

Facilities Issues: Financing, Bonds, Construction and Terminations

California Council of School Attorneys' and County Counsels'
2008 Joint Annual Workshop

December 5, 2008

THEODORA ORINGER MILLER & RICHMAN PC

Speaker Profile - Kevin A. Dorse



- Mr. Dorse has been representing government and business clients for 20 years in a wide variety of complex commercial litigation involving contract disputes, heavy construction, tunneling, class actions, insurance coverage and health care.
- *When Accidents Happen During Construction: Will Your Builder's Risk Insurance Cover the Damage?* Construction Briefings, June 2005.
- Speaker, 25th IRMI Construction Risk Conference, Las Vegas, Nevada.
- Southern California Super Lawyer for 2008 and 2006, as published in *Southern California Super Lawyer Magazine* and *Los Angeles Magazine*.

Speaker Profile - Erich R. Luschei



- Mr. Luschei has represented owners, contractors and design professionals in construction disputes and transactional matters on public and private projects for 20 years.
- *Stipulated Sum Contracts – Owner's Considerations*, American Bar Association Construction Checklists: A Guide to Frequently Encountered Construction Issues (August 2008).
- *Price Escalation and Financial Hardship Clauses: Contractual Approaches to Dealing with Hyperinflationary Market Conditions*, Const. Law Update (Aspen 2006).
- County Counsels' Association of California Public Works and Contracts Study Session Conference, Panelist, "Drafting Public Works Construction Contracts - Important Considerations for Public Owners" (San Diego, May 2008).

Speaker Profile - Scott K. Behrendt



- Mr. Behrendt's practice is dedicated to a wide range of complex commercial litigation matters in state and federal court with an emphasis on private and public sector construction advice and litigation.
- Representations include large and small private and public owners, contractors, subcontractors, and others in industries such as education, engineering and construction, water and power utilities, textiles, and hospitals and skilled nursing facilities.
- *General Conditions—Owner's Considerations*, American Bar Association Construction Checklists: A Guide to Frequently Encountered Construction Issues (August 2008).
- County Counsels' Association of California Public Works and Contracts Study Session Conference, Panelist, "Enforcing Claims Procedures in Public Contracts" (San Diego, May 2008).

Overview

- 2008 School Bond Measures Election
- School Bond Fund Legislation, Oversight and Accountability
- Prequalification Procedures for Screening Contractors
- Contract Termination Provisions
- Sureties and Financial Stress/Insolvency
- Recent Relevant Case Law

Introduction

- Earlier this year, it looked like the financial crisis may result in the failure of many school bond measures, which would deprive school districts of their primary means to fund construction and modernization projects

Introduction

- March 2008 – Bear Stearns crashed in connection with subprime mortgage disaster



Introduction

- September 2008 – Lehman Brothers went under

LEHMAN BROTHERS

Introduction

- September 2008 – AIG was on the brink of failure

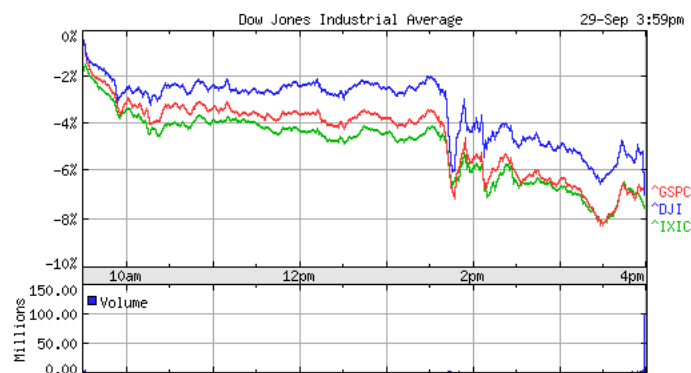


9

THEODORA ORINGER MILLER & RICHMAN PC

Introduction

- And the bottom fell out of the stock market



10

THEODORA ORINGER MILLER & RICHMAN PC

Introduction

- These developments raised concerns that in light of the economic crisis and anxiety of voters, many school construction bond measures on California ballots in November may not pass.
- Voters proved that wrong

School Construction Bond Measures

- Almost all of the over 55 school bond measures on the 2008 November ballot passed – including 23 in Los Angeles County alone

School Construction Bond Measures

- Measure D: School Improvement - El Monte Union High School - \$148 million – **Passed**
- Measure E: School Safety, Security and Repair – Beverly Hills Unified School District - \$334 million – **Passed**
- Measure J: Community College Classroom Repair, Public Safety, Nursing & Job Training – Los Angeles Community College District - \$3.5 billion – **Passed**
- Measure K: Classroom Repair, Student Safety – Long Beach Unified School District - \$1.2 billion – **Passed**
- Measure M: School Improvement – El Segundo Unified School District - \$14 million – **Passed**
- Measure O: School Improvement – Rosemead Elementary School District - \$30 million – **Passed**
- Measure Q: Safe, Healthy Neighborhood Schools – Los Angeles Unified School District - \$7 billion - **Passed**

School Construction Bond Measures

- Measure W: School Improvement – Whittier Union High School District - \$75 million – **Passed**
- Measure Y: School Safety and Core Academic Facilities – Torrance Unified School District - \$265 million – **Passed**
- Measure Z: Education Upgrades – Torrance Unified School District - \$90 million – **Passed**
- Measure AA: Santa Monica College Career Education Improvements – Santa Monica Community College District - \$295 million – **Passed**
- Measure AB: Building For Student Success Improvement – Bonita Unified School District - \$83.56 million - **Passed**
- Measure BB: Mira Costa High School Rehabilitation – Manhattan Beach Unified School District - \$67.48 million – **Passed**
- Measure CF: School Improvement – Acton-Agua Dulce Unified School District - \$13 million – **Passed**
- Measure CV: School Improvement – Centinela Valley Union High School District - \$98 million - **Passed**

School Construction Bond Measures

- Measure JJ: Public Safety, Health Care Job Training – Victor Valley Community College District - \$297.5 million - **Passed**
- Measure KC: School Repair and Upgrade – El Monte City Elementary School District - \$75 million – **Passed**
- Measure MM: Neighborhood Elementary Schools Health, Safety and Repair – Alhambra Unified School District - \$50 million – **Passed**
- Measure PS: School Improvement – Pomona Unified School District - \$235 million – **Passed**
- Measure RR: Classroom Repair, Education Improvement – Mount San Antonio Community College District - \$353 million - **Passed**
- Measure SA: County & Local Ballot Measure – William S. Hart Union High School District - \$300 million – **Passed**
- Measure TT: School Improvements – Pasadena Unified School District - \$350 million – **Passed**
- Measure WS: School Improvement – Westside Union Elementary School District - \$63.5 million - **Passed**

