

Confronting Retainage and its Disruptive Effects on the Business Practices of Commercial Concrete Subcontractors

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This paper aims to explore the extent of the damage that retainage is capable of inflicting on the financial health of commercial concrete subcontractors and strategies which can be utilized to mitigate or avoid damage to their financial health. The methodology implemented to conduct this exploration is a series of interviews with commercial concrete subcontractors. An analysis of these interviews in conjunction with a thorough literature review demonstrates that retainage does indeed impact financial health of commercial concrete subcontractor though the scale of the operation does make a difference in the severity of this impact. Whether or not the construction industry is ready to eliminate this practice, it is undeniable that there are elements of the retainage practice that are simply unfair. The immediate elimination of retainage from the construction culture is unlikely. Despite this, the perspective on retainage does seem to be shifting in favor of subcontractors as proven through the passing of recent legislation and the increasing negotiations between general contractors and subcontractors.

Key Words: Subcontractor, Retainage, Cost, Benefit, Concrete, Construction

Introduction

Construction is unique in that it is the only industry which practices the withholding of money owed for work already completed as a means of insurance. This practice is called retainage or retention and has been the source of much controversy within the construction community. The retainers often argue that the practice is necessary to ensure the safety of their own business in the event of the default of parties contracted to work below them. On the other hand, those parties from which money is retained argue that the retainage is close to, if not greater than their profit margins which means that they cannot make profit throughout the progress of the project. Instead, they will have to wait until the project is completed before they can collect the withheld money. This paper assesses the extent of the burden that retainage places on commercial concrete subcontractors, methods that can be used to ease this burden, and variations or alternatives to retainage. Information gathered from interviews will be compared to the information in the literature review in order to draw conclusions which corroborate the validity of complaints against the retainage practice and understand whether the practice is likely to change over time. It is important to note that, due to the specificity of the selected research topic, the research that is discussed throughout the literature review was collected based on resources discussing subcontractors in the general sense. Despite this, all information in the literature review was carefully compiled to remain relevant and necessary in understanding retainage as it pertains to commercial concrete subcontractors.

Retainage Background

Retainage is a sum of money that is withheld from the periodic progress payments on a construction project with the intention of guaranteeing a timely completion of the project and adequate fulfillment of other contractual obligations. There are two retainage loops which complement the project payment cycles. One loop is that of the owner. The owner, in many cases, will retain 10% of each progress payment until the withheld amount reaches 5% of the project's contract value. The accumulated retainage is finally paid to the prime contractor after it is accepted by the owner. The second retainage loop is that of the subcontractors and the retainage loop that this

paper will be focusing on. The prime contractor, similar to the owner, can withhold 10% of its progress payments to the subcontractor (Cui).

The inception of the retainage practice dates back to the 1840s during the construction of the United Kingdom railway system. The sheer magnitude of the project created a surge in the demand for contractors which, naturally, resulted in a surge in the number of contractors willing to satisfy that demand and capitalize on monetary incentives. Many of these contractors who were eager for profit ended up insolvent, presumably due to a lack of experience and necessary qualifications. As a safety measure, railroad companies implemented a system whereby a minimum of 20% of the contractors' payment was withheld so as to disincentivize defaults on contracts and create a sort of emergency fund. The emergency would ease the financial burden that is associated with finding and hiring new contractors to replace those contractors that failed to perform. (Bausman).

Though 10% seems like a relatively small quantity to withhold, the accumulation of these sums over repeated progress payments essentially amounts to 10% of the value of the concrete subcontractor's contract value. It must also be kept in mind that the money that is being withheld is for work that has already been substantially completed and that a large portion of the amount paid must be used by the subcontractor to pay construction costs already incurred. Thus, retainage, while meant to be a safety measure which incentivizes performance, has the potential to cause cash flow problems and disruption to the financial health of concrete subcontractors. These complications are explored in greater depth in the following section.

Problems with Retainage

As aforementioned, since retainage withholds money that could otherwise be used to pay operation costs and most, if not all, of the money from progress payments is contributed to the payment of already incurred construction costs, retainage can create serious cash flow problems for concrete subcontractors.

Cash flow management is of the utmost importance when it comes to effective project management and the longevity of any construction firm. An inadequate cash flow management system may result in a shortage of working capital and threaten the successful completion of a given project. In fact, cash shortages cause more contractor failures than poor management of any other resource (Cui).

