



School Business Law Update

TEL: 661.636.4830
FAX: 661.636.4843
E-mail: sls@kern.org
www.schoolslegalservice.org

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COURT ADDRESSES PENALTY FOR IMPROPER WITHHOLDING OF CONSTRUCTION RETENTION FUNDS

The California Court of Appeal has issued a reminder of the high stakes that accompany public works projects. A recent case (*S&S Cummins Corporation v. West Bay Builders, Inc.*, 159 Cal.App.4th 765) has provided some guidance on the application of penalties for failure to timely release retention proceeds on public works projects. Looking at Public Contract Code Section 7107, which provides for accrual of two percent per month interest on unpaid retention and attorney fees, the Court determined the two percent per month is like “simple interest” and is not compounded on a monthly or any other basis.

The contractor, West Bay, had been paid retention by the school district owner but had not passed the retention on to the subcontractor, Cummins, claiming Cummins delayed the project completion. Cummins sued for breach of contract and violation of the prompt pay statutes. After a jury trial, including a review of delay claims, a verdict was entered for the subcontractor for the \$130,000 in retention, other damages in the amount of \$14,000, \$14,000 in costs, \$114,000 in penalties for violation of the prompt pay statutes and attorney fees of \$122,000. The contractor’s decision to withhold the \$130,000 in retention resulted in an ultimate award of over \$400,000 against it.

The subcontractor lost the issue of compounding the monthly penalties. On that issue, the Court looked at the description of what the penalty applies to as being money “improperly withheld,” and determined the two percent per month was part of money improperly withheld, such that the next month’s penalty did not apply to the prior month’s penalty. The Court also determined that compounding the penalty would result in a harsh and absurd result, as the litigation to determine who is in the right often takes years and compounded penalties would then approximate the value of the sum that was originally improperly withheld. Absent some indication that the Legislature intended such harsh and absurd results, the Court refused to imply the penalties should be compounded.

The Court also determined the two percent penalties stop when a judgment is rendered, and the constitutional cap of ten percent takes over for post-judgment interest.

The impact of this decision could reach school districts which do not pay retention to their contractors in timely fashion, as where districts choose to offset the retention against the district’s own claims, whether for delayed completion or faulty work. A district’s decision to withhold retention raises the stakes by adding the two percent per month penalty, and attorney fees if unsuccessful, to the possible costs of getting an answer to the question of who was at fault. Of course, if the district is correct, it could recover its attorney fees also, if sued under the prompt payment statutes.

Accordingly, the decision whether to withhold retention is not one to be made lightly, or even automatically where a project is late, and an appropriate level of analysis should first be completed, confirming a material default by the contractor and the impact on the delay to the project. This, of course, takes time, which means the district needs to be on top of the situation at all times and prepared for the decision before the time expires for paying the retention.

If you have any questions concerning this matter, feel free to contact me or the other members of our business practice group.

—Bill Hornback

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