Case No. S231549

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

UNITED RIGGERS & ERECTORS, INC.,
Plaintiff and Appellant,

SUPREME COURT
FILED

v.

MAY 17 2016

COAST IRON & STEEL CO.,
Defendant and Respondent.

Frank A. McGuire Clerk

Deputy

After a Decision of the Court of Appeal, Case No. B258860
Second Appellate District, Division One

Appeal from the Los Angeles County Superior Court,
Case No. VC062679
Honorable Thomas I. McKnew, Jr.

ANSWER BRIEF ON THE MERITS OF PLAINTIFF AND APPELLANT, UNITED RIGGERS & ERECTORS, INC.

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Question Presented

May a contractor withhold retention payments when there is a good faith dispute of any kind between the contractor and a subcontractor, or only when the dispute relates to the retention itself?

Brief Answer

Under California's prompt payment statutes, a contractor may not withhold retention payments beyond the statutory time periods unless there is a good faith dispute related to the retention itself. Allowing a contractor to hold retention funds hostage when a dispute wholly unrelated to the retainage exists undermines the purpose of the retention, contradicts the intent behind the prompt payment statutes, and facilitates abuse of those whom the statutes were intended to protect.

Summary of Argument

One appellate court's faulty interpretation of a remedial statutory scheme meant to protect those vulnerable to abuse has led to a split of authority. Specifically, California appellate courts are split regarding interpretation of California's prompt payment statutes in the context of construction industry retentions.

The offending appellate court opinion, authored by Chief Justice Cantil-Sakauye when she was a Justice with the Third Appellate District, held that "any good faith dispute" between a contractor and a subcontractor entitled the contractor to withhold retention beyond the prompt payment deadlines without penalty. (*Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc.* (2009) 179 Cal. App.4th 1401, 1414 ("*Martin Brothers*").) This holding directly undermined the purpose of retention funds and the intent of the Legislature in enacting the prompt payment statutes. By disassociating the exception to the prompt payment requirements (the existence of a good faith dispute) from the retention that the statutes intended to address, the *Martin Brothers* opinion opened the door to abuse and invited unnecessary litigation. At the time *Martin Brothers* was decided, the issue of whether a dispute between the parties had to be related to the retention was one of first impression.

Since that decision, two Second Appellate District opinions have disagreed. The first, *East West Bank v. Rio School District* (2015) 235 Cal. App. 4th 742, opened with a contrary holding and specifically disavowed *Martin Brothers*. (*Id.* at 745.) The second was the appellate opinion in this case, *United Riggers & Erectors, Inc. v. Coast Iron & Steel Co.* (2015) 243 Cal. App. 4th 151 ("*United Riggers*"). *United Riggers* agreed with *East West Bank* explaining that withholding of retention beyond the statutory prompt payment deadline "is justified only if the dispute is about the retention itself." (*Id.* at 156.) Otherwise, the prompt payment statutory framework would be overlooked, and the statutes' purpose would be undermined. Only when a good faith dispute is related to the retention can a contractor withhold retention beyond statutory deadlines without penalty.

Even before this split in authority was established, the *Martin Brothers* holding triggered concern. According to this Court's Docket for the *Martin Brothers* case, eleven distinct Requests for Depublication of the opinion were filed. Further, although this Court denied the petition for review, Justice Werdegar and Justice Kennard (retired) were of the opinion that the petition should have been granted. Not surprisingly, the interpretation of remedial statutory provisions aimed at protecting parties vulnerable to abuse has raised industry and public policy concerns.

With respect to withholding of retention beyond the statutory time limits, both the prompt payment statutes for public works projects and private works projects should be interpreted to require that a good faith dispute between the parties be related to the retention. Alternatively, because of distinctions between the language of the private works statutory scheme (Civil Code §§ 8810-8822) and the language for public works projects (Public Contracts Code § 7107), this Court should at a minimum rule that private works projects require a dispute to be related to the retention. To the extent Coast Iron claims that this litigation constituted a "dispute" relieving it of its obligation to pay retention, that does not explain the months of wrongful withholding *prior* to the filing of the action. Thus, United Riggers & Erectors, Inc. respectfully requests that this Court rule in favor of upholding the intent and purpose of the prompt payment statutes and affirm the appellate court in this case.

