



PLEDGE

Pledge and Retention – Conflict Between Rights and the Bank’s Interests

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Historical Development of Pledge

The pledge is one of the oldest and most widely accepted instruments for securing claims. Already in Mesopotamian and Hittite legal systems, forms of pledge existed, although at that time even members of a debtor's family (e.g., sons) could be pledged – something unthinkable today. Only in Roman law did pledge acquire its specific name (*pignus*) and form its essential principles, ranging from possessory pledge (*pignus cum possessione*) to non-possessory pledge (*hypotheca*), with an extension to receivables. Justinian's Codex already recognized pledges on both things and receivables, including non-possessory pledges.

Over time, the principle of publicity developed, which in essence served to notify third parties that a given asset was pledged and that they could not expect to satisfy their claims against the owner from that asset.

Pledge in Serbian Law

In Serbian law, pledge on movables long had a real (in rem) character. Under the Law on Obligations, a pledge on a movable was created by delivery of the asset into the creditor's possession, while for a pledge on receivables it was sufficient to notify the debtor. The principle of publicity was only partially achieved: with movables publicity was obvious (by transfer of possession), but with receivables it was deficient since notice to the debtor was not public, and thus third parties (other than the debtor himself) could not know of the pledge. This often led to disputes over priority between the pledgee and other creditors.

This problem was resolved by the Law on Pledge on Movable Assets and Rights Registered in the Pledge Register (2005), which introduced a public register of pledges. Registration provides full publicity and resolves the conflict between possessory and non-possessory pledge: priority belongs to the registered creditor, regardless of when possession was delivered or the pledge contract concluded. Legal certainty is thereby ensured for creditors and third parties alike, since after registration all who disregard a registered pledge are ex lege deemed to act in bad faith.

Pledge in construction and infrastructure practice

In construction and infrastructure projects, pledge over receivables plays a special role. Contractors often pledge their future receivables against the employer in favor of a bank, thereby securing financing of the works. Banks rely on contractual payments to ensure their repayment. Registration of the pledge gives them priority over all other creditors, even where the secured receivable arises after another creditor has already acquired a claim against the same debtor.

Retention in Construction Contracts

FIDIC-based contracts, widely used in larger projects in Serbia, almost always provide for a retention sum. Colloquially called “retention,” this mechanism is not a true legal retention in the sense of the Law on Obligations (i.e., retention of a thing), but rather a contractual right of the employer to withhold a part of the certified value of works as security for proper performance and remedying of defects.

The function of the retention is straightforward: the employer withholds a certain percentage from each interim payment certificate and retains it until completion of works or expiry of the defects liability period. Thus, the employer acquires a claim against the contractor at the moment each interim certificate is certified, while the contractor acquires a right to payment of the retention only upon full performance of obligations.

Although often viewed as a form of security, retention is not a pledge. The employer cannot acquire a pledge over his own money. Even if it were hypothetically considered a pledge in favor of the employer, it would ex lege cease by virtue of confusion of rights.

Conflict Between Employer and Bank

A practical conflict arises when a contractor pledges his receivables against the employer to a bank, but then fails to perform his contractual obligations. The employer then uses the retention to pay third parties to complete the works or remedy defects. The bank, however, argues that retention is part of the contractor's receivables and that it is entitled to priority payment. To the bank, retention resembles a "hidden pledge" in favor of the employer, undermining its registered priority.

From the employer's standpoint, the retention does not form part of the contractor's receivables until the contractor has fulfilled his obligations. For the employer, retention simply represents the value of works not performed, which he was forced to pay others to complete.

This tension results in banks demanding that retention be paid directly to them, while employers insist they are entitled to apply it toward their costs caused by the contractor's non-performance. The bank's right to claim retention from the employer in such a situation is very limited, and in most cases impossible.

Priority of Rights and Maturity of Retention

While the bank's priority vis-à-vis other contractor's creditors is undisputed, the question is whether the employer has priority over the bank regarding retention. If retention were viewed as a pledge established in favor of the employer, the answer would be yes. However, retention is not a pledge, but a portion of the contract price for works and services the contractor must perform. Accordingly, retention used to cover costs of unperformed works or defect remedying is nothing other than a reduction of the contract price due to incomplete performance. The fact that retention was earlier included in certified interim payments does not alter its legal nature. Otherwise, the equivalence of obligations would be undermined, and retention would take the character of an advance for future works. The Law on Obligations itself provides that in cases of partial non-performance the creditor may, inter alia, demand a reduction of price.

Another decisive factor is the maturity of the pledged receivable. The Law on Obligations clearly provides that a pledgee may only collect when the claim becomes due. Under FIDIC-based contracts, the contractor's right to retention does not fall due upon certification of interim payments. Half of the retention becomes due upon issuance of the Taking-Over Certificate, and the other half after the defects liability period, provided the employer has not already used it. This means the bank may demand retention only if the contractor has fully performed in accordance with the contract, since retention is due only to the extent it has not been used by the employer.

Given the legal nature of retention, and in particular the conditions for its accrual and maturity, the bank cannot assert priority over the employer before those conditions are met. Meanwhile, the employer is free to use retention under the contract. The fact that the bank holds a registered pledge over receivables is irrelevant to the employer's contractual right to apply retention. The bank, when taking the pledge, is obliged to assess the adequacy of the pledged receivable, including contractual terms affecting its accrual and maturity. Ignoring such terms would contravene the principle of good faith. The bank knowingly accepts that the pledged receivable is conditional and future, with maturity dependent on the contractor's performance.

Moreover, the Law on Obligations explicitly grants the debtor of the pledged receivable (the employer) the right to raise against the pledgee (the bank) any objections he could raise against his own creditor (the contractor).

Set-off Practice

In practice, employers and contractors sometimes structure retention differently. Where there is no dispute over the employer's right to retain, it may happen that the employer charges the contractor for third-party costs (which the contractor was obliged to bear) and the parties then offset their mutual claims.

If the contractor's receivables are already pledged to a bank, such arrangements may give the bank the impression that the value of the pledged receivable is being diminished, potentially amounting to creditor prejudice. However, set-off need not always be voluntary – it may also be judicially enforced by way of a set-off defense or counterclaim. This means the bank is not harmed by consensual set-off between employer and contractor, since the employer would be entitled to raise the same set-off objection against the bank as against the contractor. Any contrary view would contradict the principle of good faith.

By taking a pledge over receivables, the bank knowingly assumes all risks arising from the underlying construction contract. Its right consists in collecting the receivable when due and in taking measures to preserve it. That right does not include prohibiting the employer from using retention in the manner provided under the contract including the voluntary set-off between the employer and the contractor.

Conclusion

The employer's right to apply the retention toward covering its costs is not limited by the contractor's pledge of receivables to a bank. The accrual and maturity of retention are determined solely by the construction contract.

Accordingly, any creditor taking an assignment or pledge over the contractor's receivables must acquaint itself with the contract provisions governing retention. Registration of a pledge has no effect on these contractual provisions. If the bank seeks payment of retention from the employer, the employer may raise against the bank any objections it could have raised against the contractor – including that the claim has not arisen, that it is not yet due, or that the demand concerns payment for works not performed.

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