School Construction Bond Measures

- Measure K: School Repair and Improvement Measure – Los Alamitos Unified School District 1 - \$126 million - **Passed**
- Measure L: School Facilities Improvement – Tustin Unified School Facilities Improvement District 2008-1 - \$95 million – **Passed**
- Measure M: General Obligation Bond of 2008 – Cypress School District - \$53.6 million – **Passed**
- Measure N: Bond Proposition – Savanna School District - \$24.935 million – **Passed**
- Measure O: School District School Safety, Teacher Recruitment/Fiscal Responsibility – Westminster School District - \$130 million - **Passed**
- Measure CC: Classroom Repair Education Improvement – Mount San Antonio Community College District - \$353 million – **Passed**
- Measure P: Christopher High School Construction – Gilroy Unified School District - \$150 million – **Passed**
- Measure S: School Improvements – Oak Grove School District - \$125 million - **Passed**

School Construction Bond Measures

- Measure V: Bond – Patterson Unified School District - \$50 million – **Passed**
- Measure A: Bond Measure – John Swett Unified School District - \$20 million – **Passed**
- Measure E: Bond Measure – Acalanes Union High School District - \$93 million – **Passed**
- Measure G: Bond – Mohave Unified School Facilities Improvement District 1 - \$14 million - **Passed**
- Measure H: Bond – South Kern Unified School District - \$24 million – **Passed**
- Measure I: Bond – Lakeside Union School District - \$22.5 million – **Passed**
- Measure J: Bond – Richland School District - \$23 million – **Passed**
- Measure O: Bond – San Lorenzo Unified School District - \$83 million – **Passed**
- Measure E: School Safety and Repair – Bigg Unified School District - \$6.9 million - **Failed**

School Construction Bond Measures

- Measure G: Athletic Facilities Improvement Bond – Oroville Union High School District - \$12 million – **Passed**
- Measure P: School Bond Measure – Marysville Joint Unified School District - \$47 million – **Passed**
- Measure X: School Bond - Millbrae School District - \$30 million – **Passed**
- Measure G: Repair/School Construction Educational Improvement – Colton Joint Unified School District - \$225 million – **Passed**
- Measure Z: School Safety, Vocational Education, Classroom Repair – Beaumont Unified School District - \$125 million – **Passed**
- Measure Q: School Improvement– Santa Paula Union High School District - \$39 million – **Passed**
- Measure R: School Improvement – Oak Park Unified School District - \$29.445 million – **Passed**
- Measure S: School Improvement – Moorpark Unified School District - \$39.5 million – **Passed**
- Measure J: Bond – Bellevue Union School District - \$19 million - **Passed**

School Construction Bond Measures

- Proposition R: Classroom Repair and Job Training Measure – Southwestern Community College District - \$389 million – **Passed**
- Proposition S: School Repair and Safety Measure – San Diego Unified School District - \$2.1 billion – **Passed**
- Proposition T: School Bonds – Escondido Union High School District - \$98 million – **Passed**
- Proposition U: School Bonds – Grossmont Union High School District - \$417 million - **Passed**
- Proposition V: School Bonds – Lakeside Union Elementary School District - \$79.55 million – **Passed**
- Proposition W: School Bonds – Lemon Grove Elementary School District - \$28 million – **Passed**
- Proposition X: School Bonds – South Bay Union Elementary School District - \$59.4 million – **Passed**
- Measure C2008: School Bond Repair and Upgrade Schools – Cold Springs School District - \$2.44 million – **Passed**

School Construction Bond Measures

- In all, over **\$19.7 billion** in various school related measures were approved by voters
- Goes to show that even in the most difficult financial times, voters are willing to allocate funds and incur tax assessments for classrooms and education related infrastructure and improvements
- If funds are used efficiently, voters perceive that the money is well spent, and the economic environment does not deteriorate further, it increases the likelihood that voters will continue to support school bond measure in the future

School Construction Bond Measures

- However, there is no guarantee that the actual funding is “in the door”
- Possible that not all bonds issued will *actually sell*
- Bond funding tied to assessed property values, and if assessed values were to fall, ability to finance future bonds impacted (Education Code § 15270)
- **Parcel Tax measures** as alternative funding uncertain – require two-thirds approval, impose flat fees rather than fees based on assessed property values (Cal. Const. sec. 4, Art. XIII A, Gov’t Code §§ 50075-50077, 5079, 53722)
 - 81% (17 out of 21) of Parcel Tax measures on the November 2008 ballot passed

School Construction Bond Measures – Proposition 39

- **Proposition 39** – the “Smaller Classes, Safer Schools, and Financial Accountability Act”
 - Passed by the voters and enacted in November 2000
 - Amended article XIII A, sec 1 of the California Constitution
 - Created an exception to the 1 percent limit on ad valorem taxes on real property and **reduced from two-thirds to 55 percent** the number of voters required to approve any bonded debt to be incurred by a school district, community college, or county office of education for the “**construction, reconstruction, rehabilitation, or replacement of school facilities.**” (Art. XIII A, § 1, subd. (b)(3))

School Construction Bond Measures – Proposition 39

- Established the following Accountability Requirements:
 - Funds **only for construction, reconstruction, rehabilitation, or replacement of school facilities** and not for any other purpose, including teacher and administrator salaries and other school operating expenses
 - **Must list the specific school facilities projects** to be funded and include a **certification** that safety, class size reduction, and information technology needs **have been evaluated in developing that list**
 - Must conduct an **annual, independent performance audit** to ensure that the funds have been expended only on the specific projects listed
 - Must conduct an **annual, independent financial audit** of the proceeds from the sale of the bonds until all of those proceeds have been expended for the school facilities projects

23

THEODORA ORINGER MILLER & RICHMAN PC

School Construction Bond Measures – Proposition 39

- Implementation of Prop 39: Education Code §§ 15264 – 15284
- Education Code § 15278 - **Citizens' Oversight Committee**:
 - District board "shall establish and appoint members to an **independent citizens' oversight committee** . . . to inform the public concerning the expenditure of bond revenues."
 - Committee "shall actively **review and report on the proper expenditure** of taxpayers' money for school construction [and] advise the public as to whether [the district] **is in compliance** with [Prop 39]"
 - Committee "shall convene to provide oversight for, but not be limited to . . . **ensuring that bond revenues are expended only for the purposes** described in [Prop 39] and that no funds are used for any teacher or administrative salaries or other school operating expenses."
 - Committee may review copies of the annual, independent performance and financial audits, inspect school facilities and grounds, review deferred maintenance proposals or plans and efforts to maximize bond revenues by implementing cost-saving measures

24

THEODORA ORINGER MILLER & RICHMAN PC

School Construction Bond Measures – Proposition 39

- Education Code § 15284 – “School Bond Waste Prevention Action”
 - Allows a taxpayer within a school district to bring an action – “**School Bond Waste Prevention Action**” – to obtain an order restraining and preventing any expenditure of funds received by a school district through the sale of bonds authorized by [Proposition 39]
- Education Code § 15272 – Ballot language:
 - The ballot **shall also be printed with a statement that the board** will appoint a **citizens' oversight committee** and **conduct annual independent audits** to assure that funds are spent only on school and classroom improvements and for no other purposes

