New Developments in Tennessee's Construction/Retainage Law

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Many years ago, Tennessee enacted a construction "retainage" statute. The statute mandated that if retainage (historically 10 percent of a construction contract) is withheld on a construction contract valued over $500,000, the earned retainage "shall" be placed in a separate escrow account with a third party. This law was, and still is, universally ignored by most developers, owners, architects, lenders, contractors, and subcontractors, even though this mandate cannot be "waived" in a construction contract.

However, until just recently, there had been no real "teeth" into the failure of an owner to create such an account. Over the last two years, the Retainage Law has been revised substantially, and those revisions cannot be ignored by any real estate investor, developer, bank, or financial institution involved in any commercial construction project—especially one that may be in trouble or failing.

The four primary changes in the Construction/Retainage Law are as follows:

1. The amount of retainage an owner can withhold from any construction contract (public or private) is limited to 5 percent vs the historical 10 percent;

2. If the "prime" contract is more than $500,000, the earned retainage "shall" be placed in an "interest bearing" escrow account with a third party (normally the lender) under an escrow agreement. The monies, when funded, and the interest earned, become "by law" the "property" of the contractor (or subcontractor) to whom the monies are owed;

3. The retainage and all earned interest "shall" be released within 90 days of completion of the work, which affects early completion subcontractors, or substantial completion of the entire project; and

4. Failure to abide by the new requirements is a violation of Tennessee's Prompt Pay Act, which subjects the violators to daily fines of up to $3,000, claims for attorneys fees, and finally, even *criminal* penalties, since a violation is a class "C" misdemeanor.

Historically, the "standard" retainage withheld from the monthly construction draws in construction contracts was 10 percent. For lenders, this matched the percentage of a construction loan that would be paid out over the course of a project. Retainage was not paid out of the loan proceeds—or to the contractor—until final completion of the project, thus saving the owner interest costs. In addition, banks wanted to retain "control" over 100 percent of the retainage, even if not funded, in case of a loan default by the owner. In turn, developers/owners wanted to use retainage as leverage over contractors for incomplete work—or if mechanics liens were filed against the project. The argument was that retainage belonged to the owner to use to remedy contractor defaults.

The new changes as described above affect all parties involved in a real estate deal. First, a loan is not a "construction" contract, and so a bank cannot be in violation of the retainage laws. Even though retainage is limited to 5 percent, a lender can still choose to fund only 90 percent of the loan proceeds. However, this may cause a negative impact on the project because the owner would be required by the contractor to fund, out of his own pocket, the difference between the 90 percent paid out by the bank and the

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95 percent to be paid to the contractor during the course of a project.

Second, if a demand to create a retainage escrow account is made during the middle of a project, and the bank refuses to do so, the contractor, or even a subcontractor, can sue the owner for violation of the Retainage Act. More enterprising contractors may include lenders in such lawsuits if there is an escrow account set up, if the lender is the escrow agent. Recall that the retainage is by law the "property" of the contractor.

Another primary impact of the Retainage Law is that, as stated above, most banks and owners hold onto retainage for dear life and will use it—sometimes properly, sometimes improperly—as "leverage" against a contractor to resolve end–of–the–project claims. However, the statute describes the retained monies as being the legal "property" of the company to whom they are owed, and these days most contractors "subcontract out" over 95 percent of the work. This means that 95 percent of the money in the retainage account is owed to the subcontractors, not the contractors, and upon demand, retainage must be released within 90 days.

The interesting development will be when there is a dispute between an owner and a contractor involving, for example, a potential roof defect, and the costs to remedy that default equal the amount in retainage. However, the nonroofing subcontractors will demand full payment of their retainage out of the account. Under this scenario, an owner or bank may be able to retain only that small portion of the retainage that is due to the roofer.

One reason there had been a failure to recognize the absolute requirement to "fund" a retainage account in the past was the lack of real penalties. All a contractor might do is claim the "lost" interest, which in the case of a small project over a short period of time would not add up to much interest. Most construction contracts also called for retainage to be released at the end of even a two-year long project.

However, now that violations of the Retainage Law have been tied to the penalties allowable under the Tennessee Prompt Pay Act, the game has changed. Early release of retainage—90 days—can be demanded by a subcontractor which completes early in the project. Failure to set up an account can allow a contractor to go into court, force the funding of an account, and recover attorney's fees. Substantial daily fines can accumulate. Finally, while it might be difficult to get a district attorney's attention, failure by an individual or a corporation to follow the new Retainage Law is a criminal violation, class D misdemeanor.

The bottom line, since failure to follow the mandatory Retainage Law can spell disaster in the middle or end of a project, there should be a discussion of retainage early on in any potential commercial project. This should include an up-front discussion of the Retainage Law prior to the closing of any loan, and the loan documents should include a proposed escrow retainage agreement. The laws do not mandate the form for such an escrow agreement, but one can be drafted to allow for sufficient protections of all participants in the project. ■