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Public Agency Risk Managers Association (PARMA) *2009 Annual Conference*

“Protecting Against and Managing Liabilities on Public Works Construction Project”

February 4, 2009

Presenter:
Maiya Yang

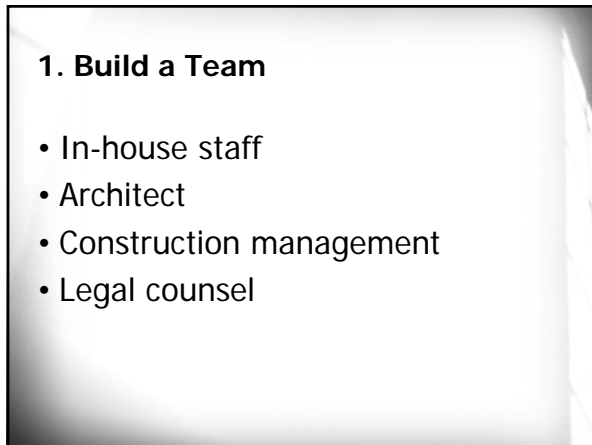
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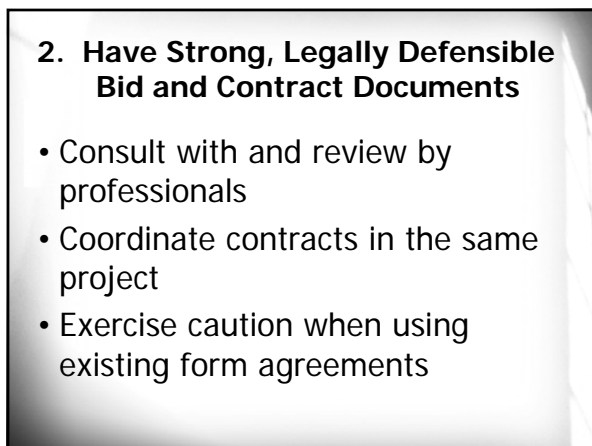
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2. Have Strong, Legally Defensible Bid and Contract Documents

- Use standard English
- Avoid ambiguity
- Avoid inconsistency
- Format and organize contract provisions

3. Plan Ahead to Avoid Bid Disputes

Common Problems

- Bidding requirements
- Bid and contract documents
- Plans and specifications

3. Plan Ahead to Avoid Bid Disputes

Common Problems cont.

- Pre-bid procedure and requirements
- Contract award
- Consulting professionals

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3. Plan Ahead to Avoid Bid Disputes

Planning

- Understand the bidding process
- Have clear and strong bid documents
- Consult with professionals early
- Consider options ahead of time

4. Require and Procure Proper Insurance

Professional

- Errors and omissions
- General liability
- Automobile liability
- Worker's compensation

4. Require and Procure Proper Insurance

Contractor

- Builder's risk
- Fire insurance
- General liability
- Automobile liability
- Workers' compensation

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4. Require and Procure Proper Insurance

Local Agency

- Builder’s risk
- Property
- Fire insurance
- General liability
- Earthquake
- Mold

4. Require and Procure Proper Insurance

Wrap-Up Insurance

- One party procures coverage for project
- Advantages
- Disadvantages

4. Require and Procure Proper Insurance

Evaluating Sufficiency of Insurance

- Admitted status
- Rating and financial status
- Policy limits
- Policy period
- Additional insured
- Certificate of insurance

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5. Requiring Performance and Payment Bonds

Performance Bond

- Not required but advisable
- Guarantee faithful performance of contract
- Remedies upon contractor default
- Issue by admitted surety

5. Requiring Performance and Payment Bonds

Payment Bond

- Contract greater than \$25,000
- Civil Code § 3248
- Issue by admitted surety
- Agency approval

6. Administration of Contract

Change Order

- Definition: change or amendment to construction contract
- Approval of governing body

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6. Administration of Contract

Prompt Payment

- Basic rule
- Progress payments
- Retention

6. Administration of Contract

Withholding Payment

- Grounds for withholding
- Status of project
- Agency's goals
- Amount to withhold
- Evidence supporting withholding
- Interest and penalty

