.85 million. The District appealed.

On appeal, the District argued that it was entitled to withhold the 10 percent because there was a "good faith dispute" between the parties and that any such dispute permitted retention under section 7107. The good faith dispute was essentially over the contract price.



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The appellate court in *FTR International* affirmed the trial court's holding, holding that the purpose of retention is to "provide security against potential mechanics liens and to insure (*sic*) the contractor will complete the work properly and repair defects." With the removal of the stop notices, and without the other limited justifications for retention present, the appellate court reasoned that the District did not have a purpose for retaining the 10% payments. The appellate court viewed section 7107 as a remedial statute which must be construed to promote its purpose, namely to deter public entities from improperly withholding retention payments. In addition, the appellate court awarded FTR, as the prevailing party, attorney's fees.

FTR International establishes that the term "dispute" in subdivision (c) of section 7107 may not be construed broadly so that whenever there exists a claim by or against a public agency in connection with a public works project, the public entity may withhold funds from retention already earned, without incurring late payment penalties. In order to withhold the retention, the nature of the dispute must be limited to the public policy purposes of section 7107. The court expressly states that the public policy purposes include only "providing security against mechanics liens and deficiencies in the contractor's performance." As the myriad of other situations that may face public agencies in a public works contract were not squarely before the *FTR International* court, it is unclear what other disputes may qualify as a proper public purpose, such as an owner's liquidated damages claims or particular contractor performance issues.

If you have any questions regarding this decision, or about handling contractor claims or disputes in general, please feel free to contact one of our [eight offices](#) located statewide. You can also visit our [website](#), follow us on [Facebook](#) or [Twitter](#), or download our [Client News Brief App](#).