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# Los Angeles Lawyer

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# Appraising Defenses

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## The Tools Available to Contractors for Recovery of Attorney's Fees

**LITIGATION IS A COSTLY UNDERTAKING**, often making the ability to recover attorney's fees a key consideration for clients deciding whether to pursue a claim. The mechanic's lien laws of California provide contractors, subcontractors, and material and equipment providers with statutory authorization to obtain attorney's fees even without a contractual basis for recovery. A mechanic's lien allows a contractor to lien, and ultimately foreclose upon, the real property the contractor caused to improve if the entity it contracted with does not pay, provided the contractor has satisfied certain statutory prerequisites.<sup>1</sup>

The special rights afforded contractors can be traced to the adoption of the California Constitution:

Holders of mechanics' liens are protected by constitutional mandate. "The mechanics' lien derives from the California Constitution itself; the Constitution of 1879 mandated the Legislature to grant laborers and materialmen a lien upon the property which they have improved; no other creditors' remedy stems from constitutional command....Moreover, the courts have uniformly classified the mechanics' lien laws as remedial legislation, to be liberally construed for the protection of laborers and materialmen...."<sup>2</sup>

The special creditor rights bestowed on contractors to lien real property has been justified by the notion "that the recordation of a mechanics' lien, or filing of a stop notice, inflicts upon the owner only a minimal deprivation of property; that the laborer and materialman...have enhanced the value of that property; and that state policy strongly supports the preservation of laws which give the laborer and materialman security for their claims."<sup>3</sup>

Given the superior rights afforded contractors by the California Constitution to enforce fee collection, it is not surprising that they have also been given a statutory right to recover attorney's fees, costs, interest, and even penalties. The exercise of this right frequently occurs in disputes over release of what is known as retention. Specifically, construction contracts usually grant owners the right to retain 10 percent from a contractor's payments until a project is completed. Under the Civil Code, for a private work of improvement, a project owner must pay this retention to the prime contractor within 45 days of project completion.<sup>4</sup> Within 10 days of the prime contractor's receipt of the retention proceeds from the owner, the prime contractor is obligated to pay that portion of retention owed to each subcontractor.<sup>5</sup>

Disputes often focus on whether a project has actually been completed<sup>6</sup> and, therefore, if the obligation to pay retention has matured. When this happens, an owner can withhold from the prime contractor, or the prime contractor can withhold from a subcontractor, 150 percent of the disputed amount until the dispute is resolved.<sup>7</sup> If retention proceeds are not paid timely and a prime contractor (or subcontractor) prevails in suit against an owner (or contractor), the prime contractor (or subcontractor) is entitled to recover 2 percent per month on the wrongfully withheld monies.<sup>8</sup> Further, the prevailing party (the prime contractor, subcontractor, or owner) is entitled to recover attorney's fees and costs.<sup>9</sup> Thus, in order to preserve a claim

for fees, costs, and interest under the Civil Code a key issue at trial is substantiating that the disputed funds actually constitute retention.

The Civil Code provides prime contractors on private works of improvement with the same rights on progress payments. A project owner has 30 days after a contractual demand for payment (typically, an invoice) to make a progress payment.<sup>10</sup> If the owner fails to pay one or more progress payments and the prime contractor sues the owner to recover those amounts, the contractor is entitled to receive 2 percent per month on the wrongfully withheld progress payments and may recover its attorney's fees and costs.<sup>11</sup>

### Public Works

For public works projects, a public entity is required under the Public Contract Code to release retention to a prime contractor<sup>12</sup> within 60 days of a project's completion.<sup>13</sup> Like private works projects, if a dispute occurs and monies are actually due and owing, a public entity

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can withhold from the prime contractor (or the prime contractor from a subcontractor) 150 percent of the contested amount until the dispute is resolved.<sup>14</sup> In contrast to private works of improvement, however, a prime contractor for a public works project must pay retention to each subcontractor within 7 days<sup>15</sup> rather than 10. On the other hand, with public works projects (as with private ones), a prevailing prime contractor or subcontractor may collect 2 percent on amounts wrongfully withheld and recover attorney's fees and costs.<sup>16</sup>

Similarly, the Business and Professions Code protects the right of subcontractors to recover progress payments that a prime contractor fails to make. Regardless of whether a project is a private or a public work of improvement, a prime contractor must pay a subcontractor within 10 days of receipt of payment.<sup>17</sup> If the contractor does not make payment by that deadline and the subcontractor brings suit and prevails in its action, the subcontractor may not only recover its attorney's fees and costs but is also entitled to collect 2 percent per month on the wrongfully withheld monies as a penalty.<sup>18</sup> When this penalty is added to the legal rate of interest of 10 percent that can be collected on a judgment for breach of contract, a subcontractor could potentially recover at least 34 percent per annum on the sums owed to it.<sup>19</sup>

Certain California statutes refer to the 2 percent per month penalty as a "charge" that is "in lieu of any interest otherwise due."<sup>20</sup> Other statutes characterize it as a "penalty" but do not contain a corresponding provision that this penalty is in lieu of interest otherwise due.<sup>21</sup> Thus, it is critical to know which of these two different statutory references applies in a given situation, because it is entirely conceivable that a party could effectively recover interest on top of interest. Stated differently, if the applicable code section specifies the imposition of a "penalty," a party would not be precluded from recovering interest at 2 percent per month in addition to the interest allowed at the legal rate or the contract. On the other hand, if the relevant statute mandates that the 2 percent be treated as a "charge," a party should be barred from recovering an additional interest payment.