Statement of the Case

1. *Point of Agreement and Obvious Gaps*

United Riggers and Erectors, Inc. ("United Riggers") agrees with Coast Iron & Steel Co. ("Coast Iron") that this Court's guidance is needed with respect to the split in authority on the question presented in this case, (OBM[1] 2) For the purposes of the review granted, the language of Civil Code §§ 8810-8822 (addressing retention within private works projects) and Public Contract Code § 7107 (addressing retention within public works projects), as well as the cases that discuss these sections, are instructive.

However, United Riggers cannot agree with Coast Iron's "Summary of the Case" because it ignores facts about the withholding of retention funds that United Riggers earned but Coast Iron refused to pay. (OBM 4-7) Considering the limited scope of the review granted, and the relevance of the retention facts to construction of the prompt payment statutes, these omitted facts are crucial.

As indicated by the appellate court in *United Riggers*:

> This case arises out of a payment dispute between a contractor, [Coast Iron], and its subcontractor, [United Riggers]. After the work on a project was finished, United sent a demand to Coast to pay for change orders and for damages that United claimed Coast caused by mismanaging the project. Coast refused to pay, and also delayed forwarding United's share of retention payments Coast had received from the owner of the project.

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[1]For the purposes of this Answer Brief on the Merits, "OBM" means Coast Iron's Opening Brief on the Merits; "AOB" means United Riggers's Appellant's Opening Brief; "RT" means Reporter's Transcript; "CT" means the Clerk's Transcript; and "MA" means Motion to Augment that was filed with the court of appeal.

(243 Cal. App. 4th at 153.) The facts that the parties contracted for retention to be withheld, and how Coast Iron handled that retention, are necessary to this Court's review.

2. *Coast Iron Failed To Meet Its Statutory Obligations*

United Riggers worked as a subcontractor to Coast Iron starting in January 2011. (3 RT 1000:14-28) At trial, there was no dispute that United Riggers timely completed all work required under its contract. (3 RT 663:7-14) Further, Coast Iron had no complaints about United Riggers's work. (5 RT 2234:22-2235:5) Counsel for Coast Iron confirmed United Riggers "did a good job on this job. Their performance was fine. There's no criticism of that . . . plaintiff performed in a timely fashion. The job finished on time, the ride opened on time. There was no problem with their performance in terms of timing." (5 RT, 2462:10-15)

In March 2012 when United Riggers completed its work, Coast Iron asked United Riggers to forward its final claims for extra work so Coast Iron could process the claims and "close out the project this week so final [change order] work and retention can be billed." (AOB, Appendix 1) United Riggers submitted its claims the same day Coast Iron asked for them, identifying $78,384 in change order requests, and $274,158.40 for expenses United Riggers incurred due to Coast Iron's mismanagement as the prime contractor. (AOB, Appendix 2-4) Even though it anticipated and asked for United Riggers's final bill and change orders, Coast Iron immediately and summarily denied all United Riggers's claims with an email stating, "I will see you in court!" (AOB, Appendix 5)

This rejection – Coast Iron's blanket denial of United Riggers's claims based on final change orders and additional expenses incurred – had absolutely nothing to do with the quality or completion of United Riggers's work. The work was already finished and accepted. Also, Coast Iron never asserted any affirmative claims against United Riggers. Instead, Coast Iron was denying it owed United Riggers anything *more* than the funds withheld as retention.

Five months later in August 2012, Coast Iron received $149,602.52 in retention funds that were supposed to be paid to United Riggers. (3 RT 663:19-25, 665:1-2) This amount represented ten percent of United Riggers's contractual earnings (earned from January 2011 through March 2012) that had been retained pending completion of the project. However, Coast Iron did not pay any portion of those funds to United Riggers until six months later, in February 2013, *after* United Riggers was forced to hire an attorney and file a civil complaint. (1 CT 6 (Complaint); 3 RT 664:16-28) Then, without explanation, Coast Iron paid United Riggers approximately two-thirds of the owed retention. (3 RT 665:8-14) Coast Iron then waited an additional ten months, until the eve of trial, before paying the remaining one-third. (3 RT 666:8-11)

In its Opening Brief on the Merits, Coast Iron again admits that it held onto retention funds that it owed United Riggers solely because it rejected claims unrelated to the retention. (OBM 16) Rather than being "compelling evidence" of a statutory good faith dispute, Coast Iron has placed all of its statutory interpretation eggs in the *Martin Brothers* basket.

