

Construction & Infrastructure Law Blog

New Legal Developments in the Construction & Infrastructure Industry

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"Good Faith" In Prompt Payment Disputes

By [Candace L. Matson](#)

In California, the payment of contractors is governed by so-called "prompt payment statutes" which are sprinkled through various legislative codes, and which impose sanctions on the paying party for non-compliance. Progress payments by general contractors to their subcontractors on private and most public works of improvement are governed by [section 7108.5 of the Business & Professions Code](#). Retention payments to subcontractors on public works of improvement are governed by [section 7107 of the Public Contracts Code](#), and on private works of improvement by [section 3260 of the Civil Code](#). In some cases the statutes permit withholding of payments only where there is a "good faith" dispute. But what constitutes "good faith"?

All of these statutes provide that monies must be released to subcontractors within a certain time except under special circumstances, i.e., where a dispute is involved or where the parties agree to an alternative payment scheme. Thus, where there is a "*good faith dispute* over all or any portion of the amount due on a progress payment," the general may withhold up to 150 percent of the disputed amount. Bus. & Prof. Code § 7108.5(c) (emphasis supplied). On a public project, "if a *bona fide dispute* exists between the subcontractor and the original contractor" the latter may withhold from retention up to 150 percent of the estimated value of the disputed amount. Cal. Pub. Cont. Code § 7107(e) (emphasis supplied). And on a private project, if "a *bona fide dispute* exists between a subcontractor and the original contractor, the original contractor may withhold from that subcontractor with whom the dispute exists its portion of the retention proceeds . . . [not to] exceed 150 percent of the estimated value of the disputed amount." Cal. Civ. Code § 3260(e) (emphasis supplied). Hence, a key factor as to when monies may be withheld from a subcontractor without exposing the general contractor to sanctions is whether there is a *bona fide* or good faith dispute between the parties.

The case of [Alpha Mechanical, Heating & Air Conditioning, Inc. v. Travelers Casualty & Surety Company of America](#), 133 Cal. App. 4th 1319 (4th Dist. 2005) was the first to

expressly examine what constitutes a "good faith dispute" on a private work of improvement under Bus. & Prof. Code § 7108.5 and Civ. Code 3260. In that case, the court observed that "the phrase 'good faith' does have a distinct meaning and purpose in the law" (*id.*, at 1339) and "suggests a moral quality; its absence is equated with dishonesty, deceit or unfaithfulness to duty," Guntert v. City of Stockton, 43 Cal. App. 3d. 203, 211 (1974) (citation omitted), or "that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation." People v. Nunn, 46 Cal. 2d 460, 468 (1956). The court noted the comments of another authority: "Good faith, or its absence, involves a factual inquiry into the plaintiff's subjective state of mind. [Citations] Did he or she believe the action was valid? What was his or her intent or purpose in pursuing it?" Knight v. City of Capitola, 4 Cal. App. 4th 918, 932 (1992).

In Alpha Mechanical, the general contractor did not make final payment because it alleged that the subcontractor did not correct work deemed defective by the owner and damaged the work of other trades - necessitating repair work for which the general would have to pay if the subcontractor did not. The appellate court found no evidence in the record suggesting that the general contractor "lack[ed] good faith in its belief that the dispute over the damage caused by Alpha justified withholding the remaining sums due it." *Id.*, 133 Cal. App. 4th at 1340. Hence, the general contractor was not subject to penalties under either Bus. & Prof. Code § 7108.5 or Civ. Code 3260.

Alpha Mechanical involved a classic dispute over work performed under the contract. However, no such dispute was involved in the more recent case of Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc., 179 Cal. App. 4th 1401 (3d Dist. 2009), involving a public work of improvement. Martin Brothers involved a dispute over changed work, specifically over additional compensation that the subcontractor contended was owed over and above the agreed contract price for work that was allegedly outside the scope of the contract. The subcontractor sought to recover penalties under Public Contract Code section 7107 for the general's failure to release retention. The appellate court in Martin Brothers held that the reference to "dispute" in section 7107 encompassed *any* dispute, so long as the dispute was *bona fide*. Hence, even though there was no dispute over the amount of retention owed under the contract, the court found the general was justified in withholding retention while the change order dispute was pending.^{1[1]} The court's holding in Martin Brothers was surprising to many observers because it allowed the general contractor to withhold undisputed sums solely due to a dispute over whether *additional* sums were owed. Alpha Mechanical and Martin Brothers constitute a very broad reading of what can constitute a *bona fide* dispute and suggest that nearly *any* dispute, so long as it is genuinely believed to exist, can enable a general contractor to withhold undisputed amounts owing from a subcontractor.

That approach was flatly rejected this year in FEI Enterprises, Inc. v. Yoon, B209862 (2d Dist. 2011), *certified for partial publication*. In the published portion of this opinion,

the appellate court addressed the good faith dispute exception to the prompt payment requirement set forth in section 7108.5 of the Business & Professions Code (which the court noted contains similar language to that found in sections 7107 and 10262.5 of the Public Contract Code and section 3260 of the Civil Code). The court rejected the subjective standard invoked by the Alpha Mechanical court, stating "that decision did not make a proper analysis of the meaning of the term "good faith dispute" as it is used in section 7108.5." It explained that the court in Alpha Mechanical essentially converted the "good faith dispute" language into a "good faith belief" standard. This court found such a standard to be "unwarranted and unwise." Instead, unless the factual circumstances dictate otherwise, an objective, "reasonable person" standard should be used to determine whether a payment from a contractor to a subcontractor is subject to a "good faith dispute" under the prompt payment statute.

Hence, there are now two cases, in the third and fourth districts respectively, which apply a subjective standard to the question of whether a good faith dispute exists to excuse prompt payment and one case in the second district which applies an objective standard to the question. **PRACTICE TIP:** If your client's dispute arise in one of the aforementioned districts, you can expect the court will most likely follow the precedent set by its own district. If the dispute arose in another district, it will be difficult to predict how a court would rule; hence, it is prudent to be conservative in recommending strategy and predicting outcomes.

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2[1] Martin Brothers also sought to recover penalties under Bus. & Prof. Code § 7108.5 for Thompson's failure to make timely progress payments. The court found that the parties had agreed to an alternative payment scheme by the terms of their subcontract in which payment was expressly "not due until Subcontractor has furnished . . . applicable [lien] releases pursuant to Civil Code section 3262." Since section 7108.5 allows parties to "opt out" of its requirements via written agreement, and since Martin Brothers had not timely submitted the required lien releases, the court held that Thompson did not violate the prompt payment statute in failing to make a progress payment under the time constraints of the statute. Id., 179 Cal. App. 4th at 1415. **PRACTICE TIP:** Subcontractors should take steps to assure that lien waivers, if required by the subcontract, are timely submitted with each invoice for progress payment.