6. Administration of Contract

Record Keeping and Accounting

- Organized and accurate records
- Full and accurate accounting
 - Contract price
 - Change order
 - Payments
 - Withheld amounts

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7. Evaluating and Handling Disputes

Contractor: Before Construction

- Problems
- Agency options
 - Forfeiture of bid bond
 - Damages
 - Defense and indemnity: subcontractor claims

7. Evaluating and Handling Disputes

Contractor: During Construction

- Initial analysis
- Consulting professionals
- Evaluating options
- Implementing option

7. Evaluating and Handling Disputes

Architect

- Initial analysis
- Consulting professionals
- Evaluating options
- Implementing option

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7. Evaluating and Handling Disputes

Subcontracts/Suppliers

- Filing of stop notices
- Withholding for stop notices
- Handling stop notice lawsuits
- Releasing funds withheld for stop notices

7. Evaluating and Handling Disputes

Surety

- Contacting surety
- Takeover agreement

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INTRODUCTION

This workshop is designed to provide risk managers and business personnel with information and practical measures that they may implement to prevent and manage liabilities on public works projects. However, we caution that the information discussed here should not be viewed as a substitute for careful planning and preparation, and cannot replace the critically important assistance of legal counsel. Public works projects present public agencies with complex and challenging legal questions and problems that frequently depend on the particular facts and circumstances. In addition, the information here reflects statutes, regulations, and administrative rules that are in effect at the time it was prepared.

1. BUILD A TEAM

A construction project, whatever its size and cost, should be undertaken only after careful planning and consultation with appropriate professionals. By selecting the right professionals to advise and assist you on a project, your agency is well on its way towards the successful and timely completion of the project. These professionals may include an architect, construction and/or project manager, and legal counsel.

- **In-House Staff:** Before commencing any public works project, your agency should evaluate the availability and expertise of in-house staff to participate in the planning, design, and oversight of the project. If in-house staff will be managing the project, your agency will need staff to process paperwork, and perform filing and other clerical functions. By doing this evaluation, your agency is better able to determine whether to retain outside experts and staff.
- **Architect:** A good architect is critical to the success of a project. The architect can assist your agency to make design concepts become a reality and play an important role in making sure that construction of the project is smooth, and the project is completed on time and in accordance with all applicable requirements and standards. A project that is designed poorly and not in accordance with applicable requirements and standards may be delayed, increase your agency's cost to construct the project, and result in costly claims and litigation.
- **Construction Management:** If your agency does not have "in-house" expertise in construction or the "in-house" expert has limited time and resources, your agency may consider hiring a project and/or construction manager. A project manager can assist your agency to use its resources effectively, oversee construction of multiple projects, and interact with other construction professionals. The construction manager typically works on a particular project and handles daily construction issues. The same construction firm can often provide these services.
- **Legal Counsel:** In most public works projects, legal counsel is not contacted until a problem arises that agency staff cannot resolve. An attorney who has knowledge and experience in public works projects can impact whether a project is completed on time, on budget, and without costly claims and litigation.

2. HAVE STRONG, LEGALLY DEFENSIBLE BID AND CONTRACT DOCUMENTS

Although there is no one correct way to plan for, and prepare bid and contract documents, there are steps that your agency can take so that the resulting documents are strong and legally defensible. We discuss some of these steps below.