Construction business fail at a rate that is among the greatest of all industries. Cash flow issues are only worsened by infamously narrow profit margins. It is actually fairly common for the percentage of the withheld amounts to be greater than the negotiated or bid percentage of profit. This means that for those subcontractors in which this scenario is a reality, a loss equivalent to the difference between the profit percentage and the withheld percentage will have to be maintained until the withheld amount is released (Viator). In other words, subcontractors will have to finance that percentage of the project out of their own pocket. If their company coffers are not large enough for this financial undertaking, then they must acquire financing from third-party lending institutions. It is worthy to note that in the event that a loan is necessary, interest rates will undoubtedly be attached to the principal amount borrowed. The interest paid on the principal amount of the loan will come directly out of the profit margins that the subcontractor expected on the given project.

According to California law, retainage is required to be released within 45 days after completion of the project (Susan). This poses a special problem for concrete subcontractors as they are usually one of the first subcontractors to finish their scope of work. This means if some other agreement is not determined, some subcontractors may not get paid for their scope of work even when they have reached substantial completion because the project is not completed in its entirety. This could amount to years of waiting for a sum of money that has been rightfully earned especially for projects that are large in scale.

Methods Used by Subcontractors to Ease the Burden of Retainage

More often than not, it is difficult to secure clearly defined alternatives to retainage. Retainage is, after all, a standard in the industry. Thus, until new alternatives to retainage can be proposed and those that already exist can become more accepted by the industry, it is important that subcontractors use any and all strategies available to them to ensure that the inevitably harmful effects of retainage on their financial health is mitigated. This is not only for the benefit of the subcontractor itself but for the benefit of all parties involved since a subcontractor's insolvency on a project exposes the general contractor and owner to risk.

Front-End Loading

A straightforward method to bridge the gap between the actual expenses incurred in a given payment period and the amount of the progress payment is to maximize payments from the owner as early as possible. This can be done by overexaggerating the amount of costs that will be incurred earlier in the construction process in the schedule of values while keeping the total contract amount the same. This way, more cash is received in the beginning than is actually expended to offset the negative impact on cash flow that is caused by the retained amount (Cheng). This method, commonly referred to as front-end loading, is controversial because the exaggeration of the progress payment essentially means that work that has not yet been completed is being paid for out of the owner's pocket. Front-end loading is, in some cases, viewed as unethical and in more extreme cases illegal so it is imperative that necessary precautions are taken before utilization of this financial strategy.

Trade Credits

Trade credits allow parties that contract with material vendors to delay the payment of the already provided materials until a certain predetermined and agreed upon date. This allows subcontractors more time to secure cash inflows from progress payments before they can pay their other expenses. Thus, the working capital of the party utilizing the trade credit is augmented. Since subcontractors rely on these vendors for purchase of materials they can utilize this financial agreement to temporarily lessen the burden of cash outflows (Cui).

Utilize Lien Rights

Mechanics' liens allow subcontractors who have performed work on a project to place a hold on the title of the building in the event that the subcontractor does not receive the rightfully earned payment. If payment is not received within the given time period, the property can be foreclosed at the detriment of the property owner. Most states grant claimants of a mechanics' lien the right to payment in the full amount of what they are owed, including retainage. Mechanics' liens are often not filed to secure retainage that is not due especially if there are no payment problems already existing as this can damage the trust-based relationships which are essential to the project's success (Viator).

Factoring

Factoring allows a third-party financier to purchase the accounts receivable of subcontractors. In other words the future cash inflow from owner's payments which would originally be paid to the subcontractor, become an asset of the factoring company who purchased it. The subcontractors, in return for selling their accounts receivable, receive working capital immediately. Often, up to 80% of the value of the sold accounts receivable is granted to the subcontractor while the other 20% is withheld by the factoring company until the cash is received by them from the debtor. Once the debt is paid to the factoring company, a fee is deducted from the 20% withheld amount and whatever is left over from this sum is sent to the subcontractor. Simply put, subcontractors are paying a small fee to expedite receipt of cash from progress payments (Soufani). This expedited receipt of money allows subcontractors who would otherwise be struggling from the cash flow problems created by money retained from previous progress payments to offset cash flow deficiencies and continue operating and growing their business.

Variations and Alternatives to the Traditional Retainage Method

Though easing the burden of retainage by delaying cash outflows and expediting cash inflows is necessary for subcontractors to secure their own financial health, these defensive measures are not adequate in changing the

standards of the construction culture. In order to do so, variations and alternatives to retainage need to be proposed and pursued so that the culture can be shaped over time.

Escrow Accounts

Escrow accounts can place the funds retained from subcontractors by the general contractor in an account belonging to a third party. While the money is in this account it remains withheld from the subcontractor but also ensures that the general contractor, who would otherwise be withholding this sum of money, cannot use the money that has been rightfully earned by the subcontractor for its own purposes” (Bausman). Thus, escrow accounts, while not a direct alternative to retainage, are a variation in the manner that the money is retained. This variation grants the general contractor more legitimacy in its act of withholding money from the subcontractor since the money cannot possibly be used for any other purpose other than being withheld for insurance. Thus, escrow accounts may make it easier for subcontractors to be more trusting of the general contractor’s purposes for retaining money and therefore has the potential to eliminate the relational problems that can be caused by the controversy of retainage.

