You’ve got to know when to hold ‘em: what California public entities and public works contractors need to know about retention

By Matthew A. Richards

A new California Court of Appeal decision, *FTR International, Inc. v. Rio School District*1 ("FTR International"), appears to place new limits on the circumstances under which a California public entity may withhold retention on public works projects under Public Contract Code section 7107(c).2 *FTR International* introduces uncertainty into a seemingly well-settled area of California construction law for public entities and public works contractors alike, and raises a host of new questions. The decision also creates a court of appeal split that the California Supreme Court may address sooner rather than later.

Case overview and key holdings

Following the completion of construction of a new school for the Rio School District, the general contractor, FTR, sued the District, seeking: (1) additional compensation for proposed change orders ("PCOs") submitted during construction; and (2) release of retention, along with associated statutory penalties and attorneys' fees. The District brought a cross-complaint, alleging False Claims Act violations based on FTR's submission of the PCOs. The District also defended against FTR's claim for release of retention on the grounds that because it had initially (and properly) withheld funds beyond the 60-day period while stop notices were being resolved, it was privileged to continue doing so while the dispute over PCOs was pending. The trial court granted judgment in favor of FTR and awarded contract damages (including for extra PCO-related work performed by FTR and delay caused by the District), statutory penalties under section 7107, attorneys' fees and prejudgment interest and costs. The trial court also granted judgment in favor of FTR on the District's False Claims Act cross-complaint. The District appealed.

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2 Unless otherwise noted, all statutory references are to the California Public Contract Code.
On appeal, the Second Appellate District panel upheld the award of penalties under section 7107 for the District’s improper withholding of retention due to FTR. In doing so, the panel made the following key holdings:

- Public entities cannot withhold retention based on the basis of PCO or other contract price dispute.
- The only permissible purposes for a public entity’s withholding retention are to provide security against: (1) mechanics liens and (2) deficiencies in the contractor’s performance.
- Public entities must release retention once these two legitimate purposes have been satisfied.

**Court of appeal split**

*FTR International* is the first published case to directly construe the duties of public entities to release retention to general contractors under section 7107(c). In doing so, *FTR International* expressly rejects *Martin Brothers Construction, Inc. v. Thompson Pacific Construction, Inc.* and appears to narrow the *Martin Brothers* holding that any “bona fide dispute” between the parties on a public works project justifies the continued withholding of retention.

*Martin Brothers*, decided in 2009, dealt with the duties of public works general contractors to release retention to their subcontractors under section 7107(e), which had been presumed to apply equally to the relationship between public entities and general contractors under section 7107(c). In *Martin Brothers*, the Third Appellate District held that a “bona fide dispute” is any good faith “controversy, debate or quarrel” regardless of the subject matter of the dispute, concluding that the “subject is immaterial to its nature as a dispute.” Subsequent courts similarly held that a good faith dispute exists so long as there is a legally tenable basis for the dispute.

*FTR International* clearly rejects *Martin Brothers* and its progeny. The *FTR International* court twice expressly states that its primary holding—“a dispute over the contract price [i.e., a change order dispute] does not entitle a public entity to withhold funds due to a contractor”—is at odds with *Martin Brothers*, a decision authored by current California Chief Justice Tani Cantil-Sakauye.

Given the uncertainty that *FTR International* has introduced into what had been an apparently settled area of California construction law and the Chief Justice’s authorship of the contrary case authority, it may be that the California Supreme Court will choose to address and resolve the uncertainty.
conflict between *FTR International* and *Martin Brothers* sooner rather than later. If and when the high court does so, the Chief Justice’s role in deciding *Martin Brothers* may portend the early demise of *FTR International*.

**Open questions and policy concerns**

*FTR International* seems to raise more questions than it resolves, among them:

— What constitutes a “bona fide dispute” under section 7107?
— What must public entities do to ensure they do not run afoul of *FTR International* when they withhold retention?
— Will the policy goals articulated by the *FTR International* court be undone by unintended consequences, such as encouraging public entities to bring cross-complaints for liquidated damages relating to general contractors’ performance on public works projects?
— Does the *FTR International* rule extend to the relationship between general contractors and their subcontractors?
— Will the California Supreme Court step in to resolve the Court of Appeal split, and, if so, when?

For California public entities and public works contractors, the answers cannot come soon enough.

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