School Construction Bond Measures – Proposition 39

- Case Law Interpreting Prop 39
- McLeod v. Vista Unified School Dist., 158 Cal. App. 4th 1156 (2008):
 - The taxpayer within a school district may bring a “School Bond Waste Prevention Action” to obtain an order restraining and preventing any expenditure of funds received by a school district ... through the sale of bonds authorized by [Prop 39]” (Ed. Code, § 15284, subd. (a)(e))
- Foothill-De Anza Community College Dist. v. Emerich, 158 Cal. App. 4th 11 (2007):
 - Community college district’s school bond proposition met the requirements of Prop 39

School Construction Bond Measures – Proposition 39

- Committee for Responsible School Expansion v. Hermosa Beach City School Dist., 142 Cal. App. 4th 1178 (2006):
 - School district's bond measure satisfied the applicable Prop 39 constitutional and statutory provisions
- San Lorenzo Valley Community Advocates for Responsible Education v. San Lorenzo Valley Unified School Dist., 139 Cal. App. 4th 1356 (2006):
 - Prop 39 bond proceeds may be used only for “the construction, reconstruction, rehabilitation, or replacement of school facilities” and not “for any other purpose, including teacher and administrator salaries and other school operating expenses”

School Construction Bond Measures – Proposition 39

- 87 Ops. Cal. Atty. Gen. 157 (2004):
 - “A school district may use Proposition 39 school bond proceeds to pay the salaries of district employees to the extent they perform administrative oversight work on construction projects authorized by a voter approved bond measure”

Bond Measures – Accountability

- Government Code § 53410 – Accountability Measures
 - A statement indicating specific purposes of bond
 - All proceeds applied only to the specific purposes
 - Creation of an account for the proceeds
 - Annual report per § 53411
- Government Code § 53411– Chief Fiscal Officer Reports:
 - Annual report re amount of funds collected and expended
 - Status of projects required or authorized to be funded

School Bond Measures – Sample Ballot Language Re Accountability Safeguards

- Annual Performance Audits
 - The Board shall conduct an annual, independent performance audit to ensure that the bond proceeds have been expended only for the purposes authorized by this measure
- Annual Financial Audits
 - The Board shall conduct an annual, independent financial audit of the bond proceeds until all of those proceeds have been spent in accordance with this measure

School Bond Measures – Sample Ballot Language Re Accountability Safeguards

- **Bond Oversight Committees**
 - All expenditures by the District of funds obtained through Bonds authorized by this Measure shall be subject to the review and oversight of the Committee as currently stipulated in its Charter
 - The Committee shall review and report on all bond fund expenditures concerning whether the expenditures were made consistent with the purposes for which the Bonds were authorized and otherwise made pursuant to a Strategic Execution Plan
 - The Committee shall have a budget sufficient to retain independent legal counsel, administrative staff, and a consultant with a background and skills in construction planning, management, and oversight, and shall have the opportunity to review and recommend for or against major projects prior to their approval by the Board of Education

31

THEODORA ORINGER MILLER & RICHMAN PC

School Bond Measures – Sample Ballot Language Re Accountability Safeguards

- **Bond Oversight Committees (cont.)**
 - The Committee will be entitled to access to all information concerning projects not subject to legal privilege and will have the responsibility to report to the public any information that Bond funds are being spent illegally or imprudently or in a manner inconsistent with the Strategic Execution Plan adopted by the Board
 - The Committee shall review annual, independent performance and financial audits of the Bond fund expenditures and report to the public no less than once each year in which Bond funds are being spent regarding the use of the funds

32

THEODORA ORINGER MILLER & RICHMAN PC

School Bond Measures – Sample Ballot Language Re Accountability Safeguards

- **Strategic Execution Plans**
 - The District shall maintain a Strategic Execution Plan for the use of the Bond proceeds. The Plan shall be adopted at a public meeting at which taxpayers, parents, students, employees, other government agencies, community organizations, and business interests shall be afforded an opportunity to comment
 - The Plan shall provide for the regular assessment of the condition of facilities for major repairs through facility inspections and industry-based standards for the life expectancy of facility components. To this end, the District shall develop and maintain information systems adequate to inventory facility systems and structures
 - The Plan and any amendments thereto, shall be reviewed by the Oversight Committee prior to final action by the Board and any amendment that may adversely affect the successful completion of the Plan shall be accompanied by an analysis of the impact of the amendment on the prospects of fully achieving the Plan's goals

33

THEODORA ORINGER MILLER & RICHMAN PC

School Bond Measures – Sample Ballot Language Re Accountability Safeguards

- **Professional Management**
 - Principal responsibility within the District for implementation of the construction and modernization program funded by the Bond proceeds shall be vested in a Facilities Services Division, which shall be headed by a Chief Facilities Executive who shall report directly to the Superintendent
 - Managers of the Division shall have educational and employment experience comparable to that of persons with similar responsibility in the private sector
 - The Board shall, no less than biennially, request a survey of compensation of managers of major construction programs and managers of major public and private facilities in comparable locations across the United States in both the public and private sector, and the Board shall make a finding that the managers of the District's Facilities Services Division are being compensated at a level that will be competitive in the marketplace

34

THEODORA ORINGER MILLER & RICHMAN PC

Contractor Prequalification Procedures

Contractor Prequalification Procedures

- With the boom in projects planned in recently passed bond measures, with existing bond funds, demand for qualified and competent contractors will be high and the pool spread thin
- Some of these contractors may be looking for the “easy kill”, i.e., ram through change orders, delay claims, etc.
- Contractors will be “coming out of the woodwork” for explosion in bond funded work – **Are they qualified?**
- Schools need to take steps to increase the likelihood of obtaining qualified and competent contractors and screening out “problem” contractors
 - If unqualified contractor slips through the cracks, it jeopardizes the timely completion of the project, the quality (and safety) of the project
 - May increase project costs – especially if a replacement contractor is ultimately needed to complete the project

Contractor Prequalification Procedures

- School districts are generally limited to competitive bidding of construction work to contractors – lowest responsive and responsible bidder
 - Public Contract Code § 20111 “The governing board shall let any contract for a public project . . . involving an expenditure of fifteen thousand dollars (\$15,000) or more, to the ***lowest responsible bidder***”
- Prequal procedures build out this threshold requirement of “responsible” bidder by screening potential contractors
- Are appropriate and lawful, even given requirements for competitive bidding of public works projects
- Are not required, but are typically used, and with boom in construction, districts should certainly consider

37

THEODORA ORINGER MILLER & RICHMAN PC

Contractor Prequalification Procedures

- Authorized per Public Contract Code § 20111.5:
 - “The governing board of the district may require that each prospective bidder for a contract . . . complete and submit to the district a **standardized questionnaire and financial statement** in a form specified by the district, including a complete statement of the prospective bidder’s financial ability and experience in performing public works”
 - “**Verified under oath**”
 - “shall adopt and apply a **uniform system** of rating bidders on the basis of the completed questionnaires and financial statements, in order to determine the size of the contracts upon which each bidder shall be deemed qualified to bid”
 - “Bids not presented on the forms so furnished shall be disregarded”
 - Must submit “at least five days prior to the date fixed for the public opening of sealed bids”
 - “May establish a process for prequalifying prospective bidders pursuant to this section on a quarterly basis”

