

- SUBJECT:** Requiring a construction fund trust account for retainage
- COMMITTEE:** Business and Industry — favorable, without amendment
- VOTE:** 5 ayes — Deshotel, Orr, Garza, Giddings, Workman
0 nays
4 absent — Bohac, S. Miller, Quintanilla, Solomons
- SENATE VOTE:** On final passage, May 18 — 20-11 (Eltife, Fraser, Harris, Hegar, Huffman, Jackson, Nelson, Patrick, Seliger, Shapiro, Uresti)
- WITNESSES:** (*On House companion bill, HB 1428:*)
For — Elisa Fox, Cummings Electricals, Inc.; Todd Hewitt, Texas Fifth Wall Roofing Systems, Inc.; Dennis Lewis, Potter Concrete, Ltd.; Kenneth Loper, TAS Commercial Concrete Construction, LLC; Richard Thomas, Texas Construction Association; (*Registered, but did not testify:* Barbara Douglas, Lumbermen’s Association of Texas; Jon Fisher, Associated Builders and Contractors of Texas; Corbin Van Arsdale, Associated General Contractors of America Texas Building Branch)

Against — John Fleming, Texas Mortgage Bankers; Manuel Munoz, Texas Association of Builders; Karen Neeley, Independent Bankers Association of Texas; (*Registered, but did not testify:* Celeste Embrey, Texas Bankers Association; David Mintz, Texas Apartment Association; Gardner Pate, Texas Building Owners and Managers Association; Kelly Rodgers, Wells Fargo Bank, N.A.)
- BACKGROUND:** Contractors, subcontractors, and suppliers secure credit through the issuance of mechanics’ and materialmen’s liens, which use property being improved as collateral for payment on construction contracts. Property Code, ch. 53, establishes who is entitled to a lien, procedures for perfecting such a lien, and what actions may be taken after such a lien is perfected. If a contractor, subcontractor, or supplier of labor or materials used in the construction, repair, or improvement of real property is not paid, a lien may be executed. If notice requirements for such liens are met

and the debt is not paid, the property subject to the lien may be foreclosed.

Retainage refers to a percentage of the contract price or value of the work in a construction project held by the owner. Sec. 53.101 provides that during the work under an original contract for which a mechanic's lien may be claimed and for 30 days after the work is completed, the owner shall retain:

- 10 percent of the contract price of the work to the owner; or
- 10 percent of the value of the work, measured by the proportion that the work done bears to the work to be done, using the contract price or, if there is no contract price, using the reasonable value of the completed work.

Sec. 53.103 says a claimant has a lien on the retained funds if the claimant sends proper notices and files an affidavit claiming a lien no later than the 30th day after the work is completed, terminated, or abandoned.

DIGEST:

SB 1425 would require a property owner who entered into a construction loan or financing agreement for the improvement of real property that was secured by a lien on the property or improvement to deposit retainage in a construction trust fund account at the time payment was made to a contractor or earlier. The bill would define a construction trust fund account as an account in a federally insured financial institution, consisting solely of retainage and funds necessary to pay account charges.

Trust funds deposited in a construction trust fund account would be required to be used first to satisfy statutory retainage requirements. Remaining funds could be used for other construction payments or for other purposes of the owner. Trust funds would not be subject to seizure, offset, or taking by the financial institution or a creditor of the owner.

A construction trust fund account would not be required for the construction, remodeling, or repair of a single-family house or duplex used for residential purposes or for improvements of \$250,000 or less.

If a property owner required to maintain a construction trust fund account opened and maintained a separate trust account with the financial institution for each project, the periodic statement received from the financial institution would be required to refer to the account as a "construction trust fund" account and identify the project for which the

construction trust fund account was maintained. If a property owner opened and maintained a trust account into which funds for two or more projects were deposited, the periodic statement received from the financial institution would be required to refer to the account as a “construction trust fund” account and the owner would be required to maintain an account record that provided information relating to:

- the source and amount of the funds in the account and the date the funds were deposited;
- the date and amount of each disbursement from the account and the person to whom the funds were disbursed; and
- the current balance of the account.

By the 14th day after receipt of a written request, a property owner would be required to provide a beneficiary of trust funds with a copy of the periodic statement received from the financial institution and the account record required to be maintained by the owner.

If a beneficiary of trust funds incurred actual damages as a result of the property owner’s failure to establish or maintain a construction trust fund account or failure to establish or maintain an account record, the beneficiary could recover actual damages, reasonable attorney’s fees, and a civil penalty of \$500 from the property owner and each trustee who was an owner, officer, director, or agent of the property owner and who received trust funds or controls or directed trust funds.

The bill would take effect September 1, 2011, and would apply only to an amount retained under an original contract entered into on or after the effective date.

**SUPPORTERS
SAY:**

SB 1425 would ensure that contractors and subcontractors were paid for their work. Lenders typically only disburse 90 percent of a construction loan, with the rest held as retainage to protect contractors and subcontractors from nonpayment. However, in circumstances where the owner has defaulted on the construction loan, lenders have failed to disburse the final 10 percent of the loan and have effectively seized retainage. Lenders may even know that the owner has defaulted but will take no action until the building has been completed to improve the lender’s position in a foreclosure. This is unfair to contractors and subcontractors who complete their work but will not be fully paid. When subcontractors are not fully paid, they are often forced to lay off workers

or go out of business, since subcontractors in Texas are typically small, closely held businesses.

Mechanics' and materialmans' liens are typically wiped out in a foreclosure because a lender's deed of trust mortgage is superior to mechanics' liens. For this reason, retainage is the primary form of protection for contractors and subcontractors. SB 1425 would ensure that contractors and subcontractors actually received retainage.

Owners are required under current law to hold 10 percent of the contract price as retainage. These funds can come either from loan proceeds or the owner's own funds. Owners who are drawing down only 90 percent of the loan are not complying with current retainage law.

OPPONENTS
SAY:

SB 1425 would increase construction costs. Under current law, construction lenders typically only disburse 90 percent of the loan. SB 1425 would require an owner to pull down the full amount of the loan and hold 10 percent as retainage in a trust account. This would require owners to pay interest on the full amount of the loan, rather than 90 percent of the loan. It is also possible that banks would refuse to disburse the full amount of the loan and instead the owner would have to fund the trust account from the owner's own funds. Owners already are subject to significant equity requirements in order to obtain a construction loan. Requiring owners to pay for retainage from the owner's own funds rather than from the construction loan would be overly burdensome.

SB 1425 would create a special protection for contractors and subcontractors over and above the protections they enjoy under current law. In addition to mechanics' and materialmans' liens, contractors and subcontractors would enjoy the benefit of a trust account. The bill would give contractors and subcontractors a higher level of priority that would increase business risks for other creditors.

SB 1425 would change the relationship between borrower and lender. Under current law, the relationship between borrower and lender is arm's length. Requiring a trust account to be established would create a fiduciary relationship between the borrower and lender.

The bill also would require retainage to be held in a financial institution. Recent bank failures have highlighted the risk of keeping account balances

over FDIC insurance limits. For large construction projects the value of a construction trust fund account could easily exceed FDIC limits.

NOTES:

The House companion bill, HB 1428 by Deshotel, was reported favorably, as substituted, by the House Business and Industry Committee on March 30.