3. *Arguments Beyond the Review Granted Should Be Ignored*

Even though this Court limited its review to a single statutory construction issue, Coast Iron included arguments about the propriety of the underlying trial court's award of attorney's fees (which was reversed by the court of appeal) (OBM 17-19), and about the "pragmatic test" being used to determine the prevailing party. (OBM 19-21).

United Riggers will only address these arguments to the extent they implicate the statutory construction of the prompt payment statutes at issue, or the purpose for which the statutes were enacted. Specific to this limitation, the underlying trial court award of $150,000 in attorney's fees to Coast Iron, ostensibly pursuant to the prompt payment statutes[2], was an error the appellate court correctly rectified.

Based on these facts, and as explained more fully below, United Riggers respectfully requests that this Court affirm the opinion of the appellate court.

[2]The Statement of Decision drafted by Coast Iron and signed by the trial court referenced "*Public Contract Code* section 1717 and *Business and Professions Code* section 7108.5" as the only statutory bases for an award of attorney's fees to Coast Iron. (MA, Statement of Decision, p. 9, lines 4-7) In addition to the attorney's fee award in Coast Iron's favor undermining the purpose of the prompt payment statutes, these statutory references undermine the validity of the award because there is no section 1717 of California's Public Contract Code, and Business & Professions Code § 7108.5 has nothing to do with penalties associated with retention funds.

<u>Law and Argument</u>

I. The Appellate Court Correctly Construed Civil Code § 8814 to Require a Contractor Claiming Protection Under an Exception to the Rule of Prompt Payment of Retention Funds to Prove Its Refusal to Timely Pay Was Because of a Good Faith Dispute Related to the Retention.

This case turns on the interpretation of the statutes enacted to require prompt payment of retention funds to contractors and subcontractors who have already earned the money withheld as "retention," but who have contractually agreed to wait until the completion of the project to receive those retained funds. While there are many statutes similar in nature to the question at issue in this case, the two main statutory schemes related to prompt payment requirements for retention funds are Civil Code §§ 8810-8822 (addressing retention within private works projects) and Public Contract Code § 7107 (addressing retention within public works projects).

The appellate court in this case addressed both, stating that Public Contract Code § 7107 functions identically to Civil Code § 8814 with respect to requiring a contractor to promptly pay a subcontractor the retention unless a good faith dispute exists. (*United Riggers*, 243 Cal. App. 4th at 156.) To facilitate discussion of these statutes, the inherent ambiguity within them, and the proper interpretation of the "good faith dispute" language, review of the nature and purpose of contractual retention is important.

A. <u>The Purpose of Retention in Construction Projects Is to Secure Performance and Reduce the Owner's Risk.</u>

This case requires a clear understanding of the nature and purpose of retention in the context of construction contracts. Construction contracts often include provisions for installment payments *and* retention of a percentage of funds earned by the contractor (and subcontractors) to protect an owner's construction funds. (*Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal. 4th 28, 55 (*citing* 11 Cal. Jur. 3d Building and Construction Contracts, § 37, p. 54).) The retention of ten percent of money earned by contractor or subcontractor for work done on a construction project until final completion is common. (*See id.*; *Blois Construction, Inc. v. FCI/Fluor/Parsons* (2016) 245 Cal. App. 4th 1091, 1093; *Pittsburg Unified School District v. S.J. Amoroso Construction Co., Inc.* (2014) 232 Cal. App. 4th 808, 814; *Westamerica Bank v. City of Berkeley* (2011) 201 Cal. App. 4th 598, 601; *McAnrew v. Hazegh* (2005) 128 Cal. App. 4th 1563, 1566-1577; *Western Landscape Construction v. Bank of America* (1997) 58 Cal. App. 4th 57, 59.)