Line Item Releases

Line item releases allow for the release of retainage based upon the completion of an identifiable section or scope of completed work as opposed to the completion of the entire project. This solves the problem that was aforementioned regarding trades that achieve substantial completion and, therefore, should be entitled to retained funds but are not since the contract stipulates that the entire project needs to be finished. Concrete subcontractors would benefit from this especially considering they finish their scope of work earlier than most other trades (Stockenberg).

Replacing Retainage with Subcontractor Performance Bonds

Subcontractor performance bonds are agreed upon in a contract between a subcontractor and surety. In this agreement the surety guarantees to complete the project in place of a subcontractor in the event that the subcontractor fails to perform. Therefore, this bond acts as insurance for the general contractor and owner. Though both retainage and performance bonds provide some form of insurance for the general contractor and owner, retainage seems to be more preventative in nature since it directly disincentivizes subcontractors from abandoning a job. This disincentive comes from the fact that the subcontractor will lose all the money retained from work they have completed in the event of their default (Melinda).

Replacing Retainage with Retainage Bonds

Retainage bonds, though similar to performance bonds in their function, are a unique alternative to retainage. This type of bond forms an agreement which stipulates that in return for the general contractor not withholding a certain percentage of progress payments, the surety will pay up to the amount that would’ve been owed in those withheld amounts to the general contractor in the event that the subcontractor defaults. This allows the general contractor the same amount of monetary insurance it would have received from the retainage while allowing the subcontractor to eliminate most of the financial harm that would have otherwise come from the percentage withheld from each progress payment. If the bond is called and evidence of default is provided by the general contractor, the surety will pay out the general contractor the amount of owed retainage and will seek recovery from the subcontractor. Thus, the surety is taking on the risk that the general contractor would have taken if the bond hadn’t been secured (Guarantees).

Changes in Retainage Trends and the Construction Culture

It is difficult to gauge exactly where the industry, as a whole, stands on the matter of retainage since opinions vary and bias is often inevitable in the vocalization of these opinions. One way to assess the status of retainage as part of the construction culture is through the passing of legislation. This is because legislation considers the information orbiting an issue in a predominantly impartial manner and aims to establish general equitability.

The spearhead of the changes in retainage practices is the United States federal government through its regulation of these practices on public jobs. Modifications to the Prompt Payment Act include a restriction of the government from holding more than 5% retainage unless justified, requiring general contractors to pay subcontractors within seven days of receipt of funds from the government, allowing a party not paid on time to secure attorney's fees through litigation, and requiring interest to be paid on funds that were paid late. State governments have also become involved with this movement and, in some regards, seem to favor the subcontractor's cause. California, for instance, requires retainage to be released within 45 days after the date of completion, requires the general contractor to pay each sub within 10 days from the time that all or any portion of the retention was paid by the owner, and requires the retaining party to pay 2% interest per month, attorney's fees, and other costs associated with wrongfully withheld retainage. One other provision that has been implemented is that in the event of a good faith dispute between the prime contractor and the subcontractor, the prime contractor is not to withhold an excess of 150% of the estimated value of the disputed amount. This is very important in changing the way that retainage is used since it makes it more difficult for the prime contractor to abuse retainage by forcing compliance in an unfair manner (Susan).

Methodology

Due to the qualitative nature of the interview questions that were being asked it was found best to use an exploratory model. The method through which this exploration was carried out is a series of interviews. Though, the literature review proved helpful in highlighting and reflecting on general information that is already available and accessible, it is not an adequate means of exploration for this particular topic. This is because the information that exists regarding the experience and viewpoints of commercial concrete subcontractors is extremely limited and therefore the literature review could only cover information relevant to all subcontracting trades in the general sense.

The polar nature of yes or no survey questions would not allow the viewpoint of selected concrete subcontractors to be captured in the detail that it deserves, so the interview methodology was considered superior. Three concrete subcontractors agreed to participate in the interviews. These companies were Largo Concrete Inc., Pacific Structures, and Nibbi Concrete. From Largo Concrete Inc., Chris Forster, Vice President of Operations, and Donald Kahn, Project Executive, were interviewed. From Pacific Structures, Mitch Zutter, Project Manager, was interviewed. From Nibbi Concrete, Jeff Hartman, Division Manager, was interviewed. The interview questions that were asked of the individuals stated above can be found in Appendix A.