- **Consult With and Review by Appropriate Professionals:** Before issuing requests for proposals for professional services, have your agency’s legal counsel review the requests for proposal and the contracts. Similarly, before soliciting bids for a construction contract, your agency should allow time for, and schedule time with the architect and legal counsel to, review the bid and contract documents. This better ensures that these documents contain all required and appropriate terms and conditions, and do not contain conflicting provisions. In addition, the professionals can advise on laws, requirements, and procedures that are applicable to the project and/or a particular contract.
- **Coordinate Contracts In the Same Project:** Contract documents should be coordinated with the architect’s contract and any contract for construction management or inspection services for the project. This coordination reduces overlapping duties that can lead to confusion, contention, and delay the project.
- **Exercise Caution When Using Existing Form Agreements:** If your agency is using existing forms as the basis for contracts with the architect or construction management, or the construction bid and contract documents, make sure to delete provisions that do not apply to the situation, insert provisions that are required or appropriate, and modify provisions to reflect the requirements of your situation.
- **Use Standard English:** Although certain language is required to create a valid and binding contract, legalese and jargon are not required. All contracts should be written in standard English so they can be easier understood, implemented, and enforced.
- **Avoid Ambiguity:** Local agencies should avoid using language in contract documents that is susceptible to different interpretations by different people. For example, terms such as “reasonable,” “material,” “substantial,” and “promptly” may be interpreted differently by different people.
- **Avoid Inconsistency:** In preparing contracts with the architect, other professionals, and the contractor, care should be taken to avoid inconsistency within each contract or between the contracts. Because the bid and contract documents consist of multiple documents, it is important to review and coordinate the documents to make sure they do not contain inconsistent or conflicting provisions.
- **Format and Organize Contract Provisions:** Contracts should be viewed as “living” documents that people will need to be able to read, implement, and enforce. Some people mistakenly view contracts as documents that will be filed away, not to surface and be read until a dispute with the other party arises. Thus, little or no

consideration is given to format and organization of a contract. The result is often a contract that is disorganized, difficult to read, understand, and implement.

3. PLAN AHEAD TO AVOID BID DISPUTES

With careful planning, local agencies can reduce last minute questions and uncertainties, and by doing so, reduce the risks of bid protests and disputes.

Common problems leading to bid protests and disputes include the following:

- **Bidding Requirements:** (1) Seeking an emergency bid exception without adequately making a record for the governing body's reference demonstrating that the work is needed to prevent or mitigate the impairment of life, health, property, or essential public service¹; (2) bid splitting or failing to have documents justifying projects below the bid limit to avoid accusations of bid splitting; (3) using uniform construction or cost accounting, rather than bidding, without actually instituting the cost accounting procedures;² and (4) failing to meet notice requirements prior to mandatory pre-bid conferences or site visits.³
- **Contract and Bid Documents:** (1) Unclear, vague or contradictory bid documents; (2) confusion regarding bid alternates or failure to use a blind selection process in conjunction with the alternate procedures⁴; (3) failing to identify a bid clock and specific time deadline to submit bids in bid documents; and (4) failing to include an escrow agreement in the contract documents.⁵
- **Plans and Specifications:** (1) Attempting to alter plans or specifications resulting in a material change to the total cost within 72 hours of the bid opening without extending the time for submitting bids⁶; (2) failing to include sufficient contingencies in the technical specifications to address conditions revealed after work commences, particularly on the modernization of older facilities; and (3) failing to identify whether matching materials are available or must be utilized.
- **Pre-Bid Procedures and Requirements:** (1) requiring a mandatory pre-bid walk through without adequately notifying potential bidders⁷; and (2) failing to investigate adequately the presence of asbestos or underground or other obscured or unknown conditions in order to ensure more accurate bids and avoid change orders.
- **Awarding of Contract:** (1) Attempting to award a bid to a materially non-responsive bidder (i.e., one who did not attend a mandatory walk-through, failed to submit a bid bond, etc.); (2) attempting to find a contractor non-responsible without giving it adequate notice and due process in which to make his or her case, and without establishing a record and making the local agency's case; and (3) failing to confirm that the payment bond required by the bid documents is in fact issued by a California admitted surety insurer.⁸

- **Timely Consulting of Appropriate Professionals:** Failing to consult with legal counsel before, rather than after, a bid goes awry.

To reduce and avoid bid disputes, local agencies should understand the bidding process and relevant statutory requirements, have clear and strong bid documents, and consult with appropriate professionals to resolve issues before they turn into disputes.

4. REQUIRE AND PROCURE PROPER INSURANCE

Local agencies should consult with their risk management regarding the appropriate insurance coverage. Although insurance policies may look and contain similar provisions, you should never assume that insurance policies that are designated as a certain type of policy provide identical coverage. Many insurance companies use forms prepared by Insurance Services Offices. However, except where California law requires that particular language be included in a policy, an insurance company may broaden or limit the coverage it provides under its policies. Thus, a policy issued by one insurance company may provide slightly or substantially different coverage from a policy containing the same name but issued by another insurance company.