38

THEODORA ORINGER MILLER & RICHMAN PC

Contractor Prequalification Procedures

- Take steps to avoid legal challenges to procedures and successful bid
- Keep the procedures consistent and objective
- Utilize a consultant and/or legal counsel to review and approve procedures
- Avoid questions that may appear to circumvent competitive bidding and/or show favoritism towards a preferred contractor
- Include adequate procedures to disqualify bidders:
 - Spell out grounds for **automatic disqualification** (e.g., **convicted of a crime** involving award of a government construction contract in last five years) and
 - Request details/follow up information on matters that could result in **discretionary disqualification** (e.g., **assessed and paid liquidated damages** in the last five years)

Contractor Prequalification Procedures

- Sample prequalification questions
 - Latest copy of **audited financial statement** with accompanying notes and supplemental information
 - Notarized statement from an admitted surety insurer and authorized to issue bonds in the State of California, which states: (a) current **bonding capacity is sufficient** for the project; and (b) **current available bonding capacity**
 - Has Contractor's **license been revoked** at any time in the last five years?
 - Has a **surety firm completed a contract on your behalf**, or **paid for completion** because your firm was in default or terminated by the project owner within the last five (5) years?
 - Has your firm ever been **ineligible to bid on or be awarded a public works contract**, or perform as a subcontractor on a public works contract, pursuant to either Labor Code section 1777.1 or Labor Code section 1777.7?

Contractor Prequalification Procedures

- Sample prequalification questions (cont.)
 - At any time during the last five years, has your firm, or any of its owners or officers **been convicted of a crime** involving the awarding of a contract of a government construction project, or the bidding or performance of a government contract?
 - Has there been **any change in ownership** of the firm at any time during the last three years?
 - **How many years has your organization been in business** in California as a contractor under your present business name and license number?
 - Is your firm currently the **debtor in a bankruptcy** case?
 - Was your firm **in bankruptcy** at any time during the last five years?
 - At any time in the last five years has your firm been **assessed and paid liquidated damages** after completion of a project under a construction contract with either a public or private owner?

Contractor Prequalification Procedures

- Sample prequalification questions (cont.)
 - In the last five years has your firm, or any firm with which any of your company's owners, officers or partners was associated, **been debarred, disqualified, removed or otherwise prevented** from bidding on, or completing, any government agency or public works project for any reason?
 - In the last five years has your firm been **denied an award of a public works contract** based on a finding by a public agency that your company was not a responsible bidder?
 - In the past five years has any claim **against** your firm concerning your firm's work on a construction project been **filed in court or arbitration**?
 - In the past five years has your firm made any claim against a project owner concerning work on a project or payment for a contract and **filed that claim in court or arbitration**?

Contractor Prequalification Procedures

- Sample prequalification questions (cont.)
 - Any **surety company made any payments** on your firm's behalf as a result of a default, to satisfy any claims made against a performance or payment bond issued on your firm's behalf, in connection with a construction project, either public or private?
 - In the last five years has any insurance carrier, for any form of insurance, **refused to renew the insurance policy** for your firm?
 - Has your firm or any of its owners, officers or partners ever been found **liable in a civil suit or found guilty in a criminal action** for making any false claim or material misrepresentation to any public agency or entity?
 - Has your firm or any of its owners, officers or partners ever been **convicted of a crime** involving any federal, state, or local law related to construction?

Contractor Prequalification Procedures

- Sample prequalification questions (cont.)
 - Compliance with Occupational Safety and Health Laws and with Other Labor Legislation Safety
 - Prevailing Wage and Apprenticeship Compliance Record
 - Details re Recent Construction Projects Completed thin
- California Dept. of Industrial Relations Model Form
 - http://www.dir.ca.gov/od_pub/prequal/PubWksPreQualModel.doc

Contractor Prequalification Procedures

- Prequalification helps weed out incompetent and financially incapable contractors, but unfortunately, not always “savvy” ones, *i.e.*, those who know how to “game the system,” with change orders and the like.

Terminations

“Terminations – Can’t we all just get along?”

Termination For Cause

- Provides a back-up when unqualified contractors slip through the pre-screening measures, if the job is not getting done, or if a contractor's line of credit dries up due to frozen credit market and is unable to continue
- Grounds for termination must be "material" and "substantial" and stated in the contract
- Opportunity to cure
 - Contract provisions may specify that terminating party (usually owner) must give (contractor) notice and an opportunity to "cure" the default
 - Even absent a contract requirement, courts likely expect that notice/opportunity to cure should generally be given
 - Owner may want to specify that opportunity to cure need not be given for certain types of breaches

47

THEODORA ORINGER MILLER & RICHMAN PC

Termination For Cause

- Sample termination for cause provision:
- "If, in the opinion of owner, contractor at any time during the progress of the work:
 - Fails to perform work in accordance with project schedule;
 - Fails to immediately correct or remedy defective work;
 - Fails to supply sufficient material, labor or equipment;
 - Fails to promptly pay subcontractors and suppliers;
 - Fails to keep payment and performance bonds in effect; or
 - Commits any act or omission that by itself or in combination with others acts or omissions constitutes a material or substantial breach of contract; then,

(cont.)

48

THEODORA ORINGER MILLER & RICHMAN PC

Termination For Cause

- Sample termination for cause provision (cont.):
 - “The owner shall provide written notice to contractor and its performance bond surety giving contractor and/or its performance bond surety five days to correct and/or to commence correcting the deficiencies in a diligent and expeditious manner, as determined by the owner. In the event contractor and/or its performance bond surety fails to do so, owner may proceed without any further notice to terminate contractor’s right to proceed with the work of the contract, in whole or in part, without terminating contractor’s obligations under the contract.”

Termination For Cause

- Sample provision w/ ***solvency related issues***:
- “Owner may terminate Contractor’s right to proceed by giving notice to Contractor, with the termination effective on the date specified in the notice, if any of the following occurs:
 - Contractor makes an assignment for the benefit of creditors or other arrangement under a law which prevents collection of debts in full;
 - Contractor becomes insolvent or is otherwise unable to pay its debts as they come due in the ordinary course of business;
 - Contractor defaults, or receives a notice of default, under any of its other contracts;
 - Contractor ceases or suspends operation of or sells a substantial portion of its business or any portion of its business relating to the performance of the Work; or
 - a trustee, liquidator or receiver is appointed over some or all of the assets of Contractor used in the performance of the Services.”

Drafting Tips: Grounds for Termination

- Additional provisions to **enable Owner to monitor** default/termination events effectuate Owner's ability to exercise its remedies:
 - Contractor shall assure that all agreements with its subcontractors and suppliers and their subcontractors and suppliers, include an assignment to Owner, which (i) Owner may accept at its option, (ii) is effective only after termination of the Contract by Owner and only for those subcontract agreements Owner accepts by notifying the subcontractor in writing, and (iii) is subject to the prior rights of the surety, if any, obligated under a performance bond relating to the Contract.
 - Contractor to provide Owner copies of [audited] financial statements (either automatically at certain intervals or upon the request of Owner).
 - Owner's right to set off or recoup any claims arising out of a breach of the contract against monies owed by Owner to the Contractor (or any of its affiliates).

