

## Law & Accounting

# Law limiting retainage in private construction takes effect

This year, the Colorado General Assembly adopted new limits on the amount of retainage that can be withheld on private construction contracts.

■ **Retainage and limits.** Retainage is a percentage of a contract price withheld from a contractor pending completion of its scope or the construction project. Retainage serves two main purposes. First, retainage provides an incentive to complete a project on time; if a contractor knows that it will not receive final payment until the work is done, it can be a motivating factor to close out a job rather than letting punchlist or other minor items linger. Second, retainage provides protection to an owner against issues such as substandard work, liens and defaults; by holding money back, the owner can reduce the risk of overpaying for work that has to be redone or of paying double to settle lien claims.

Historically, it was not uncommon for an owner or general contractor to withhold 10% of a total contract price as retainage. This meant that a contractor or subcontractor, after completing their portion of a project, would only get 90% of what was due, sometimes waiting until the entire job was finished before they could receive final payment. Because this retainage often would be passed down (with owners withholding retain-



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age from general contractors, general contractors withholding retainage from subcontractors, subcontractors withholding retainage from subcontractors, and so on), lower-tier subcontractors were the ones most affected by such provisions, especially on jobs with tight profit margins. This led to some industry advocates arguing that retainage terms were being abused in an effort to make subcontractors "finance" owners' projects. This, they argued, increased overall construction costs as subcontractors raised their prices to hedge against excessive withholdings.

To address some of these concerns, Colorado's General Assembly adopted limits on retainage for public works projects in 1991 under Colo. Rev. Stat. § 24-91-103. The original statute included a 10% initial retainage cap for such jobs, and the Legislature lowered this cap to 5% in 2011. The cap applies whenever a state, county, city, town, district or political subdivision enters into a construction contract with a price exceeding \$150,000. It does

not, however, limit retainage on private projects.

■ **The 5% cap now applies to private construction contracts.** The recent changes, which Gov. Jared Polis signed into law in May under House Bill 21-1167, place a similar 5% cap on many private construction contracts.



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The new statute applies to construction projects with a price of at least \$150,000. It contains exceptions for single-family homes and multifamily dwellings with less than four units, and it excludes public works projects governed by the existing statute. For most other jobs, however, the statute prohibits an owner, general contractor or subcontractor from withholding more than 5% of a contract price as retainage from a lower-tier contractor.

By its own language, the new statute does not restrict other provisions of a construction contract such as terms that set deferred payment deadlines or permit backcharges, deductions and setoffs due to incomplete or defective

work. The statute likewise does not limit pay-if-paid or pay-when-paid clauses; such clauses permit general contractors to wait until receiving payment from an owner before paying a subcontractor. Subcontractors should be mindful of these provisions, as they can lead to payment delays should a dispute arise with an owner on a job.

The new statute also states that, in order to receive full payment, the recipient must provide an executed lien waiver whenever required by contract. It is noteworthy that the drafters chose to place this language in a separate section rather than address lien waivers along with other contract terms undisturbed by the limits on retainage. This could be interpreted as placing special emphasis on the importance of the lien waiver, but whether courts will interpret this section as creating any new rights remains to be seen. Regardless, this inclusion should help assuage owners' concerns that paying a contractor in full might subject them to a subcontractor's lien in the future. To take advantage of this provision and protect themselves against lien claims, owners and contractors should draft their agreements to require lien waivers as a condition precedent to making final payment. This has always been a prudent business practice, and it is crucial

in light of the recent amendments.

Contractors also should note that the new statute does not alter existing law requiring them to hold money in trust for the payment of subcontractors and suppliers. Under Colo. Rev. Stat. § 38-22-127, a contractor must always hold funds received on a job in trust for the payment of subcontractors, suppliers and laborers on a job, and the contractor must maintain separate records of account for each project or contract. This is true regardless of whether any amounts are designated as retainage, and the failure to hold funds in trust (in the absence of a good faith setoff) can subject a contractor to liability for treble damages and attorney fees. In extreme cases, contractors who have taken money from a project for personal use also have faced criminal prosecution for theft.

The new law took effect Sept. 7 and is codified at Colo. Rev. Stat. §§ 38-46-101 to -104. It aligns Colorado with around a dozen other states that have instituted 5% to 10% caps on retainage for private contractors. Property owners and general contractors, especially those using older form contracts, should take care to ensure that their agreements do not inadvertently violate the new statute or fail to take advantage of its lien waiver provisions. ▲