

# PUBLICATION

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## Recent Changes to Tennessee Law Affecting the Construction Industry

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For many years, a provision in the Tennessee lien law required owners and prime contractors to keep retainage in a separate escrow account when the contract or subcontract price is \$500,000 or greater. However, such escrow accounts were not required to bear interest.

Effective July 1, 2007, such escrow accounts must now bear interest, and all accrued interest is to be paid to the contractor from whom it is withheld. However, the law continues to apply only to those contracts or subcontracts in excess of \$500,000.

The new law does not set any benchmark for the amount of interest that the escrow account must earn, or the type of account in which the retained funds must be held. Because the owner or prime contractor withholding the funds now has no incentive to maximize the return on these retained funds, the prime and remote contractors whose contracts are subject to mandatory escrow of retainage should consider including specific provisions in such contracts requiring the retained funds to be placed in accounts that will maximize the interest earned.

Subcontractors and material suppliers should note that the new law does not require a contractor to pay interest downstream to those remote contractors from whom it also withholds retainage. This appears to be a shortcoming in the new law, which was presumably enacted to distribute interest earned on retained funds to those from whom it was withheld. Subcontractors and material suppliers doing business in Tennessee should include specific provisions in their contracts that require the prime contractor to pass through their pro rata share of any interest earned on retained funds.

### **Retainage Statutorily Capped at Five Percent**

More significant is amendment to the Prompt Pay Act of 1991, adding a provision that limits retainage in all construction contracts to five percent (5%) of the contract price. Traditionally, retainage has been withheld at ten percent (10%). The new law applies to all contracts and subcontracts, whether public or private, executed on or after July 1, 2007.

The new law significantly benefits remote contractors, whose cash flow will improve from this reduction. For prime contractors, it is arguably a mixed blessing. Limiting the retainage an owner may withhold will improve a prime contractor's cash flow. However, the new law similarly limits a prime contractor's ability to secure its remote

The law does not apply retroactively to contracts or subcontracts executed prior to July 1, 2007. Therefore, a prime contractor that entered into a contract with an owner before July 1 may find that, although the owner may lawfully withhold ten percent retainage under the prime contract, the prime cannot lawfully withhold more than five percent from subcontractors, if those subcontracts were executed on or after July 1.

The new law further provides that retainage held for "work completed" is to be released within 90 days of the completion of such work, or within 90 days of substantial completion of the project, whichever comes first.

“Work completed” is to be construed to mean “completion of the scope of the work and all terms and conditions covered by the contract under which the retainage is being held.”

Trade industries that lobbied for the new law note that the modification was intended for retainage to be released as work is completed and accepted (so-called “line item retainage”), changing the current practice of holding all retainage until the entire project is completed. If so interpreted, the new law will benefit trades whose work is completed early in a construction project (e.g., graders, concrete), but have traditionally been required to wait until a project’s completion to receive final payment for work that was completed and accepted much earlier. The inclusion of “all terms and conditions” appears to support an owner’s or prime contractor’s right to withhold some portion of retainage for punchlist or defective work, or for delay damages.

Prime contractors are obligated to pay retainage to subcontractors within 10 days of receipt of retainage from the owner, and subcontractors are likewise obligated to pay retainage to sub-subcontractors or material suppliers within 10 days of their receipt of retainage from the prime contractor.

Contractors, both prime and remote, should make use of this new law in contract drafting and negotiation. Retainage provisions in prime contracts should require release of identifiable amounts of retainage upon completion and acceptance of identifiable scopes of work. Remote contracts (subcontracts) should require similar release of retainage, or, at the very least, release of all retainage upon completion of the remote contract.

Even if contract language does not specifically require periodic release of retainage, it should be requested. Because the new law is part of the Prompt Pay Act, an owner or prime contractor risks liability for additional interest (at the contract rate, or 10% if the contract is silent) and attorney’s fees if it is found to have wrongfully withheld payment in violation of the Act. Although the new law is not clear that retainage must be released on a scope-by-scope basis, the risk of additional liability under the Act may be sufficient to persuade an owner to release such retainage, or persuade a prime contractor to seek release of such retainage from the owner.

Because the law has been enacted as part of the Prompt Pay Act, it does not apply to contracts for residential construction, or to contracts with banks, other financial institutions or insurance companies, all of which are excepted from the scope of the Prompt Pay Act.

1. Tenn. Code Ann. § 66-11-144.

2. Tenn. Code Ann. § 66-11-144(g). The original draft of the bill increased the threshold to \$860,000.00; however, that provision was stricken from the final bill signed into law.

3. Of course, subcontracts of \$500,000 or more are subject to the law, which requires the prime contractor to keep the remote contractor’s retainage in a separate account. Simply earmarking a portion of the retainage withheld by the owner does not comply with the technical requirements of the statute.

4. Acts 2007, ch. 201 § 3. The new law has not yet been numbered, but is anticipated to be codified at Tenn. Code Ann. § 66-34-103, and is cited hereafter as such.

5. Tenn. Code Ann. § 66-34-103(a); Acts 2007, ch. 201 §§ 3, 7.

6. Tenn. Code Ann. § 66-34-103(b).

7. *Id.*

8. *Id.*

9. Tenn. Code Ann. § 66-34-702. For purposes of this law, “residential construction” means the construction of a building “used or designed to be used as a residence or dwelling place for one (1), two (2), three (3) or four (4) single family units. *Id.*

10. Tenn. Code Ann. § 66-34-703.