Insurance policies that should generally be required and procured by the different parties who typically provide services on a project are:

- **Architects, Engineers, and Other Professionals:** When a local agency retains architects, engineers, and other professionals to perform services on a public works project, there are risks and potential liabilities. First, these professionals may not perform, or may negligently perform, the duties and services required of them under their respective contracts with the local agency. Second, these professionals may cause bodily injury, property damage, or other losses while performing the duties and services on the project.

Generally, the following insurance should be required from, and procured and maintained by architects and engineers: (1) professional liability, which generally protects the professionals from claims and lawsuits for professional negligence; (2) commercial general liability insurance, which generally provides for the indemnity (pay any judgment or settlement) and defense (retention and payment of attorney) of the insured (the architect or engineer) and any additional insured (e.g., your agency and its governing body, officers, employees and agents) against a third party's claims for bodily injury or property damage; (3) commercial automobile liability insurance; and (4) worker's compensation insurance.

- **Contractor and Subcontractors:** Generally, the following insurance policies should be required from, and procured and maintained by contractors and subcontractors throughout the project: (1) commercial general liability, (2) fire Insurance, which is more or less standard throughout the United States and indemnifies the insured for damage to or loss of property due to fire and other specified perils, regardless of fault;

(3) course-of-construction/builder's risk, which generally covers the risk of loss or damage to work during construction and prior to completion of the work, regardless of fault; (4) commercial automobile liability; and (5) workers' compensation.

- **Local Agency:** In most circumstances, the insurance that the contractor and its subcontractors procure will cover all property damage, bodily injury, and other liabilities that occur on a project, and the local agency's insurance policies are never triggered. However, there are circumstances where the local agency's insurance becomes important. For example, the contractor and subcontractors' insurance policies may not provide the required coverage, or unbeknownst to the local agency, may have been terminated or cancelled. Further, and with respect to a completed project or portions thereof, the local agency is likely the only entity that will have an insurable interest upon completion of the project. Thus, the local agency is the only entity that can obtain insurance coverage at that point. In these circumstances, it is important that the local agency procure and maintain its own insurance coverage in addition to that required to be provided by the contractors and subcontractors.
- **Wrap-Up Insurance:** Because of the costs of and complexity involved in making claims under multiple insurance policies, wrap-up insurance programs have emerged as an alternative method for insuring a project. With wrap-up insurance, one party procures insurance policies covering all parties in the project. The primary benefit of a wrap-up insurance program is potential reduced costs, procurement of uniform insurance coverage, elimination of redundant coverage, and assurance to the local agency (where the local agency has procured the program) that insurance is in effect and has not been canceled or terminated. In addition, a wrap-up insurance program may allow small to medium size contractors and subcontractors to bid on projects that they would not otherwise had been able to because of the insurance requirements.

Upon receipt of proof of insurance, the local agency should review it for compliance with the requirements of the contract documents. When evaluating proof of insurance, some items to consider include: (1) whether the insurer is admitted to transact insurance in California; (2) the rating and financial stability of the insurer, (3) whether the policy limits meet the contract requirements, (4) whether the policy period covers the duration of the project or will be extended to so cover; and (5) if the local agency is a named additional insured, an additional insured endorsement is provided to the local agency.

5. REQUIRING PERFORMANCE AND PAYMENT BONDS

Although surety bonds are frequently issued by insurance companies, they are not a type of insurance. In an insurance transaction, there are only two parties, the insured party and the insurance company. In a surety transaction, there are three parties: (1) the principal (contractor) who furnishes the bond; (2) the obligee (person, company, or public agency) for whom the bond is provided; and (3) the surety who undertakes to complete the project and/or pay money in the event the principal fails in its contractual obligations to the obligee. The surety is like a guarantor of a debt. In suretyship, losses are not calculated into the premium. When a surety

makes payment, the principal is expected to repay the surety's losses. In fact, prior to issuing surety bonds, virtually all sureties require the principal and its major owners to execute an indemnity agreement.

