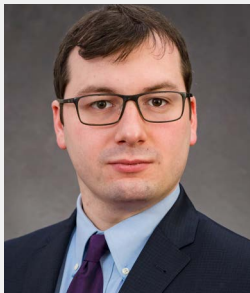




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## New York Revises Retainage Requirements for Private Construction Contracts: Overview of the “5% Retainage Law”

On November 17, 2023, the State of New York enacted the “5% Retainage Law.” This legislation effectively limits the amount of retainage that can be held from general contractors and subcontractors to no more than 5%. It applies to many but not all construction contracts. In addition, the new law revises late stage billing requirements, enabling contractors to invoice for retainage at substantial completion. Previously, the parties to a construction contract were free to negotiate any retainage amount, limited only by an unspecified “reasonable amount” that would be released as the parties contractually set forth.

### Summary

The new law amends Sections 756-a and 756-c of the General Business Law (part of Article 35E of the GBL, known as the “Prompt Pay Act”), and applies to private construction contracts “where the aggregate cost of the construction project, including all labor, services, materials and equipment to be furnished, equals or exceeds one hundred fifty thousand dollars.”

Through this new 5% Retainage Law, owners, prime contractors, and subcontractors are also prohibited from withholding more than 5% from their lower tier contractors. In no case may a contractor or subcontractor withhold more than the percentage the owner retains on the prime contract. Additionally, the statute provides an important right to prime contractors by allowing them to “submit a final invoice to the owner for payment in full upon reaching substantial completion.” The term “Substantial Completion” is as “defined in the contract or as is contemplated by the terms of the contract.” For sake of reference, under the previous version of the law prime contractors were permitted only to “invoice for payment in full upon the performance of all the contractor’s obligations under the contract.” Such an invoice would include items such as retainage (to the extent any further amounts were remaining on the contract) and other holdbacks, including those for punch list work.

Nonetheless, this does not mean that an owner must release all retainage upon Substantial Completion. The law, as it did before this amendment, still requires that the owner release all retainage to the prime contractor no later than 30 days after final approval of the work under the contract. The changes to the law merely accelerate the time in which a contractor may submit its final invoice. While such an earlier submission could, in turn, accelerate the time for final payment, an Owner may still avail itself of contractual and statutory defenses to make the payment or otherwise delay same.

As in the prior version of the law, prime contractors and subcontractors are required to release a “proportionate amount of retainage,” to the “relevant parties” (i.e., their lower tiers), after receiving payment of retainage from the tier above.

The penalty for failing to comply with the law remains the payment of interest at 1% per month from the date the retention becomes due.

## **Can the Law be Contracted Around?**

### **a. Retainage Caps**

Given that there has not yet been any judicial interpretation of the 5% Retainage Law, it is unclear whether owners and contractors can simply agree to higher retainage amounts and enter contracts that sidestep the new statutory language. There is an argument that under the terms of the Prompt Pay Act (GBL Article 35-E), of which this law is a part, such a tactic could be possible.

Specifically, in an earlier part of the Article, (GBL Section 756-a), the law provides that the terms of a construction contract “shall supersede the provisions of this article... [e]xcept as otherwise provided in this article.” The later Section 757 identifies a limited and specific list of contract terms that are void and unenforceable, including such provisions as: subjecting construction contracts to the laws of other states; requiring disputes to be venued other than in New York; intruding on statutory rights of suspension; intruding on the statutory right to arbitration of disputes under the Prompt Pay Act; establishing payment provisions that differ from those in 756-a(3); and obviating the penalty provisions of 756-b of the Act. However, the alteration of the retainage provisions contained in Section 756-c, are not included among this list of prohibited/voidable terms.

Thus, a plain-meaning reading of the statute would appear to permit the parties to enter contract terms that differ from the statute’s 5% retainage requirements and the other requirements of Section 756-c. At the same time, we can envision an argument that the legislature would not have amended the retainage law simply to leave open a loophole by which parties could ignore same by the terms of their contract. It would appear then that the enforceability of the new 5% Retainage Law and its restrictions may very well become the subject of litigation to clarify its applicability.

