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Construction Law Update

Legal Update: Under new laws effective January 1, 2012, *when* can a public entity withhold retention of greater than 5% and *should* it exercise its right to do so?

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Among the new laws which took effect January 1, 2012, public entities may only withhold 5% retention, rather than the previous up to 10%, unless specific criteria are met. Specifically, Public Contract Code section 7201(b)(4) now provides as follows: "Notwithstanding any other provision of this subdivision, the retention proceeds withheld from any payment by the awarding entity of a city, county, city and county, including charter cities and charter counties, district, special district, public authority, political subdivision, public corporation, or nonprofit transit corporation wholly owned by a public agency and formed to carry out the purposes of the public agency, from the original contractor, by the original contractor from any subcontractor, and by a subcontractor from any subcontractor thereunder, may exceed 5 percent ***on specific projects where the governing body of the public entity or designee, including, but not limited to, a general manager or other director of an appropriate department, has approved a finding during a properly noticed and normally scheduled public hearing and prior to bid that the project is substantially complex and therefore requires a higher retention amount than 5 percent and the awarding entity includes both this finding and the actual retention amount in the bid documents....."*** *(Emphasis added.)*

What is "Substantially Complex"?

The critical issue with respect to the new law is that it does not define the phrase "substantially complex".[1] Therefore, the making of such a finding on a project which is not clearly complex may provide the basis for contractors to challenge the bid documents, the contract award, or the contract terms. This likelihood was noted by Governor Gray Davis when several years ago he vetoed a bill identical to SB 293 (the one which recently revised section 7201).

The Dangers of Making a Formal Finding that a Project is "Substantially Complex"

The California Special Districts Association and a coalition of local public agencies wrote the following in opposition to the new law during the legislative process: "....The 'substantially complex' exemption language is a step in the wrong direction and will lead to dangerous unintended consequences: It will raise project costs, change-order costs, and insurance costs. By acknowledging up-front that a job is 'substantially complex', a public agency will publicly certify an elevated degree of difficulty to bidders, who will then be able to charge a new 'higher substantially complex' premium. This will also increase the cost of bonds and insurance coverage, and impact the relationship between the agency and contractor with regard to change orders and other issues as the substantially complex designation could be used against the public agency."

The concerns raised by the California Special Districts Association and others is something that should not be overlooked as we believe they are correct that a "substantially complex" finding, while allowing the public entity to protect itself via the higher retention withholding, could also likely drive up project costs at bid time and provide potential justification for use by contractors when making claims for additional compensation during the project.

These concerns are especially important given the fact that retention is no longer routinely maintained at 10% until project completion anyway. The concept of retention is one based on the ability of the owner to hold a sufficient amount *to promote satisfactory completion*. When a project reaches 50% or more in completion, it has been common in the past decade or two to have the owner elect

[1] The legislative history for SB 293 does not provide any insight in to the meaning of the term "substantially complex" as used in the new law.

to reduce retention to 5% on the overall project, meaning that, during the last 50% of the project, retention is not withheld from progress payments and therefore effectively the retention rate becomes 5% overall. While the election to reduce retention to 5% is in the discretion of the owner, it is frequently exercised. Therefore, the recent change in the law mandating only a 5% retention rate is, effectively, not a real material change for most projects and project owners.

Alternative Ways to Recover Costs

Finally, there are other ways for the public entity to recover the amounts necessary to complete/repair the prime contractor's work should the 5% permitted retention prove insufficient. Specifically, the new law (Public Contract Code section 7201) expressly notes that it does not alter the public entity's long established ability to withhold 150% of the value of any disputed amount of work from the final payment, as provided for in Section 7107(c). In addition, the public entity can make a claim against the defaulting contractor's performance bond to recover the amounts expended to correct/complete the contractor's work. There is also no provision in the new law that prohibits the withholding of progress payments for other reasons (such as delay, claims, etc.).

Given the potentially serious consequences, most notably increased construction costs and higher probability of claims by contractors, the election by a public entity owner to declare that a project is “substantially complex" is one which should be exercised with extreme caution. The potential downside to doing so (i.e., exposing the owner to claims of delay and loss of efficiency if and when issues arise) seem to strongly outweigh the benefit of holding up to 5% more in retention at the end of a project. We urge public entities to consult with counsel to discuss the risks and/or benefits of such an election prior to taking any such action.

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