Established 1872

Reprinted from the
Commercial Real Estate Monthly section of November 24th, 2014

www.BankerandTradesman.com

BANKER & TRADESMAN

THE REAL ESTATE, BANKING AND COMMERCIAL WEEKLY FOR MASSACHUSETTS

A PUBLICATION OF THE WARREN GROUP

TIMING IS EVERYTHING

Should Lenders Care About The New Retainage Law?

What's At Stake Under The New Payment Rules

BY GARY MARKOFF
SPECIAL TO BANKER & TRADESMAN

The new retainage law took effect two days after Election Day, Nov. 6, for contracts entered into after that date.

Lawyers and their owners scrambled to finish their construction contracts before the effective date. Why? Because there are several provisions in the new statute that present new and unique challenges for owners, and their construction lenders.

GARY MARKOFF

The law deals with private construction contracts of $3 million or more between the primary contractor (i.e. the general) and the owner. One- to four-unit residential projects are exempt.

The definition of "substantial completion" in the statute is particularly troublesome. The work must only be "sufficiently complete in accordance with the contract for construction so that the project owner may occupy or utilize the work for its intended uses." While simplicity has its virtue, there are many items that are typically included in the definition of substantial completion, like a certificate of occupancy (even a temporary or partial one), which go missing from the definition. Owners may now be more motivated to phase their projects in order to apply the concept of substantial completion for each phase. Owners would then avoid the shock of an unexpected notice of substantial completion for the entire project.

A difficult logistical problem for owners and their lenders is the period within which

to respond to a written notice from the general contractor that their project is "substantially complete;" only 14 days, not business days. Those 14 days could become less than 10 effective business days if the notice is given late on a Friday afternoon before a long weekend. If the owner doesn't respond, then she is deemed to have accepted the notice and the project is deemed substantially complete, which is "final and binding on the project owner and its successors and assigns."

Did I mention that notice can be sent by email?

No Mitigating Factors

What does this all mean for a mortgagee stepping into a troubled project after the notice has been given? What if the project owner does not receive or see the notice, or ignores the notice? Perhaps the owner is on vacation in the Fiji islands where communication is sparse and not 21st-century compatible. An exotic or extreme vacation could cost the owner and his lender dearly, since non-responsiveness is deemed consent to the notice of substantial completion "for all purposes." No mitigation factors are considered.

Will a lender be able to mobilize its inspecting engineer in time to adequately evaluate the notice of substantial completion? What if the lender (or its OREO subsidiary) accepts a deed-in-lieu without knowledge of the notice of substantial completion? The lender or its subsidiary will be bound by the notice.

But should that notice also apply to the successful bidder at a foreclosure sale? The answer is unclear, but one way to possibly mitigate potentially adverse consequences is to include protective language in the contractor's consent typically given to the assignment of the construction contract as collateral. The language in the consent could provide that if the lender does not receive a copy of the notice of substantial completion, it is not bound by the notice. But even this

Reprinted with permission of Banker & Tradesman.
This document may constitute advertising under the rules of the Supreme Judicial Court of Massachusetts.

measure may not work because "a provision in a contract for construction which purports to waive, limit or subvert this section or redefine or expand the conditions for achievement of substantial completion for payment of retainage shall be void and unenforceable."

Is such consent by the contractor a "provision in a contract for construction," that violates the statue? Probably not, but one cannot be sure. The lender, nevertheless, will not be worse off by requiring the consent language, and it may give it a fighting chance to avoid being bound by its borrower's inattention. But most owners are vigilant and have the right to object to the notice within the 14-day period. That objection needs to be in writing and specify its reasons (i.e. provide the "factual and contractual basis for the rejection and certification that the rejection is made in good faith.") The written objection should include a description of all defective or incomplete work and all outstanding deliverables required under the prime contract. It also needs to put a value on each item of incomplete or defective work or deliverable. Within seven days after receipt of the owner's list, the prime contractor must then submit a similar list (certified as made in good faith) of all defective or incomplete work and outstanding deliverables to each sub-contractor from whom it is withholding retainage. Multiple sequential applications for release of retainage are permitted as work is completed or corrected, deliverables are delivered, and claims are resolved.

New Financial Burdens Possible

Perhaps, the most publicized aspect of the new statute is the cap on retainage of 5 percent. No more 10 percent with the possible reduction to 5 percent or less when the project is 50 percent complete. Will lenders now require more equity as a result? Will lenders now require performance, payment and lien bonds more frequently? The cost of bonds particularly with CRA credits often creates a severe financial burden for the project budget. But because this statute sets the stage for potentially more disputes over substantial completion, mechanics liens may become more prevalent, a strong argument for bonds.

Note that unless the owner has declared the prime contractor in default under its contract, the owner cannot withhold retainage owed by the contractor to a subcontractor unless that sub is in default under its contract with the primary contractor.

There are very technical rules for the timing of application for and release of retainage that need to be reviewed by lenders. Monitoring the construction budget earlier in the project may now be more critical for both lenders and owners. An owner's request to re-allocate between line items or apply the contingency reserve needs to be evaluated with the new statute in mind. The lender may also want more involvement in approving the subs.

Needless to say owners and lenders woke up too late in the day to have their interests properly reflected in this statute. Efforts to amend the statute will no doubt be on the agenda for the 2015 legislative year. ■

Gary M. Markoff is a partner at Boston law firm Sherin and Lodgen. He can be reached at gmmarkoff@sherin.com or (617) 646-2141.

Reprinted with permission of Banker & Tradesman.
This document may constitute advertising under the rules of the Supreme Judicial Court of Massachusetts.