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CUT THE CHECK

A law taking effect in November cuts in half the amount of money that building owners and developers can withhold from contractors until they complete construction projects.

Steve Adams | Banker & Tradesman Staff

NEW SET OF RULES FOR PRIVATE BUILDING PROJECTS

Subcontractors Win Payment Battle

BY STEVE ADAMS | BANKER & TRADESMAN STAFF

The final stages of a construction project are often the most contentious, and can lead to a disproportionate share of financial disputes.

For years, the industry's solution has been a concept called retainage fees. Essentially, the fees act like a security deposit that owners withhold from contractors, and general contractors hold back from subcontractors, giving them an incentive to tie up the loose ends of the job.

Beginning in November, the ground rules will change in Massachusetts for private construction projects $3 million and up. A new law sets a maximum retainage fee of 5 percent, down from the widely-accepted industry standard of 10 percent. And it spells out a series of deadlines for when the money is due.

Legal experts say the new law could reshape every step of the construction cycle, as funds flow from lenders to developers, and in turn to general contractors and subcontractors. Some predict it could drive up the cost of projects.

"There are many traps in here for the uninformed," said Peter McGlynn, a managing director at Boston-based Bernkopf Goodman LLP.

Passage of the law, signed by Gov. Deval Patrick last month, was a victory for unionized building trades and subcontractors, who had lobbied for the more aggressive requirements on payments for three years.

Opponents say the law will lead to more disputes and lawsuits that shut down projects.

NAIOP Massachusetts, which represents commercial developers and owners, was not invited to provide input on the bill, and the result is flawed legislation, said Tamara Small, NAIOP's senior vice president of government affairs.

"It doesn't really have any flexibility and it eliminates the ability of owners to negotiate this on a project-by-project basis," Small said. "As a result, owners and developers are going to use well-established contractors and not going to take a risk with the ones they don't have a relationship, because they don't want to take the risk of them not finishing the job."

Backers say the new law was needed because late payments are a chronic problem in the industry, with subcontractors sometimes forced to wait years to get paid in full.

Passage of the "prompt payment bill" in 2010 addressed some of those complaints, said Richard Fisher, president of Associated Subcontractors of Massachusetts. That law gave subcontractors the ability to suspend work if they were behind in receiving payments, without running the risk of being held in breach of contract.

The latest bill, Fisher said, takes it a step further by setting 5 percent as a more reasonable retainage fee, one that has been adopted by 10 other states.

"It's a behavior that over the years has gotten out of hand, and the practice is abused," he said. "Too much money is withheld at 10 percent."

Subcontractors perform 85 percent of the work on major building projects in Massachusetts, Fisher estimated. Owners and general contractors have been treating the 10 percent retainage as a free ride for work that's already been performed, he said.

"They have been using money that's sort of free of interest and free of risk, and they don't want to let that go," he said.

The new law spells out a timeline for when retainage fees are released. It starts ticking when the contractor submits a notice of substantial completion. The owner has 14 days to accept or reject it and provide details of what needs to be finished. Contractors or subcontractors then have seven days to file a protest, sending the dispute to mediation, arbitration or litigation.

The new timeline is aggressive and could sour the relationship between owners and contractors, McGlynn said.

"Once that button is pushed, whatever good relationship [they may have had] is out the window," he said.

Christopher Whitney, an attorney with Pierce Atwood in Providence, said the 10 percent retainage standard had another advantage: It gave owners some financial wiggle room when a project was delayed before they started imposing late penalties.

With retainage reduced to 5 percent, they might be quicker to fine contractors on overdue jobs, triggering litigation or a walk-off, Whitney said.

"This is a potential example of unintended consequences," Whitney said.

Eventual Adjustment Expected

Lenders, for their part, may require that owners and general contractors hold back more money during earlier stages of projects, and demand more documentation about when subcontractors are paid, said Edward Hershfield, a partner and real estate attorney at Brown Rudnick LLP in Boston.

"It's going to add a lot more paper and formality to the process," Hershfield said. "People are going to be more cautious on dollars going out the door to the general contractor that are eventually supposed to be going to the subs."

Robert Petrucelli, CEO of Associated General Contractors of Massachusetts, said many of the same objections greeted the passage of the prompt payment law, but have proven to be unfounded.

"It's going to take a little while to play out, but people thought the sky was going to fall and nothing happened. We have not heard any negative fallout to the prompt pay legislation," he said.

AGC had opposed the bill in previous years. It signed on this summer after new language was added giving owners and general contractors more leverage to withhold payments, as long as they can document unfinished work.

"It's going to take a little while to play out, but we think the industry is going to adjust to this law," Petrucelli said. ■

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