Termination for Convenience

- A termination for convenience clause permits an owner to terminate a contract without cause and without exposure for full breach of contract damages
- Clause permits owner to terminate "all or any part" of the contract for "owner's convenience at any time"
- Clause establishes standard for determining contractor's compensation (e.g., payment for earned value to date of termination, plus incurred but reimbursed costs, minus value of unused materials, plus demobilization costs)

Termination for Convenience

- Termination for convenience gives owner flexibility that may be helpful if owner's needs change (e.g., other projects take priority, project funding dries up)
- With conversion clause, termination for convenience clause may protect owner against wrongful termination damages if the owner terminated for cause but lacked cause for termination
- Clause enables owner to define contractor's remedy and process for resolving compensation for termination for convenience (e.g., work completed to date, demobilization, work in process)

Termination for Convenience

- Sample termination for convenience provision:
 - "Owner may, whenever its interests require, terminate this contract for the convenience of owner upon notice to contractor indicating the date upon which such termination is effective. Upon receipt of such notice, contractor shall cease work as directed and incur no further obligations with regard to the terminated work, except to take reasonable actions to protect work in place."
 - "Upon termination of the contract for convenience of owner, contractor shall transfer title and deliver to owner in the manner required by owner all parts fabricated or not, portions of the work in process, completed portions of the work, completed or partially completed plans, drawings, information and other property which would be required to be furnished to owner upon contract completion. Contractor shall protect and preserve property in its possession in which owner has an interest. If owner does not request transfer and delivery of such property, Contractor shall use its best efforts to sell such supplies and material for exclusive benefit of owner."

(cont.)

Termination for Convenience

- Sample termination for convenience provision (cont.):
 - “Upon termination of the contract for the convenience of owner, contractor shall be paid:
 - For completed and acceptable work performed, including all overhead and profit on such work
 - For storage, transportation and other costs reasonably necessary for the preservation or disposition of the work and/or inventory
 - “Contractor shall not be paid:
 - For work not completed or for contractor and/or subcontractor expected overhead and profit had the work and/or project not been terminated
 - Amounts required to be withheld by law, including without limitation, for stop notices until the stop notice issues are resolved
 - “Any outstanding disputes as of the date of termination shall be resolved pursuant to the contract’s dispute resolution and claim procedures”

55

THEODORA ORINGER MILLER & RICHMAN PC

Termination – Mitigating the Impact

- Terminations can be very disruptive to project
- Owner may want to include language in the termination provision that lessen impact of termination and include owner’s rights on termination.
 - Owner may assume responsibility for and take title to and possession of the work site and all work, materials and equipment remaining thereon.
 - Owner may at its option finish the Project by whatever method Owner may deem expedient.
 - Owner may make payments directly to unpaid subcontractors or vendors of Contractor, which payments shall be for Contractor’s account and shall be deducted from any amounts that may otherwise be due to Contractor.

56

THEODORA ORINGER MILLER & RICHMAN PC

Termination – Mitigating the Impact

- Sample Rights on Termination provision:
- **Owner's Rights on Termination.** In the event the Contractor's right to proceed with the work is terminated with or without cause, all of the following shall apply without prejudice to any other right or remedy Owner may have.
 - Owner shall have the right to request of Contractor in writing, and Contractor shall use all reasonable efforts to do all of the following as promptly as possible:
 - Except as Owner may specify, cease all further work and services, withdraw from all work areas, remove all equipment, materials, tools and instruments, and clean up all waste and debris.
 - Assist Owner in preparing an inventory of all material and equipment Contractor has taken possession of but not yet delivered to Owner.
 - Assign to Owner, or to any replacement contractor designated by Owner, title to all property not already owned by Owner, together with all subcontracts and other agreements (including warranties) as may be designated by Owner.
 - Assign to Owner, to the extent assignable, all permits, licenses, authorizations, approvals, patents and other proprietary rights, if any, then held by Contractor pertaining to the Project.
 - Give all notices, orders and directions which Owner may think expedient for the purposes of this Contract.

Termination – Conversion Clause

- Conversion clause: avoids owner uncertainty as to whether a court will treat an invalid termination for cause as a constructive termination for convenience
- Some assert such clauses encourage marginal terminations for cause because of protection afforded to owner
- Sample provision:
 - "If owner exercises its rights pursuant to section 10.1 to terminate contractor for cause, in the event said termination is deemed to lack the prerequisites of a termination for cause, the termination shall automatically convert to a termination for convenience pursuant to section 10.2 of this contract"

Continuing Duty to Perform

- Contractor generally has right to suspend or terminate work/walk off job due to material breach by owner
- This may be contractor's greatest leverage against owner
- Public owners can mitigate this risk by including contractual requirements to continue work and resolve disputes through claims procedures in the contract
- Known as "continuing duty to perform clauses" or "waivers of the right to terminate"

Continuing Duty to Perform

- Courts generally enforce such provisions, but language of contract is key:
 - "Contractor, in the event of a dispute or controversy with Owner . . . over any matter whatsoever shall not cause delay or cessation in or of Contractor's work . . . but shall proceed under the Contract with performance of the work hereby required."
B.C. Richter Contracting Co. v. Continental Casualty Co., 230 Cal. App. 2d 491, 499-500 (1964)
 - "Pending the final resolution of any dispute involving this contract, Contractor agrees to proceed with performance of this contract, including the delivery of goods, in accordance with Owner's instructions." *Metric Systems Corp. v. McDonnell Douglas Corp.*, 850 F.Supp. 1568 (N.D. Fla. 1994)

Continuing Duty to Perform

- Sample continuing duty to perform provision:
 - "Contractor acknowledges that all time deadlines under the Contract are of the essence and the school facilities being built for owner under this Contract are critically needed to provide seats, classrooms and other facilities for the children of the District. Accordingly, at all times, Contractor shall proceed with the Work even if Contractor contends Owner and/or anyone else is legally responsible for, has materially and/or otherwise breached the Contract; and even if there exists a dispute, disagreement, or a proceeding and/or a claim is pending. The Work, shall not be stopped, delayed, postponed and/or otherwise suspended pending the resolution of any dispute, claim, proceeding, and/or disagreement of any kind. This provision constitutes an advance waiver by Contractor of any right, if any, to rescind this Contract."

Sureties and Financial Stress/Insolvency

The Credit Crisis—Some Perspective

- *December 2005*—the “hot topic” for our panel presentation and article at the Construction Superconference in San Francisco was hyperinflationary price increases in the construction industry.
 - Hyperinflationary price increases were breaking contractors, who were trying to break contracts in court, using impossibility, mistake and frustration of purpose as legal theories.
 - Owners and contractors were exploring alternative contractual approaches to address the impact of sudden price spike on fixed price contracts.