### Stop Notices and Payment Bonds

In addition to the rights afforded by a mechanic's lien, contractors have another powerful tool to recover fees. A "stop notice" or "notice to withhold" allows a contractor to assert a claim directly against construction loan proceeds. A stop notice is available on private and public works projects.<sup>22</sup> Under Civil Code Section 3158, a prime contractor can serve a stop notice on a lender but not on the owner. When an

owner is served with a stop notice by a subcontractor, the owner is generally required to withhold from the prime contractor sufficient money to answer the claim.

In private works projects, contractors can take the additional step of obtaining a bonded stop notice, which provides contractors with another potential means of recovering attorney's fees and costs.<sup>23</sup> If a contractor decides to purchase a stop notice bond in order to pursue a claim against a construction lender, the lender must withhold funds<sup>24</sup> upon receipt of the bond as long as the contractor has met certain statutory prerequisites.<sup>25</sup> Thereafter, if the contractor decides to file a bonded stop notice claim and names the lender as a party in the action, the prevailing party in that action is entitled to recover "reasonable attorneys' fees in addition to other costs and in addition to any liability for damages"<sup>26</sup> from the entity found liable by the court.

In contrast to the practice for private works of improvement, public entities typically require a prime contractor to obtain a payment bond on public works projects. On a public works project a contractor generally has a payment bond under which to make a claim, because under Civil Code Section 3247(a), "Every original contractor to whom is awarded a contract by a public entity, except as provided in...the Public Contract Code, involving an expenditure in excess of twenty-five thousand dollars...for any public work shall...file a payment bond...." Additionally, under Public Contract Code Section 7103(a), "Every original contractor...awarded a contract by a state entity...involving an expenditure in excess of five thousand dollars for any public work shall...file a payment bond...."

Because of these payment bond requirements, subcontractors have another mechanism by which to recover their attorney's fees. Specifically, the surety issuing the payment bond must pay any subcontractor, among others, who is not paid for its work on the project.<sup>27</sup> In fact, the same Civil Code section mandating that payment bonds be issued for the benefit of subcontractors also requires that the language of bonds themselves provide that the sureties will pay reasonable attorney's fees if a lawsuit is brought to recover on a payment bond.<sup>28</sup>

### Mepco and Performance Bond Claims

In 2007, a prime contractor, Mepco Services, Inc., sued an Orange County school district for breach of contract and other causes of action.<sup>29</sup> The contract between Mepco and the school district did not have an attorney's fees provision but did require the contractor to obtain a performance bond.<sup>30</sup> The school district responded by filing a cross-complaint against Mepco and the surety that issued the

performance bond. A performance bond, unlike a payment bond, is a bond that the public entity can look to when the contractor fails to perform under the contract. Under the performance bond, the surety is required to satisfy the prime contractor's obligations under the prime contractor-public agency contract. The public agency claimed that the contractor was at fault for the project delays, with the result that the agency was entitled to liquidated damages.<sup>31</sup> The performance bond provided for recovery of attorney's fees solely by the school district.<sup>32</sup>

After Mepco received a jury verdict in its favor, the contractor sought to recover its attorney's fees based on the terms of the performance bond, notwithstanding the fact that the terms of the bond limited the award of these fees to the school district.<sup>33</sup> Mepco argued that the terms and conditions of the performance bond were an integral part of the agreement between it and the school district, even though the bond was a document separate from the contract. The trial court agreed with Mepco and awarded attorney's fees to the contractor.

In affirming the lower court ruling, the appellate court concluded that "the trial court properly determined that it could award Mepco attorney fees pursuant to the terms of the performance bond."<sup>34</sup> The basis for the appellate court decision rested first on the school district's decision to include a claim in its cross-complaint for enforcement of the bond against Mepco and its surety and to seek recovery of its attorney's fees. If the school district had prevailed in its enforcement action, the district would have been allowed its attorney's fees. Accordingly, based on the reciprocity principles set forth in Civil Code Section 1717(a), Mepco was entitled to a similar recovery in defending against the performance bond claim.

The appellate court also stressed that Mepco was entitled to attorney's fees because a common issue existed between the school district's affirmative claim that Mepco had breached its contract with the district and Mepco's defense against that claim. Before the school district could recover against the bond, it first had to establish that Mepco had defaulted. Since Mepco was successful in defending against that accusation, the contractor not only defeated the district's breach of contract claim but also succeeded on its own breach of contract claim. Since the school district would have been entitled to attorney's fees and costs if the verdict had been in its favor, reciprocity compelled the same result for Mepco when it prevailed.

