

RETAINAGE NO MORE

State Lawmakers move to eliminate the DOT's right to withhold full payment.



*Christopher S. Dunn
Waller, Lansden, Dortch &
Davis, PLLC*

The Tennessee Department of Transportation's (TDOT's) practice of holding construction project retainage¹ is about to change. Beginning with contracts signed after Aug. 1, 2005, the Department will no longer keep project retainage from its general contractors. In a related move, TDOT is also expected to prohibit its prime contractors from withholding full payment from their own subcontractors and suppliers.

These changes will come as a surprise to some, as these laws have been on the books in Tennessee for decades. To understand the reasons for the changes it helps to have an understanding of the federal laws impacting TDOT projects.

Federal Highway Funding Laws and Regulations

Since 1982, all federal highway funding acts have required that a portion of federal highway funds be spent on contracts with businesses owned by "socially or economically disadvantaged persons." State highway agencies wishing to receive federal highway funds must comply with these funding acts, including the rules relating to such disadvantaged business enterprises or "DBEs."

In March 1999, the U.S. Department of Transportation (USDOT) created a regulation (the DBE rule) that required states receiving USDOT funds to establish a prompt payment clause to ensure that general contractors paid all subcontractors for satisfactory performance. This prompt payment rule applied regardless of whether the subcontractor was a DBE or not,² and included the payment of retained funds after satisfactory completion of the work. The USDOT created this rule because it perceived delays in payment to be a significant barrier to competitiveness of small subcontractors.³

In response to the prompt pay requirements, some states receiving federal highway money eliminated retainage provisions. They did this to avoid causing hardship for prime contractors who were required to pay downstream subcontractors in full even though a portion of their funds were being retained by the state. Tennessee, for example, was one of the states where a prime contractor could be adversely affected given a longstanding law prohibiting TDOT from paying more than 96.5 percent of a contract amount before final acceptance.⁴

In July 2003, the USDOT decided it needed to assist general contractors caught in this predicament. In that month, the USDOT revised the DBE rule by requiring that the states adopt one of three retainage reforms as a condition to receiving federal transportation dollars. The state's options consisted of these choices:

- (1) Decline to hold retainage from prime contractors and prohibit prime contractors from holding retainage from subcontractors;
- (2) Decline to hold retainage from prime contractors and require a contract clause obligating prime contractors to make prompt and full payment of any retainage kept by the prime contractor to its subcontractor within 30 days after the subcontractor's work is satisfactorily completed; or
- (3) Hold retainage from prime contractors and provide for prompt and regular incremental acceptances of portions of the prime contract, pay retainage to prime contractors based on these acceptances, and require a contract clause obligating the prime contractor to pay all retainage owed to its subcontractors for satisfactory completion of accepted work within 30 days after payment to the prime.

Tennessee's Response

TDOT considered the alternatives and eventually selected the first option. To implement its choice into law, TDOT drafted and sponsored a concise bill⁵ that made its way through the House and passed the Senate in May 2004.

The TDOT bill passed by the General Assembly modified only a few existing Tennessee statutes. What follows is a brief review of these modifications, or amendments. All the amendments go into effect Aug. 1, 2005.

1. Retainage

Old Law: Not more than 96.5 percent of the contract amount on a TDOT project shall be paid until the work is completed and accepted.⁶

New Law: Although it is somewhat anticlimactic, there actually is no "new" law to replace the 96.5-percent rule. This is so because the General Assembly simply wiped out the 96.5-percent retainage statute without putting a substitute in its place. The General Assembly did not write a law, which

says, "TDOT cannot withhold retainage on its construction projects." Likewise, there is no law stating that TDOT will prohibit its prime contractor from withholding retainage from its subs.