The Credit Crisis—Some Perspective

- *December 2008*—the sky is falling in the other direction in most parts of the world with dramatic deflationary trends, liquidity constraints, but contrarian voter support for expansive public construction in California.
- Contractors typically finance projects for owners on an ongoing basis, and their working capital is tied up in work in process.
 - Contractors are especially vulnerable to constraints on their cash flow or liquidity (*i.e.*, credit crises).
- The surety industry experienced dramatic changes in the composition of its major players even before the credit crisis due to severe losses resulting from intense competition.

The Credit Crisis—Some Perspective

- Public construction projects depend upon an adequate pool of capable contractors having working capital to carry projects to completion and good credit relationships with sureties.
- Payment bonds are required on most public construction projects of more than \$25,000. Civ. Code § 3247(a).
- Work may not “commenc[e]” “on the contract” until the bond is filed. *Id.*
- “[N]o claim in favor of the original contractor arising under the contract shall be *audited, allowed or paid* by the public entity awarding the contract” unless the “payment bond is filed and approved as provided.” *Id.* § 3251.

The Payment Bond

- The purpose of payment bonds: to protect subcontractors, suppliers, laborers and others with no direct contractual relationship with the public owner from payment defaults by contractors.
- Mechanics’ liens cannot be enforced against public property. Those providing value to a public project through a contractor are dependent upon payment bonds and stop notices for their remedies in the event the original contractor defaults on payment. *Capitol Steel Fabricators, Inc. v. Mega Construction Co.*, 58 Cal. App. 4th 1049, 1060 (1997).
- Many public owners require bid and performance bonds as well.

The Payment Bond

- The public entity is liable to subcontractors, suppliers and laborers if it allows the contractor to commence work without the required bond and the contractor fails to make payment.
- *Electrical Electronic Control, Inc. v. Los Angeles Unified School Dist.*, 126 Cal. App. 4th 601, 611 (2005) (public owner held liable to subcontractor where original contractor never filed payment bond).
- *Walt Rankin & Associates, Inc. v. City of Murrieta*, 84 Cal. App. 4th 605, 622 (2000) (public owner liable where original contractor filed worthless bond; public owner had obligation to verify surety was “admitted surety insurer”).

The Surety

- Sureties are the “gatekeepers” for public projects and determine whether otherwise capable contractors can secure the bonds public owners require. Sureties are in effect lenders of “creditworthiness” or financial wherewithal.
- By statute, they are the cornerstone of the bonding scheme for public construction projects. “Notwithstanding any other provision of law, *any bond required on a public works contract, as defined in Section 1101 of the Public Contract Code, shall be executed by an admitted surety insurer.* Civ. Proc. Code § 995.311(a) (emphasis added).

The Surety

- They can terminate their bonds on 30 days notice and owners and contractors scrambling for cover. Civ. Proc. Code §§ 996.320 & 996.330.
- “If the [contractor] does not give a new bond within 30 days after notice of cancellation or withdrawal is given, *all rights obtained by giving the original bond immediately cease . . .*” Civ. Proc. Code § 996.340(a) (emphasis added).
- The public owner is at risk for liability to subcontractors, suppliers and laborers under *Electrical Electronic Controls* and *Walt Rankin* if the owner allows the contractor to continue working after the surety bond expires.

Payment Bonds—Surety Insolvency

- Experience indicates that the sudden departure of admitted surety insurers from the construction market may substantially disrupt school construction projects.
 - Amwest Surety Insurance was declared insolvent on June 7, 2001, and its bonds were cancelled July 6, 2001.
 - Amwest’s subsidiary, Farwest Insurance Company, also an admitted surety insurer, had its bonds cancelled then, too.
 - Frontier Pacific Insurance went into liquidation in Nov. 2001, and its bonds cancelled December 30, 2001.
 - How do contractors and owners respond to these circumstances?

Contractor and Owner Response to Surety Insolvency

- The fall out from the failures of Amwest, Farwest and Frontier Pacific was fairly limited for several reasons, although much of the available information is anecdotal.
- First, those business failures occurred as a result of losses from intense competition among sureties, not from recessionary business conditions.
 - Most contractors who were creditworthy were able to obtain substitute bonds from other sureties and to develop new relationships with different sureties.
 - At least a half a dozen LAUSD contractors vanished or assigned their assets for the benefit of creditors

Contractor and Owner Response to Surety Insolvency

- Second, the liability provisions of the Bond and Undertaking Law do not relieve sureties from liability for damages resulting while their bonds are in place, but only for liability arising after the effective date of the cancellation of their bonds. Civ. Proc. Code § 996.360
 - Public owners can protect themselves against future loss through avoidance by assuring that their contractors obtain substitute bonds
 - They can file claims for past losses against the surety

Contractor and Owner Response to Surety Insolvency

- Finally, the claims against Amwest, Farwest and Frontier Pacific were handled administratively in liquidation and were not public proceedings.
 - The claim bar date varied from 6 months to a year after the bonds were cancelled.
 - The claims took years to resolve.
 - The projects had long been completed by the time the claims were resolved.

Contractor and Owner Response to Surety Insolvency

- There is not much that public owners presently are able to do to control strategic economic behavior by sureties.
- Sureties are not required to bond projects and have the statutory right to cancel and withdraw from their bonds.
- The Bond and Undertaking Law preempts efforts to “prequalify” sureties, even presuming a public owner would want to try. See Civ. Proc. Code § 995.670 (“No public agency shall require an admitted surety insurer to comply with any requirements other than those in Section 995.660 whenever an objection is made to the sufficiency of the admitted surety insurer on the bond or if the bond is required to be approved”).

Contractor and Owner Response to Surety Insolvency

- Surety insolvency brought about by recessionary conditions or liquidity constraints is likely to have much more severe impacts on public construction.
- Sureties are likely to follow the lead of banking institutions in tightening lending standards, lowering bond limits and requiring additional collateral to secure credit arrangements.
- Contractors need more than ever before to get their financial houses in order, and develop relationships with multiple sureties.
- Owners should protect consider protecting themselves and their contracting pools by encouraging their prequalified contractors to develop and maintain relationships with multiple sureties.

75

THEODORA ORINGER MILLER & RICHMAN PC

Contractor and Owner Response to Surety Insolvency

- Owners should consider requiring multiple sureties on project bonds for projects with lower dollar values than typical.
- Owners also should consider methods to help ease working capital impacts on contractors from rules limiting time for payment of installed work—(e.g., payment for major equipment upon delivery when contractor must pay for it rather than months later when system passes 48 continuous operation test).
- Owners should solicit suggestions to avoid no-bid or sole bid situations where lack of competition drives up the cost of constructing projects.