- a. **Performance Bond:** A performance bond provides financial assurance that the contract documents will be fully performed, even if the contractor defaults and does not finish the project. The surety's financial obligation to complete the project is normally limited to the bond's penal sum, which equals the cost of the project. Upon default, the most useful provision in a performance bond is a requirement that the surety take over and complete the project. Other options, such as the surety obtaining bids, can cause delays and increase costs. If the local agency does not require a performance bond and the contractor defaults, the local agency's only remedy is usually to proceed against the contractor.
- b. **Payment Bond:** A payment bond is required for suppliers of labor, materials, and equipment to the project. It provides assurance they will be paid if the contractor does not pay them. An unpaid subcontractor or supplier may file a claim against the surety that issued the payment bond without first filing a stop notice with the local agency. The surety's financial obligations are normally limited to the payment bond's penal sum. The surety makes payment and is usually subrogated to any funds the local agency may owe to the contractor for the work performed, or supplies and materials furnished by the subcontractor.

A contractor who is awarded a contract for more than \$25,000 must file a payment bond with the public agency.⁹ The form of the bond, at a minimum, must comply with the requirements of Civil Code 3248, although the public agency may prescribe additional requirements. The payment bond must be executed by an admitted surety insurer.¹⁰

The public agency must approve a payment bond filed by the contractor before work may begin on the project.¹¹ The public agency should investigate the surety (see discussion below). A public agency might be held liable for failure to investigate the financial status of the surety or failure to require a proper bond, if the failure injures the claimant.¹²

Upon receipt of a surety bond from a contractor, a local agency should determine that the surety is admitted in California, and evaluate the surety's financial strength and the bond's compliance with applicable statutes and the contract documents.

6. ADMINISTRATION OF CONTRACT

During the construction of a project, the team that the local agency assembled plays a critical role in administrating the construction contract and in whether a project is completed on time and within budget. We consider some typical issues that the team will need to handle and resolve.

- a. **Change Order.** A change order is a change or amendment to the construction contract documents agreed upon by the local agency and the contractor. Because of this, a local agency should comply with applicable statutes and its policies and procedures required for a

valid agreement. Generally, this means that if the contract was approved by the local agency's governing body, the change order should similarly be approved.

- b. Payments to and Withholdings of Payments from Contractor.** Under Public Contract Code section 20104.50, all local agencies must promptly process and make payments to a contractor. When a local agency withholds payments to a contractor, it takes the risk of having to pay interest and/or a penalty on the withheld amount. Public Contract Code sections 7107 and 20104.50 govern the award of interest and penalties respectively. In addition, if the contractor obtains a judgment against the local agency, there is the possibility that the local agency may have to pay pre-judgment interest under Civil Code section 3287.

Because of the multiple California statutes that address when a local agency may withhold payments, a local agency should consult with legal counsel before withholding payments from a contractor. After a decision is made to withhold payments from the contractor, there should be frequent reexamination to make sure that the withholding is proper. Factors that should be considered by the local agency in deciding whether to withhold payments from a contractor include: (1) the legal basis for withholding payments from the contractor; (2) the status of the project: on a project that is substantially completed but not completed on time, the local agency may decide to waive liquidated damages and the cost of the incomplete punchlist items; however, if the project is nowhere near completion but the project completion date has long passed, the local agency may wish to withhold payments for liquidated damages in order to encourage the contractor to complete the project; (3) the local agency's goals: if the local agency's goal is to have the contractor complete the project, it may decide not to withhold payments; withholding payments may hinder the contractor's ability to pay for materials and subcontractors, and further delay completion of the project; however, if the local agency's goal is to terminate the contractor, the local agency may wish to withhold for liquidated damages, and if grounds exist, back charges, incomplete punchlist items, damages to local agency or third party property, and other damages or loss as authorized by statutes or the contract documents; (4) the amount to withhold, which may require that the local agency obtain estimates from the architect or another contractor in the case of back charges, damages to property, or incomplete punchlist items; and (5) evidence the local agency has to support each withholding of payments from the contractor.

- c. Record Keeping and Accounting.** On any project, a local agency should, and require that the architect, construction management firm, and the contractor and its subcontractors, maintain organized and accurate records and accounting relating to the project and the contract documents. Having such records and accounting document significant events in the project, may resolve problems before they become disputes, and prepares the local agency for potential disputes and litigation.

