RETAINAGE MISTAKES THAT THE TENNESSEE CONSTRUCTION INDUSTRY STILL CONTINUE TO (and over and over and over) MAKE

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The most ignored set of laws in Tennessee which impact owners, prime contractors and subcontractors are the construction "retainage" laws which are unique in the United States. Serious mistakes are still being, and failure to know what the law requires can go right to the bottom line. While the lawyers may love the new cases and legal fees that retainage mistakes can generate, it does not do any good for the companies involved. The purpose of this article is to provide a summary primer of the law and what mistakes are being made.

While the laws have been revised over the past 5 years, the basic rules are as follows: (1) retainage cannot exceed 5% of any pay application (whether from the prime to the owner or a subcontractor to a prime; (2) if retainage is withheld and the prime contract between the owner and the prime contractor exceeds $500,000, it is MANDATORY (under criminal and civil penalties) that the owner, every single time that retainage is withheld, place the retainage into a separate, interest bearing "project" retainage escrow account with a third party, normally the lender; and (3) because so few prime contractor's self-perform, making sure that there is a project retainage account fulfills the prime's mandatory retainage escrow obligation to its own subcontractors (regardless of the amount of the subcontract) that the retainage the prime per the subcontract is withholding from its subcontractors; and (4) once deposited, the retainage by law becomes the "legal" property of the company from whom retainage has been withheld.

The penalties for noncompliance can be severe. "Ignorance of the law" is no excuse. Failure of an owner or prime contractor to comply with these laws is not only a criminal violation (a Class C misdemeanor), but if the escrow mandate is ignored, the civil penalty (for the owner and the prime contractor) is $300 a day…from the very first day that retainage was withheld and not escrowed. To make this very clear, while if a prime contractor "discovers" that the owner did not escrow retainage, and thus has a $300 a day claim for 100 days=$30,000, there's an argument that each of the subcontractor's, whose retainage was also not escrowed, EACH has a $300 a day claim against the prime (do the math on a project with a substantial number of subcontractors). In a recent court case, an owner who did not escrow less than $50,000 in retainage was forced to pay the contractor…a $300,000 retainage penalty.

The escrow laws were given this compliance "teeth" by the Legislature because of instances (arising out of the 2008 financial collapse) where projects and single-use developers went belly up; lenders foreclosed (and wiped out any mechanics liens); and the earned, approved but un-escrowed "retainage" was part of the "unfunded" (and defaulted) loan. The contractors (and primarily their subcontractors) were then out in the cold. Their "retainage" was lost even if a third party purchased the property and improvements from the lender after foreclosure.

Even though these laws and penalties have been in effect for a number of years, what mistakes do Tennessee construction lawyers see that their clients and others (mostly out of town developers and non-Tennessee based contractors) make:

(1) Withholding more than 5% retainage. It is an open question if it is a violation of the 5% if the parties agree to, for instance, withhold 10% retainage for the first 50% of the job, and then zero retainage, or some other type of calculation;

(2) Ignoring or believing that the retainage "escrow" mandate can be waived or ignored;

(3) Believing that if the owner chooses not to withhold retainage from the prime, but the prime withholds retainage from the subcontractors, that the prime has no obligation to escrow the subcontractor's retainage: it does;

(4) While not required by the laws, not negotiating at the beginning of a project a "retainage escrow agreement" signed off by the prime, the owner and the lender;

(5) An owner or prime contractor "co-mingling" retainage on one project with other projects or with other funds: this violates the laws which require a separate escrow account for each project;

(6) Primes not knowing that there is a statute which outlines when retainage must be released by the owner: retainage shall be released 90 days from the **earlier** of: (1) when an owner begins to use the project; (2) when the codes department issues a certificate of occupancy; or (3) when the project architect signs a typical "certificate of substantial completion." This 90 day provision does not apply to when payment of retainage to the subcontractor has to made after a prime's receipt. There is also a 2016 reported Tennessee appeals decision which calls into question this very purpose of retainage. The Court of Appeals ruled that, <u>regardless</u> of what the contract says about an owner withholding retainage, even if there is serious defective work which far exceeds the retainage amount, retainage must be released to the contractor within the 90 day period. To make this even clearer, assume there is $100,000 in properly escrowed retainage, but it is discovered near the end of the project

that the entire roof is defective, needs replacing and will cost $300,000 to repair. Assume further than the owner and lender did not require a performance bond. Under this new case, even if the contractor is financially unstable, or even out of business, the owner is required to fork over the $100,000. This Court of Appeals case is now being used by lawyers for contractors in hotly disputed state court lawsuit to recover their withheld retainage.

Be careful out there.