76

THEODORA ORINGER MILLER & RICHMAN PC

Recent Case Law that Deserves Attention In light of Vast Amount of New Bond Funds

77

THEODORA ORINGHER MILLER & RICHMAN PC

Recent Case Law that Deserves Attention In light of Vast Amount of New Bond Funds

- Overview
 - Unlicensed Contractors – No Recovery, and Disgorgement of Prior Payments Received, by Unlicensed Contractors
 - No Recovery by Contractors for Unauthorized Work
 - False Claims
 - Owner Rights and Obligations re Withholding of Contract Retention Funds

78

THEODORA ORINGHER MILLER & RICHMAN PC

Recent Case Law – Unlicensed Contractors

- With the large amount of bond funded work to be done, and the need for large numbers of general contractors and subcontractors to perform the work, there is a risk that some contractors may not be licensed, or that they may lose their license during the course of construction
- Schools can research the licensing status and history of contractors via Contractors State License Board at <http://www2.cslb.ca.gov/OnlineServices/CheckLicense/NameRequest.asp>

Recent Case Law – Unlicensed Contractors *MW Erectors*

- *MW Erectors, Inc. v. Niederhauser Orn. & Met. Wks. Co., Inc.*, 36 Cal. 4th 412, 418 (2005)
 - California Supreme Court affirmed general rule under B&P Code § 7031 (Construction Services Licensing Law) “**denying recovery of all compensation** for work requiring a contractor’s license if a valid license was **not in place when performance began**, or if licensure **lapsed at any time during the work**”
 - Per B&P Code § 7031(a), a subcontractor that received its license **shortly after** executing a contract, but **not before it began performance**, could not bring an action to recover against the general contractor for **any work performed once it became licensed**

Recent Case Law – Unlicensed Contractors

Great West Contractors

- *Great West Contractors Inc. v. WSS Industrial Construction Inc.*, 162 Cal. App. 4th 581 (2008)
 - Broadly construed the licensing requirements of Bus. & Prof. Code § 7031 to preclude any recovery by a contractor if it was **unlicensed when it submitted its bid proposal**
 - Subcontractor did not have a contractor's license when it submitted its bid proposal and performed some preliminary tasks
 - The bid proposal was incorporated into the subcontract, and the contractor's license was obtained shortly thereafter
 - Subcontractor filed suit to recover payment from the general contractor and its surety for work performed

Recent Case Law – Unlicensed Contractors

Great West Contractors (cont.)

- Court held that the preliminary work performed, which included shop drawings, was work for which **licensure was required** under B&P Code § 7026
- Therefore, B&P Code § 7031(a) barred the subcontractor from maintaining a suit to recover compensation for the work performed under the contract
- Even though the subcontractor obtained a license while working on the contract, it **could not recover compensation** because it was **not licensed at all times**
- The individual license of the subcontractor's president could not support a finding of "substantial compliance" under B&P Code § 7031(e)
- Subcontractor was unable to invoke the statutory exception of "substantial compliance" under B&P Code § 7031(e) because it was never licensed prior to beginning performance

Recent Case Law – Unlicensed Contractors

Barak Construction

- Goldstein v. Barak Construction, 164 Cal. App. 4th 845 (2008)
 - Supports the argument that an owner can seek **disgorgement (refund)** of all funds paid to a contractor who was unlicensed at any time during the contract, **even funds for work performed while licensed**
 - Homeowners filed an application for a right to attach order and order for issuance of a writ of attachment against a contractor **to recover funds paid** for a home improvement project where the contractor was unlicensed at the time it commenced performance
 - The trial court issued attachment orders in favor of the homeowners, which were upheld on appeal

Recent Case Law – Unlicensed Contractors

Barak Construction (cont.)

- If a contractor is unlicensed at any time during a project, it is **not entitled to “offset”** the value of work performed while licensed against the funds sought to be recovered by the owner
- “Because appellants were not licensed at the time performance under the contract commenced, they are not entitled to any recovery for work performed even if Barak obtained its license during construction. . . . Any **postlicense work may not be set off** against respondents' potential recovery”

Recent Case Law – Unlicensed Contractors

Barak Construction (cont.)

- Makes clear that B&P § 7031 applies to “extra work” e.g., change order work in addition to that specified in the contract:
- “Appellants contend that any compensation for ‘extras’ was paid pursuant to separate *oral* agreements and, with one exception, such work was performed subsequent to Barak becoming licensed. We have disposed of the argument that work performed after Barak obtained licensing is subject to a different rule than work performed before licensing, performance having begun without a license. We further hold that ‘extras’ undertaken in furtherance of the contract are subject to the [Contractors’ State License Law].”

85

THEODORA ORINGHER MILLER & RICHMAN PC

Recent Case Law – Unlicensed Contractors

- Importance of *MW Erectors*, *Great West Contractors*, and *Barak Construction* for School Counsel:
 - Gives schools greater leverage when negotiating claims with contractors who may have been unlicensed (or had unlicensed subcontractors) at any point during the project because they are at risk of not receiving any recovery and of possibly having to refund money already paid, even for work performed while licensed

86

THEODORA ORINGHER MILLER & RICHMAN PC

Recent Case Law – Claims Procedures

- Unfortunately, as the number of school construction and modernization projects increases as a result of new bond funding, so too does the potential for contractor claims, disputes, and litigation

Recent Case Law – Claims Procedures

Arntz Builders

- Arntz Builders v. City of Berkeley, 166 Cal. App. 4th 276 (2008)
 - If a claim is governed by a claims procedure prescribed in a public works contract (Gov't Code § 930, et seq.), the presentation of an additional, statutory claim pursuant to the Government Claims Act (Gov't Code § 905, 910, et seq.) **is not required** prior to filing a lawsuit **unless** doing so is **expressly mandated by the contract**
 - Many public entities expect to receive and investigate a claim through their internal Government Claims Act procedures as a last step before facing litigation
 - If so, then in light of *Arntz*, they need to consider including an express provision in their public works contracts to ensure the same

Recent Case Law – Claims Procedures

Arntz Builders (cont.)

- Here's a sample contract provision addressing *Arntz*:
 - “Notwithstanding the dispute and claim resolution procedures set forth herein, a statutory claim must also be presented in accordance with Government Claims Act (Title 1, Division 3.6, Part 1 through 3 of the California Government Code) prior to the filing of a court action on CONTRACTOR'S dispute or claim. Nothing herein shall be deemed to amount to a waiver or modification of any party of the Government Claims Act.”

Recent Case Law – False Claims

- Some contractors may think schools are now “rich” because of bond funding and may be incentivized to overreach and submit questionable claims for payment

Recent Case Law – False Claims

Allison Engine

- *Allison Engine Co., Inc. v. United States*, 128 S.Ct. 2123 (2008):
 - New U.S. Supreme Court case that says subcontractors are not shielded from false claims liability to the government when they submit claims through or to their contractor
 - Concerns the federal False Claims Act, which imposes civil liability on those who submit false records or statements to get a false claim paid by the government
 - It has traditionally applied in the context of prime contractors who submit fraudulent claims for payment directly to public owners on construction projects

Recent Case Law – False Claims

Allison Engine (cont.)