All that said, TDOT certainly wants to remain eligible to receive federal highway funds, and did sponsor a bill eliminating an existing Tennessee law requiring it to keep retainage. The Department also issued a "Talking Points" memo with its bill that clearly stated that it had selected the first of the three options. Given these facts, and the history of the DBE rule, it makes sense to expect that TDOT will alter its contracts to eliminate retainage in any contracting tier, even if there is no new Tennessee law that says they must.

2. Claim notices

Old Law: The Department could not make full settlement with a prime contractor until the Department provided 30 days advertised notice in a newspaper published in the county where the work is done. After that advertising period, any subcontractors or suppliers dissatisfied with payment had 30 days to file a notice of claim with TDOT.

Continued on pg. 26



"An ounce of prevention is worth a pound of cure."

Addressing employee issues *before* they become lawsuits is something Waller Lansden's attorneys help Tennessee employers do every day.

Waller Lansden Dortch & Davis

wallerlaw.com

Nashville City Center | 511 Union Street, Suite 2700 | Nashville, TN 37219 | Phone: (615) 244-6380
520 South Grand Avenue, Suite 800 | Los Angeles, CA 90071 | Phone: (213) 362-3680
809 South Main Street | Columbia, TN 38402 | Phone: (931) 388-6031

Waller Lansden Dortch & Davis, PLLC | Waller Lansden Dortch & Davis, LLP

Continued from pg. 25

New Law: The new law is identical except that subcontractors and suppliers must now file a notice of claim with TDOT and the prime contractor's surety.

3. Money withheld by TDOT to satisfy claims

Old Law: For contracts executed prior to Aug. 1, 2005, TDOT has the power to withhold a "sufficient sum" from a contract balance due to pay any properly noticed claims.⁷ Thus the Department had broad discretion to keep a prime contractor's funds. If subcontractors or suppliers filed suit to pursue a claim, the Department then paid the withheld sum into court.

New Law: The new, amended law is almost identical to its predecessor except that it now states that the Department shall withhold from the general contractor a sum sufficient to pay all claims "from the three-and-one-half percent (3.5%) retained on any contract executed prior to August 2005."

This difference seems to imply two things. First, that the Department will not withhold more than 3.5 percent retainage on contracts signed before August 2005, and second that TDOT does not intend to hold retainage on contracts executed after August 2005, because the law simply does not address the question of how TDOT should handle retained funds on contracts signed after this date.

Practical Effects

As one might expect, the change in the law concerning TDOT project retainage will affect the manner in which the industry conducts business. Clearly, prime contractors and the others they hire should now get paid in full, and no

longer need to worry about their retained payments being properly placed in interest-bearing escrow accounts as required by Tennessee law.⁸ That is positive news for builders and suppliers alike.

Another foreseeable consequence, however, is that general contractors may insist on subcontractors securing performance and payment bonds, given that retainage can no longer be kept as security. Recognizing that many prudent prime contractors may take such a step, the General Assembly also enacted a new law authorizing TDOT to create a construction bond guarantee program. The program is the subject of a separate article in this issue (see page 28), but its existence clearly underscores the USDOT and TDOT's interest in clearing the path for DBEs and other small businesses to participate in highway construction projects in Tennessee. Look for this trend to continue as the DBE programs evolve.

Chris Dunn is a construction attorney at Waller Lansden Dortch & Davis, PLLC. Waller Lansden serves as the TRBA's legal counsel.

¹ "Retainage" means those earned funds withheld by an owner or contractor to ensure full or adequate performance.

² 49 C.R.R. § 26.29.

³ 68 FR 35542, 35549.

⁴ Tennessee Code Annotated § 54-5-121.

⁵ Senate Bill 3458.

⁶ Tennessee Code Annotated § 54-5-121.

⁷ Tennessee Code Annotated § 54-5-123.

⁸ Tennessee Code Annotated § 66-11-144.



**TO
ADVERTISE
IN**

TENNESSEE

ROAD BUILDER

Call Megan Brown at
614.846.8761 or 800.288.7423
mbrown@triad-inc.com

