

The True Meaning Of A Good Faith Dispute? Court of Appeal Rules That A General Contractor's Good Faith Dispute Defense To A Prompt Pay Penalty Claim By A Subcontractor Must Be Based Upon An "Objectively Reasonable" Belief On The Part Of The General Contractor That A Good Faith Dispute Exists In The First Place...

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California has a series of what are known as "prompt pay" statutes that require general contractors to pay their subcontractors within a specified, brief time period, subject to the imposition of harsh monetary penalties. One of the statutes, Business and Professions Code Section 7108.5, provides that a general contractor shall pay a subcontractor not later than ten days after receipt of each progress payment (unless otherwise agreed in writing) "the respective amounts allowed the contractor on account of the work performed by the subcontractor... to the extent of each subcontractor's interest therein". The statute further provides that the failure to comply with that statute shall subject the general contractor to a penalty of two percent of the amount due per month for every month that payment is not made as required in the statute. However, a prompt pay penalty will not accrue where there is a "good faith dispute" which justifies the withholding of the progress payment. Quoting Business and Professions Code Section 7108.5(c):

"If there is a good faith dispute over all or any portion of the amount due on a progress payment from the prime contractor or subcontractor to a subcontractor, the prime contractor or subcontractor may withhold no more than 150 percent of the disputed amount."

A dispute often arises, however, as to whether a "good faith dispute" exists. In the case of Alpha Mechanical, Heating & Air Conditioning, Inc. v. Travelers Casualty & Surety Company of America (2005) 133 Cal.App.4th 1319 ("Alpha Mechanical"), the California Court of Appeal, 4th District, ruled that a subcontractor was not entitled to statutory penalties absent a demonstration of the general contractor's lack of good faith in its belief that a dispute existed over damage caused by the subcontractor and whether that damage justified withholding sums due the subcontractor. The Court of Appeal noted that, while there was no authority expressly interrupting the good faith dispute standard set

forth in Section 7108.5 of the Business and Professions Code, it found that good faith in the context of a prompt pay dispute "suggests a moral quality; its absence is equated with dishonesty, deceit or unfaithfulness to duty". On that basis, the Court of Appeal ruled that, due to a lack of evidence in the record demonstrating the general contractor's lack of (subjective) good faith in its belief that a dispute over the damage caused by the subcontractor justified withholding their remaining sums due, prompt pay penalties would not apply. While instructive, the Alpha Mechanical decision appeared to leave open the question of whether the "good faith" belief on the part of the general contractor is determined based on whether the general contractor subjectively believed there to be a good faith dispute or if the existence of a good faith dispute should be evaluated on an objectively reasonable standard as determined by the trier of fact.

That question has now been largely answered in the recently published opinion in Fei Enterprises, Inc. v. Kee Man Yoon (2011) 194 Cal.App.4th 790 ("Fei Enterprises"). In Fei Enterprises, the California Court of Appeal, 2nd District, questioned the analysis of the term "good faith dispute" as set forth in the Alpha Mechanical case, and ruled that, for there to be a good faith dispute, there had to be an objectively reasonable belief that a good faith dispute existed.

The facts of the Fei Enterprises case are common enough. In that case, a low voltage electrical subcontractor for two Los Angeles area residential developments, one with nineteen units and another with seventeen units, became embroiled in disputes with the general contractor in regard to the rough electric work. In essence, the subcontractor argued that it had completed its work and the general contractor, and owner, disputed that. At trial, the trial court held that the subcontractor had not caused any delay and was due the sums it claimed. However, based upon the facts before the trial court, including ambiguities in the parties' contracts, the trial court ruled that there was insufficient evidence of bad faith on the part of the general contractor and ruled that prompt pay penalties were not owed. The Court of Appeal, on appeal, affirmed the trial court's ruling but, in extensive commentary, explained that the reasoning in Alpha Mechanical in regard to the definition of good faith was flawed and that the determination of the existence of a "good faith" dispute had to be based upon an objectively reasonable standard. The Court of Appeal commented that the subjective "belief" of the non paying party may be of evidentiary interest, but it cannot be the standard for evaluating whether a good faith dispute exists.

The Fei Enterprises decision should provide guidance in determining how a good faith dispute defense to a prompt pay claim should be evaluated. While the subcontractor in the Fei Enterprises case did not prevail in that case, it is the authors' belief that prompt pay penalties may become more available to subcontractors as a sincere belief on the part of a general contractor as to the existence of a dispute will no longer suffice.

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