Since public works contracts rarely contain an attorney's fees provision, the ruling in *Mepco* is significant because it provides contractors with the ability to recover attorney's

fees through the provisions in a performance bond authorizing recovery. Mepco effectively purchased the right to recover its attorney's fees when it obtained the bond that it was statutorily required to provide for the project. Under *Mepco*, when there is a performance bond, contractors have an alternative means of collecting attorney's fees, because these bonds ordinarily contain such a provision.

One issue that remains is whether a public entity must pursue a claim under a performance bond in order to trigger the attorney's fees clause in that bond. Given the court's ruling in *Mepco*, lawyers for public agencies will argue that their client must

make a claim under the bond before a contractor can invoke the attorney's fees provision in that bond. On the other hand, lawyers for contractors may argue that the bond is an integral component of the overall contract documents and, therefore, it is unnecessary for the public entity to pursue a claim on that bond as a prerequisite to a contractor having recourse under the attorney's fees provision of the bond. Contractors may also benefit from the court's ruling in *Mepco* because public agencies may reconsider making a claim against a contractor's performance bond if it means that they may be subject to the attorney's fees provision of the bond if they are not the prevailing party.

Contractors in California are afforded a host of recovery rights afforded to no other creditors. Contractors must not only be completely familiar with these rights in order to protect their interests and maximize the potential recovery that can be obtained in any litigation, they must also know the applicable statutory prerequisites required to invoke those rights and ensure they are in compliance. ■



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<sup>1</sup> See CIV. CODE §§3097 *et seq.*

<sup>2</sup> *Truestone, Inc. v. Simi W. Indus. Park II*, 163 Cal. App. 3d 715, 723 (1984) (quoting *Connolly Dev., Inc. v. Superior Court*, 17 Cal. 3d 803, 826-27 (1976)).

<sup>3</sup> *Connolly Dev., Inc. v. Superior Court*, 17 Cal. 3d 803, 828 (1976).

<sup>4</sup> CIV. CODE §3260(c).

<sup>5</sup> CIV. CODE §3260(d).

<sup>6</sup> CIV. CODE §3260(c). See also CIV. CODE §§3093, 3086.

<sup>7</sup> CIV. CODE §3260(c), (e).

<sup>8</sup> CIV. CODE §3260(g).

<sup>9</sup> *Id.*

<sup>10</sup> CIV. CODE §3260.1(b).

<sup>11</sup> *Id.*, CIV. CODE §3260(g).

<sup>12</sup> PUB. CONT. CODE §7107(c).

<sup>13</sup> *Id.*

<sup>14</sup> PUB. CONT. CODE §7107(c), (e).

<sup>15</sup> CIV. CODE §3260(d); PUB. CONT. CODE §7107(d).

<sup>16</sup> PUB. CONT. CODE §7107(f).

<sup>17</sup> BUS. & PROF. CODE §7108.5(a), (b).

<sup>18</sup> BUS. & PROF. CODE §7108.5(b), (e).

<sup>19</sup> See CIV. CODE §3289: "If a contract...does not stipulate a legal rate of interest, the obligation shall bear interest at a rate of 10 percent per annum after a breach."

<sup>20</sup> See, e.g., CIV. CODE §3260(g); PUB. CONT. CODE §7107(f).

<sup>21</sup> See BUS. & PROF. CODE §7108.5(b); CIV. CODE §3262.5(b) (referring to a "penalty" and not "in lieu of any interest otherwise due"). See also *Morton Eng'g & Constr., Inc. v. Patscheck*, 87 Cal. App. 4th 712, 717-18 (2001) ("We do not agree with Patscheck that allowing recovery of prejudgment interest...and the 2 percent penalty would result in a double recovery for the subcontractor."). See also *Wisper Corp. v. California Commerce Bank*, 49 Cal. App. 4th 948, 960 (1996).

<sup>22</sup> See CEB, CALIFORNIA MECHANICS' LIENS AND OTHER REMEDIES §1.71 (1988); see also CIV. CODE §§3181, 3158.

<sup>23</sup> CIV. CODE §§3159(a), 3176. A subcontractor may serve a public entity with a stop notice, which does not require a bond, but there is no attorney's fees provision associated with the public works stop notice. CIV. CODE §§3181, 3179 *et seq.*

<sup>24</sup> CIV. CODE §3159(a).

<sup>25</sup> CIV. CODE §3160.

<sup>26</sup> CIV. CODE §3176.

<sup>27</sup> CIV. CODE §3248(b).

<sup>28</sup> *Id.* See also CIV. CODE §3250 (attorney's fees).

<sup>29</sup> *Mepco Servs., Inc. v. Saddleback Valley Unified Sch. Dist.*, 189 Cal. App. 4th 1027 (2010).

<sup>30</sup> *Id.* at 1045.

<sup>31</sup> *Id.* at 1030.

<sup>32</sup> *Id.* at 1045.

<sup>33</sup> The attorney's fees provision in the performance bond reads: "Contractor/Principal and Surety agree that if the DISTRICT is required to engage the services of an attorney in connection with the enforcement of this bond, each shall pay DISTRICT's reasonable attorneys' fees and costs incurred, with or without suit, in addition to the above amount."

<sup>34</sup> *Mepco*, 189 Cal. App. 4th at 1044-45.