MEMORANDUM OF LAW

DATE: October 5, 1993

TO: Millie Garcia, Accounts Payable Manager,
City Auditor's Office

FROM: City Attorney

SUBJECT: Stop Notices on Public Works Contracts --
Costs of Administration

By memorandum dated August 6, 1993, you posed several questions that are addressed below. As background, a meeting was held on August 3, 1993, where representatives from your department explained that there are growing difficulties and costs associated with the administration of stop notices filed on public work contracts. The Auditor is receiving more and more stop notices that are consuming staff time to process and track. Since the stop notice is a statutory mechanism used by subcontractors or suppliers to secure payment from general (prime) contractors on public works, the City is usually a mere stakeholder in these disputes. The City has become concerned about the costs of its necessary but undesired involvement in the stop notice resolution process. With this background, here are the questions and answers:

A. How can (the City) "debar or alienate" those problem vendors or initiate any appropriate action during the bid and award process?

Answer: San Diego City Charter section 94 requires that public work contracts be awarded to the "lowest responsible and reliable bidder." Therefore, a contract cannot be refused to a low bidder unless 1) all bids are rejected or 2) the low bidder is found to be nonresponsible. The term "responsible" includes the attribute of trustworthiness and also has reference to the quality, fitness, and capacity of the low bidder to satisfactorily perform the proposed work. City of Inglewood - L.A. County Civic Center Auth. v. Superior Court, 7 Cal. 3d 861, 867 (1972). In the award of a contract to other than a low bidder, the awarding body (City Council) must make an actual determination of a bidder's nonresponsibility under these criteria. Id. at 871.

In reference to your question, the Council would have to

determine that a contractor has acted so irresponsibly toward its subcontractors in past City contracts that a finding of nonresponsibility is warranted. There are, however, several reasons why such conclusions would be very difficult for the Council to make on the basis of stop notice filings alone.

First, there may be valid reasons why a prime contractor disputes the claims of a subcontractor. The fact that a subcontractor claims it is due a certain amount does not necessarily mean that the subcontractor is entitled to that amount. Just as there may be prime contractors who do not timely and fully pay their subcontractors, it is equally possible that there are subcontractors who file stop notices without good cause. Neither can be faulted simply for exercising the right to dispute amounts claimed, so long as there is no evidence that rights are being abused, or duties routinely breached.

Second, many stop notices are filed by suppliers who do not have direct privity of contract with the prime contractor, but instead have contracts with subcontractors. Since the subcontractors, and not the prime contractor, have direct responsibility for payment to those suppliers, the prime contractor has no direct control over payment issues at this level. These situations are beyond the prime's immediate control, although the stop notice process allows the lower tier subcontractors and suppliers to raise their complaints to the prime level. Again, the prime cannot be faulted simply because one of its subcontractors, whom the prime has paid, has not in turn paid its suppliers. The withholding of money from a prime due to a supplier's stop notice often has the practical effect of compelling the prime to have its subcontractor settle the supplier's dispute, or to otherwise resolve it.

In short, the filing of a stop notice by a subcontractor or supplier on its face cannot be taken to be evidence of nonresponsibility, as there could be many valid reasons for a prime's position in these matters.

However, if there is evidence that a prime contractor repeatedly has large numbers of stop notices filed against it, and further evidence of an established record of ultimately settling the claims for full value, or of having judgments on claims made against it, there might be sufficient facts to support a finding of nonresponsibility. This will depend on the facts of the situation, although it would seem to be a rare circumstance. Primes have as much right as subcontractors to contest amounts owned on stop notices, and they generally cannot be penalized for exercising their rights in this regard.

B. With the increasing number of stop notices being

filed not only by subcontractors but by subs' subcontractors, what is the feasibility of charging a filing fee?

Answer: It makes no difference who files the stop notice, be it a subcontractor or a supplier to a subcontractor (except that those not having a direct contract with the prime must first file a 20 day preliminary notice pursuant to Civil Code section 3183). For the City Auditor's purposes, a stop notice is a stop notice, regardless of the level of the person claiming to have supplied labor or material. Although lower tier labor and materialmen may be increasing the total volume of stop notices received by the Auditor, this in no way affects the City's statutory duty to withhold on those stop notices.

In any event, the question concerns the possibility of charging a fee. We believe that a fee cannot be charged for filing a stop notice with the City. This conclusion is based on the fact that the statutes which cover stop notices on public work do not provide for such charges. (Civil Code sections 3179 - 3226). One statute does allow a $2.00 charge for the service of notifying a stop notice claimant that a notice of completion or cessation has been filed (Civil Code section 3185), but there is no provision allowing charges for the filing of the stop notice itself.

It should be noted, however, that Civil Code section 3186 provides that the City is duty-bound to withhold on stop notices "in an amount sufficient to answer the claim stated in the stop notice and to provide for the reasonable cost of litigation thereunder." This provision is the authority for the present practice of withholding 125% on stop notice claims. Specifically, the extra 25% is an amount the City has figured as reasonable for costs of "litigation." Since costs of "litigation" might include administrative costs incurred by the City Auditor, it could perhaps be argued that the Auditor's costs may be recouped from the extra 25% withheld on each stop notice. However, it is also plain that this could not be argued if those funds were otherwise payable to the prime contractor where the stop notice dispute gets settled without any litigation, as most of them do. And even if there is litigation, the award of costs may not be certain, for entitlement to legal fees and costs is often a matter dictated by the outcome of the litigation itself.

C. What is the possibility of incorporating a "waiver clause" in the construction contract that prime contractors are solely responsible for all of (their) financial activities?

Answer: The City is bound to a statutory duty in regard

to stop notice claims and there is no authority in the statutes to allow the City to compel contractors, through use of a contract clause, to waive their rights to dispute stop notice claims. Again, prime contractors in many instances have no control over who will file stop notices, so it would be unreasonable and arguably contrary to public policy to in effect require them to carry the owner's administrative expense. In the end, a prime contractor is responsible for all its financial activities under the contract, and this is precisely the purpose of the stop notice statutes. The City, as a public owner, has a statutory duty to assure (through withholding) that the prime discharges that duty. This duty and its concomitant expense are incidental to the City's role in public contracting.

D. The City withholds 125% of the stop notice claims, why and what is the (extra) 25% for?

See answer to Question B.

E. Other issues involving Purchasing Department and Award of Contracts?

See generally the answer to Question A.

Conclusion

Unless actual litigation results from a stop notice and costs are awarded to the City, no statutory authority exists to recover costs of stop notice administration. The statutes instead provide a structure for the resolution of disputes between primes and subcontractors and the administrative costs of supporting that structure should be considered part of the City's cost of contracting. However, if there is compelling evidence that a prime or subcontractor is unreasonably abusing rights or breaching duties, that contractor's responsibility might be legitimately questioned.

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By
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