7. EVALUATING AND HANDLING DISPUTES

A dispute may arise during any stage of a project. When disputes arise, it is important for the local agency to analyze and understand the situation and the nature of the disputes, consult with appropriate professionals and legal counsel, and arrive at an effective resolution of the dispute. We discuss some of the considerations in evaluating and handling disputes with contractors, architects, sureties.

- a. **Architect.** A local agency's claims against an architect will generally involve the architect failing to perform or negligently performing its obligations under its contract with the local agency. The architect's claims will generally involve the local agency's failure to pay for services provided by the architect under the contract.
- b. **Contractor.** When problems arise before construction commences, the local agency's rights and remedies against the contractor are generally governed by applicable statutes and/or local laws, the contract documents, and the bid bond. The local agency may be able to: (1) seek forfeiture of the bid bond amount;¹³ (2) seek damages; and/or (3) demand that the local agency be defended and indemnified in regard to subcontractor claims.

The contract documents and performance bond generally control what options are available to a local agency if the disputes with the contractor are not resolved and constitute contractor default on the project. The following options are typical, although each situation must be evaluated on a case-by-case basis: (1) continue with the contractor under the same, or with an adjustment in, the scope of work, (2) negotiate termination with the contractor and the surety, or (3) terminate the contractor for cause.

- c. **Subcontractors and Suppliers.** A subcontractor or supplier, who has not been paid by the contractor, may file a stop notice with the local agency.¹⁴ A stop notice is a claim against the project funds stating that the subcontractor or supplier has not been paid by the contractor. The contractor is not allowed to file a stop notice.¹⁵ Stop notices can be filed at any time during the project and up to 30 days (plus 5 days for mailing) after the recording of a notice of completion or notice of cessation, or if no notice of completion or cessation is recorded, 90 days after completion or cessation of the project.¹⁶ Civil Code section 3186 requires the local agency to withhold project funds to satisfy stop notices, and specifically authorizes the local agency to withhold retention proceeds for that purpose.

Upon receipt of a stop notice, a local agency must withhold money sufficient to pay the stop notice, plus fees and costs for the local agency as well as interest on the funds. The local agency has no discretion concerning the amount to withhold in response to a stop notice.¹⁷ Stop notices only attach to project funds in the local agency's possession that are owed to the contractor. As a result, stop notices do not appear to attach to funds that a local agency is withholding for incomplete punchlist items or other disputed items.

- d. **Surety.** Most contractors are concerned about their ability to obtain bonding for future projects. Because of this, a contractor may not want a local agency to contact the surety regarding the contractor's failure to pay subcontractors and suppliers, or to perform the work

required by the contract documents. Before contacting a contractor's surety, we recommend you consult with your agency's legal counsel.

ENDNOTES

- 1 Pub. Contract Code § 1102 and *Marshall v. Pasadena USD* (2004) 119 CA4th 1241.
- 2 Pub. Contract Code § 22000, *et seq.*
- 3 Pub. Contract Code § 6610.
- 4 Pub. Contract Code § 20103.8.
- 5 Pub. Contract Code § 22300.
- 6 Pub. Contract Code § 4104.5.
- 7 Pub. Contract Code, § 6610.
- 8 *Walt Rankin & Associates, Inc. v. City of Murrieta* (2000) 84 Cal.App.4th 605.
- 9 Civil Code § 3247.
- 10 Code of Civil Proc. §§ 995.311 and 995.120.
- 11 Civil Code § 3247(a).
- 12 *Walt Rankin & Assocs. v. City of Murietta* (2000) 84 Cal.App.4th 605; *C.A. Magistretti Co. v. Merced Irrig. Dist.* (1972) 27 Cal.App.3d 270, 274.
- 13 Two California Supreme Court cases, from the same year, on this issue: *Inyokern Sanitation Dist. v. Haddock-Engineers, Ltd., et al.* (1950) 36 Cal.2d 450 and *Petrovich v. City of Arcadia, et al.* (1950) 36 Cal2d 78.
- 14 Civil Code § 3181.
- 15 Civil Code § 3181.
- 16 Civil Code § 3184.
- 17 *Jasper Constr., Inc. v. University Casework Sys., Inc.* (1974) 39 Cal.App.3d 582,585.