### **b. Timing of the Final Invoice and Substantial Completion Itself**

As referenced above, the change in the law that now allows billing for payment in full at “substantial completion as ... defined in the contract,” rather than at final completion, is a significant change that may drive parties to redefine “substantial completion” in a direction closer to traditional final completion requirements. It may also result in contractors seeking to bill for all retainage, and even for work not yet performed as of “substantial completion,” depending on how that term is contractually defined.

Furthermore, general contractors will need to take heed of any relevant definitions that impact the timing of payment or “substantial completion” that are placed within the prime contract as they will intersect with the general contractor’s obligations to pay its subcontractors and may impact any pay-when-paid timing protections. Such issues are likely to be highly fact specific and contractors may be well served by consulting with counsel regarding their rights and obligations under the new legal framework.

## **What About Pre-Existing Projects?**

The new law does not apply to contracts that were entered into before the effective date of November 17, 2023, meaning that contractors will not have to revise or amend pre-existing contracts or practices to comply with the new retainage and final billing requirements. Work proceeding under work orders or master-service type agreements should be addressed on a case-by-case basis.

## **Considerations for Contractors**

Because retainage traditionally could be held until final completion of the work, it was (and is) a useful tool for incentivizing contractors and subcontractors to dutifully complete their work through project close-out. Likewise, retained funds have traditionally been applied as a set-off to satisfy unpaid expenses, costs, or claims on behalf of contractors and subcontractors that fail to fulfil their contractual obligations. However, there may be concerns

that the new 5% Retainage Law reduces the security that retainage is intended to provide. Fortunately, there are methods that can be utilized to address the apprehension felt by owners and general contractors that a reduced retainage cap may take the purpose and teeth out of their contractual retainage provisions.

**a. Final Invoice Versus Final Payment and Related Procedures**

While the new law allows prime contractors to bill for final payment at “substantial completion,” final payment is not required to be distributed at that time. Under New York’s Prompt Pay Act, the owner and prime contractor may still withhold payment of amounts invoiced if there is a reasonable basis for doing so, such as disputed job progress, defective work, or failure to comply with material provisions of the contract, similar to the contractually specified conditions for final payment.

Such withholding requires that a written notice be issued within twelve business days of invoice receipt, in compliance with GBL Section 756-a. However, given that the law also sets a 30-day time limit for the owner to remit retainage after final completion of the work (in addition to other payment requirements), it certainly aims to accelerate downstream payment of the entire contract sum. Stated otherwise, owners have to keep in mind how much time they have both to articulate their objections to payment, but must also keep in mind the deadline to remit retainage after final completion absent any such objection.

**b. Proper Retainage Schemes**

Because the new law caps retainage at 5% of the total contract sum, and not 5% of each invoice, contractors may, as a practical matter and if permitted under the contract, alter the amount of retainage withheld from its subcontractors on a pay application basis. For instance, it appears that contractors may withhold retainage in excess of 5% in early phases of the project and then reduce the retainage withheld in later phases—or vice versa—so long as the total retainage withheld at the end of the project is less than or equal to either 5% of the total contract or the percentage withheld by the owner, as the case may be. This allows contractors to maintain a sufficient stockpile of retainage for when they may need it most, like during critical construction phases of the project. Consequently, the customary practice of holding 10% until 50% completion would seem permissible under the new law.

**Final Thoughts**

While only in its initial months of effectiveness, the new 5% Retainage Law poses some interesting, and perhaps alarming questions and hurdles for owners and contractors. For owners, they must now face a statutory scheme in which contractors are potentially entitled to their contract sum sooner rather than later. For contractors, measures will have to be put in place to ensure that they are following the law’s requirements on the proportionate release of retainage to their subcontractors based upon owner payments. Further, questions remain as to the applicability of the law in the context of payment and performance bonds. Certainly, there are open questions and potential gaps posed by the new law (such as the extent to which parties can contract around the retainage caps), which leaves all parties operating without clarity regarding their rights and obligations. At a minimum, the new law makes it imperative that all parties give their contracts and operational processes additional scrutiny.

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