RETAINAGE TRUST FUND

BACKGROUND

Texas law requires non-public property owners to withhold 10% of the value of the work that is performed by a contractor and subcontractor under a construction contract until completion of the work. This 10% amount is called *retainage*. In situations where a lender is providing construction financing, typically the lender only funds a loan amount for 90% of the value of the work each month and does not fund the remaining 10% until the project is finished. When a loan default occurs, the 10% not funded by the lender does not get paid to the construction team.

PROBLEM

Often, owners assume the 10% not funded by the bank to be retainage. It is not. If the owner of a construction project funds construction with a loan from a lender and the 10% retainage is not transferred to the owner each time the lender advances loan proceeds, then contractors and subcontractors and others entitled to the retainage often do not get paid if the owner defaults on the construction loan.

SOLUTION

The owner should be required to set aside in a separate trust account the retainage amount not paid each month to the contractor for construction costs during the life of a project to ensure that the contractor and subcontractors will be paid the retainage to which they are entitled. This trust account can be a simple bank checking or savings account and does not require a lawyer-prepared trust agreement. The owner could, instead of setting aside the retainage, purchase a retainage bond for the benefit of the construction team.

Detailed Information on Reverse

RETAINAGE TRUST FUND – Detailed Information

Background: Texas law requires non-public owners to withhold and set aside 10% of the construction contract price or 10% of the value of the work for work that is performed on a private project. This 10% is part of the amount owed for work performed or materials furnished and is called “retainage.” Normally the retainage is held until at least 30 days after the completion of the project. Typically, the retainage requirement applies by contract through the entire delivery chain to include the general contractor, its subcontractors and their subcontractors.

Problem: Moneys already earned but withheld are vulnerable to defaults of the owner and superior claims of lenders. A sour economy fosters an increasing number of instances where the owner defaults on payment and the moneys ostensibly withheld for labor and materials performed disappear, are diverted, or are claimed by others such as lenders with superior lien rights.

If the owner of a construction project funds construction with a loan and if the 10% retainage is not transferred to the owner each time the lender advances loan proceeds, then subcontractors and others entitled to the retainage often do not get paid if the lender forecloses. This scenario is fairly typical on a construction project when a lender forecloses on a loan.

If the owner/borrower does not default on the loan, the retainage is eventually funded by the lender to the owner/borrower who in turn pays it out to the general contractor or to the appropriate subcontractor. The problem arises when the owner/borrower defaults on the loan. In this situation, if the owner/borrower does not set aside the retainage during the life of a project the funds have not become part of the construction loan and still reside with the lender. The contractors and subcontractors in most instances will not receive the retainage they have earned and to which they are entitled.

Chapter 162 of the Texas Property Code provides that construction payments are trust funds if the payments are made to a contractor or subcontractor under a construction contract for the improvement of specific real property and loan receipts are trust funds if the funds are borrowed by a contractor, subcontractor, or owner for the purpose of improving specific real property, and the loan is secured in whole or in part by a lien on the property. Chapter 162 does not apply to the problem described above where the owner has not borrowed and set aside the retainage for the benefit of the contractors and subcontractors.

Solution: Legislation needs to be enacted that would require a project owner to set aside retainage in a separate trust account covered by Chapter 162, Property Code, during the life of a project to ensure that those contractors and subcontractors will be paid the retainage to which they are entitled. If the owner does not want to set aside the retainage, they should be provided the alternative to purchase a retainage bond for the benefit of the construction team.