Even though retention is not paid until completion of the project, retention is not synonymous with the last installment payment owed to a contractor or subcontractor. (*Yassin v. Solis* (2010) 184 Cal. App. 4th 524, 533-534.) Rather, retention funds are distinct; they are comprised of a percentage of all installment payments already earned through the course of the construction contract. (*Id.*) Thus, "retention funds are not akin to contract payments either for contract work or extra work." (*Pittsburg Unified School District*, 232 Cal. App. 4th at 824.) Another reason retention funds are distinct from progress payments and payments for change order work is that "a contractor has no claim to retention funds until the project is completed." (*Id.*) Retainage is earned and withheld until completion of the project. (*Western Landscape Construction,* 58 Cal. App. 4th at 59 ("'[R]etention' payments [are] payments relating to work already done but which are not presently paid, which instead are withheld until completion of 100 percent of the subcontractor's work.").)

California courts have recognized multiple purposes for retention of earned funds. As explained by this Court in *Cates Construction, Inc.*, "[a] percentage of funds held until completion of all the work is called retainage and is intended to both reduce the risk of nonperformance by the contractor and to assure the completion of the work in accordance with the contract terms." (21 Cal. 4th at 55.)

With respect to retention by an owner from a prime contractor in the public works arena, the court in *Westamerica Bank* explained: "[R]etained earnings serve as an incentive for timely completion of the contract. They are effective for this purpose precisely because they are under the control of the owner who can use them if the contractor defaults on his obligations." (201 Cal. App. 4th at 610-611.) The court in *Pittsburg Unified School District* explained:

> The purpose of retaining a percentage of the funds otherwise due the contractor until completion of the contract work is to encourage the contractor to complete the work in a timely and competent manner and to protect the owner against the risk of having to pay a replacement contractor to repair or complete defective or unfinished work.

(232 Cal. App. 4th at 812.) An owner may use retention funds to repair or complete a project, "but this does not preclude the contractor from

challenging that decision" under the provisions of Public Contract Code § 7107. (*Id.* at 823.)

Likewise, with respect to retention by an owner from a prime contractor in the private works arena, the court in *Yassin* explained retention provides security against mechanics' liens and ensures "that the contractor will complete the work properly and repair defects." (184 Cal. App. 4th at 534.) In another private works case, the court explained retention provides incentive to complete the work "in a satisfactory fashion." (*Western Landscape Construction*, 58 Cal. App. 4th at 59.) Likewise, the court of appeal in this case explained retention was used as "a guarantee of satisfactory performance" by contractors and subcontractors. (*United Riggers*, 243 Cal. App. 4th at 155.)

Thus, retention funds are the product of a contractual agreement whereby a prime contractor (or subcontractor) agrees to allow the owner (or prime contractor) to withhold a percentage of contractually earned funds for work on a construction project pending completion of the project. (*See, e.g.*, Pub. Contract Code § 7200(b)(2) ("In a contract between the original contractor and a subcontractor, and in a contract between a subcontractor and any subcontractor thereunder, the percentage of the retention proceeds withheld may not exceed the percentage specified in the contract between the public entity and the original contractor.")) Upon satisfactory completion of the project, those funds, which by their nature are already owed to the contractor and subcontractor from whom they were withheld, must be paid. The party withholding retention has received the benefit of the bargain by the successful completion of the project. The party owed retention should not be denied payment if it met its contractual obligations.

The nature of retention funds is consistent with the purpose of such funds. When the project is satisfactorily completed, and there are no stop notices or mechanics' liens pending, the purpose of withholding the retention no longer exists. The owner or prime contractor does not need the retention funds to repair faulty work or to incentivize completion. The party who earned the retention has no further obligation with respect to the funds owed. Thus, the retention has served its purpose, and it should be promptly paid upon completion of the project. In fact, this is precisely the purpose of the prompt payment statutes. Under California law and as explained below, nothing in the prompt payment statutes should be read to undermine the nature or purpose of retention funds in construction contracts.

B. The Language of Public Contract Code § 7107 and Civil Code § 8814 That Led to Split of Authority.

1. *Public Works Projects*

The initial split of appellate authority occurred over the interpretation of Public Contract Code § 7107, subsections (d) and (e), and the impact they have on the penalty provisions of subsection (f) for the wrongful withholding of retention beyond statutory deadlines. These subsections, addressing retention in a public works project, state:

> (d) Subject to subdivision (e), within seven days from the time that all or any portion of the retention proceeds are received by the original contractor, the original contractor shall pay each of its subcontractors from whom retention has been withheld, each subcontractor's share of the retention received. However, if a retention payment received by the original contractor is specifically designated for a particular subcontractor, payment of the retention shall be made to the