- In *Allison*, the Court held that **a subcontractor can also violate the False Claims Act**, even though it does not submit requests for payment directly to the public owner, if it submits a false statement to the prime contractor **intending that contractor to use the statement to get the public owner to pay its claim**
- Although *Allison* concerned the federal False Claims Act, it may provide guidance to courts interpreting the California False Claims Act (Gov't Code § 12650, et seq.), which applies to school district construction projects

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *Thompson Pacific*

- *Thompson Pacific Construction, Inc. v. City of Sunnyvale*, 155 Cal. App. 525 (2007)
- Attorneys' fees and costs:
 - In an action by a contractor for wrongful withholding of retention in violation of Public Contract Code ("PCC") § 7107, a prevailing public entity **need not prove that the contractor's action to recover the funds was frivolous** in order to recover its attorney's fees and costs incurred in the action
 - Instead, the prevailing party in a PCC § 7107 action, in this instance the City of Sunnyvale, **shall be entitled** to attorney's fees and cost as a matter of law and the trial court has no discretion to refuse the award

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *Thompson Pacific (cont.)*

- Penalties:
 - To recover penalties for violations of the Subletting and Subcontracting Fair Practices Act, PCC § 4100, et seq. ("FPA") (e.g., contractor improperly substitutes in a subcontractor not listed in the bid documents), the **public entity itself must assess the penalties** because the court lacks jurisdiction to award the penalties in litigation
 - "[A] prime contractor violating any of the provisions of this chapter violates his or her contract and *the awarding authority may exercise the option, in its own discretion*, of . . . assessing the prime contractor a penalty in an amount of not more than 10% of the amount of the subcontract involved, and this penalty **shall be deposited in the fund out of which the prime contract is awarded**," but the FPA **does not allow** a public entity to pursue a civil action to recover those penalties
 - "There is no provision in . . . in the FPA that allows the awarding authority to pursue a civil action for monetary penalties"

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *Thompson Pacific* (cont.)

- Importance of *Thompson Pacific Construction* to School Counsel:
 - Increases the likelihood of recovering attorneys' fees in a PCC § 7107 dispute – no need to prove the contractor's claim was "frivolous," only need to prevail
 - "Use it or lose it" as to assessing penalties from contract funds when discover violations of the Fair Practices Act, PCC § 4100 because there is no right to pursue a subsequent civil action to recover them

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *Murray's Iron Works*

- *Murray's Iron Works, Inc. v. Boyce*, 158 Cal. App. 4th 1279 (2008)
 - Statutory penalties and attorneys' fees for wrongful withholding of payment for work performed **only apply to withholding of final payment**, not progress payments
 - Contractor prevailed at trial, and pursuant to Civil Code section 3260, et seq., the court awarded attorneys' fees and a 2% penalty on the unpaid portion owed to the contractor
 - The appellate court overturned the award after concluding that an owner's wrongful withholding of a portion of **final payment**, as opposed to withholding a "**progress payment**," does not entitle a contractor to penalties and attorneys fees under Section 3260

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *Murray's Iron Works* (cont.)

- "In conclusion, we hold that the term 'progress payment' has a particular meaning in the construction industry. As enacted in Civil Code section 3260.1, a progress payment is a payment other than a down payment that is to be made before the project is completed. Accordingly, because the agreement . . . called for a payment of the net due under the contract upon satisfactory completion of the project there was no evidence that [owner] wrongfully withheld a progress payment. Therefore, the trial court erred."
- Although analogous public entity contract statutes, e.g., PCC § 7107 (withholding and release of retention proceeds) and Civil Code § 3320 (progress and final retention payments to prime design professionals), were not at issue in this case, the distinction made by the court between "progress payment" and "final payment" arguably applies in the context of these statutes as well.

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *Murray's Iron Works* (cont.)

- Importance of *Murray's Iron Works* to School Counsel:
 - Could potentially limit exposure of schools to statutory penalties and attorneys' fees for wrongful withholding of payments to those instances where final payment, as opposed to a progress payment, is withheld

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *S&S Cummins Corp.*

- *S&S Cummins Corp. v. West Bay Builders, Inc.*, 159 Cal. App. 4th 765 (2008)
 - Addresses the meaning “2% penalty” for wrongful withholding of contract retention per PCC § 7107
 - Contractor withheld retention on a public works project from a subcontractor, and the subcontractor prevailed at trial
 - Court determined that the 2% penalty means 2% per month and 24% per annum on the wrongfully withheld amount, **not 2% compounded** monthly on the total

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *S&S Cummins Corp. (cont.)*

- Importance of *S&S Cummins Corp.* to School Counsel:
 - In the event a court determines that a school wrongfully withheld contract retention, liability is limited to 2% per month on the amount withheld

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *Great Western Drywall v. Roel*

- *Great Western Drywall v. Roel*, 166 Cal. App. 4th 761 (2008)
 - Subcontractor (“SC”) sued the general contractor (“GC”) for unpaid extra work performed on unapproved change order requests
 - GC cross-complained against the SC for allegedly inadequate work, abandonment, and damages to the work of others
 - SC recovered damages at trial for the unpaid extra work performed, the GC recovered on its cross-complaint and received an award that **exceeded the sub's award**
 - Court held that the GC was **entitled to a setoff** of its entire award against the SC's award and the SC **not entitled** to any prejudgment interest on the value of the extra work performed or 2% penalties for the GC's failure to timely make progress payments

101

THEODORA ORINGER MILLER & RICHMAN PC

Recent Case Law – Rights and Obligations re Withholding of Contract Retention – *Great Western Drywall v. Roel* (cont.)

- Involved a dispute between a GC and a SC, but the holding arguably applies to disputes between an owner and a GC
- Thus, if a GC prevails against an owner in a change order dispute, if the owner has cross-claims against the GC that equal or exceed the amount of the GC's claims, and the owner prevails in full on those claims, the owner **should be entitled to a setoff** that **precludes the GC** from recovering prejudgment interest on the value of the extra work performed or any 2% statutory penalties
- **This case is a good one to keep in mind when negotiating claims with a GC against whom the owner has cross-claims, i.e., if GC may not be able to recover interest and penalties, the GC may be more willing to negotiate a resolution

102

THEODORA ORINGER MILLER & RICHMAN PC

Recent Case Law – Rights and Obligations re Withholding of Contract Retention

- Pointers re Withholding of Contract Retention, Claims Resolution, and Owner/Contractor Relationship:
 - In light of the large number of construction and modernization projects expected after passage of bond measures, quality contractors will be in high demand, but perhaps, short supply
 - If contractors determine that an owner is unreasonable, overly confrontational, or unfair in how it deals with its contractors, those contractors may simply choose not to bid on that owner's projects in the future – and word can spread fast
 - As a result, an owner suffers by not having quality contractors willing to work on their projects

Attorney Contact Information

Kevin A. Dorse, Esq.
Theodora Oringher Miller & Richman PC
535 Anton Boulevard, Ninth Floor
Costa Mesa, CA 92626
Telephone: 714.549.6200
Fax: 714.549.6201
Email: kdorse@tocounsel.com

Erich R. Luschei, Esq.
Theodora Oringher Miller & Richman PC
535 Anton Boulevard, Ninth Floor
Costa Mesa, CA 92626
Telephone: 714.549.6200
Fax: 714.549.6201
Email: eluschei@tocounsel.com

Scott K. Behrendt, Esq.
Theodora Oringher Miller & Richman PC
535 Anton Boulevard, Ninth Floor
Costa Mesa, CA 92626
Telephone: 714.549.6200
Fax: 714.549.6201
Email: sbehrendt@tocounsel.com