Additional justification for this research methodology is that every subcontractor may deal with the problem that retainage poses in their own unique ways. By compiling many of these solutions and strategies based on strategic inquiries, correlations can be drawn to the information in the literature review and those solutions that work the most effectively can be highlighted. The interview methodology may also make the paper of more interest to members of the industry who are curious to see how their peers are handling this widely shared problem and allow them to better communicate possible solutions.

Results

Most of the interview questions were close-ended questions that asked for further explanation of the yes or no response. The purpose of this was so that the yes and no responses could be quantified and turned into visual aids to summarize the results in a manner that is easily and quickly interpretable. These visual aids can be seen as pie charts in Appendix B. The explanations to those open-ended questions could then be used for a more thorough qualitative comparison to the literature review in order to draw conclusions. A non-negligible consistency could be observed in the close-ended responses to the interview questions as demonstrated by the aforementioned pie charts.

All three interviews showed that retainage was common on most jobs. In fact, all three individuals clarified that it is prevalent on almost every job. One interviewee stated, "I don't know of a single job that I've done in the last twenty years that didn't have retention on subcontractors." Thus, the prevalence of the retainage practice is

irrefutable when considering the collected data. This is a little discouraging when comparing it to the literature review because it shows that the substitution of retention for other forms of insurance such as performance and retainage bonds is probably not as prevalent.

When asked if retainage has ever required the borrowing of funds from third party financial institutions, only one of the interviewees responded with no. This interviewee stated that, "If you're a subcontractor that has lower tier subs below you, you're holding that retention on them... so your exposure is really on your labor." In other words, the amount retained by the general contractor from the subcontractor can be offset by retaining that amount from lower tier subcontractors by the primary subcontractor. Thus, the financial risk to cash flow is in areas where work is self-performed since the financial burden of retained money cannot be transferred to any other party. Offsetting the retainage to other parties is not exactly a solution to retainage, however, since the lowest tier subcontractor will end up bearing the full burden of the retainage. Another interviewee who responded yes to the question clarified that, "We are a contractor, we are not a bank. Generally speaking, typical fees contractors can put on a project and stay competitive are less than the retentions being withheld." This statement exposes the fact that retainage can be a way to help the cash flow of those retaining, especially the owner. These parties transfer the need for financing the amount of money retained to the subcontractor who unfairly may have to secure that financing at high interest rates. Though this is not the intended purpose of retainage it can certainly be a large motivating factor in why those benefiting from these delays in cash outflows are in such strong support of the practice.

In response to the question posed regarding whether the interviewees experienced the replacement of retainage with negotiated alternatives all said that they did indeed secure such negotiated alternatives at one point or another. This data proves promising for those affected by retainage as it demonstrates the willingness of all parties to work together in coming to agreements that can be beneficial to each of them. It is this type of negotiation and cooperation which is essential to change the status quo for the betterment of the industry as a whole. The "alternatives" stated by all three parties include investment into securities, reduction in retention percentage in accordance with project progress, and line item releases. It is important to note that these are not necessarily alternatives since they are not replacing retainage but altering it through dilution of its negative impact. These responses can still be interpreted as positive in that most of the variations to retainage that were discussed in the literature review are actually utilized and, therefore, not just theoretical propositions.

When asked if ever felt the need to voluntarily comply with the General Contractor's wishes outside of their contractual duties in order to prevent a power struggle that could complicate the timely receipt of retainage two parties responded with yes while one responded with no. The party that responded no clarified the nature of job billings by stating that, "The way a job gets billed every month is through a pencil draft. You formally submit that pencil draft billing which is approved by the GC, or bank, or lending institution. So, once you have billed that money and it has been approved you are legally owed that money." It seems that this interviewed company does not necessarily need the money that is retained immediately and, therefore, had no serious concerns that the retainage would be held over the company's head since that retained money legally belonged to them for work completed. This goes to show that the financial structure of a company being assessed is important in the way they respond to retainage. A company that does not experience serious cash flow issues from the money withheld may be less likely to comply with tasks that fall outside of their contractual obligations since they are less desperate for receipt of the retainage.

Conclusion and Future Research

The truth is that retainage, when used in the traditional sense of retaining 10% and not releasing it until the end of the entire job, is simply unfair and, in many ways, nonsensical. This is because there is no reason that a subcontractor who has finished its scope of work in its entirety should not be paid in full. Additionally, if the scope and contractual obligations are fulfilled then the risk that the subcontractor will not perform is no longer relevant and therefore the need for that insurance should be relieved justifying the timely release of retainage. The complete elimination of the retainage practice seems unlikely in the near present, however. Given the research that was collected in the literature review, it is unlikely that owners and general contractors would be willing to part ways with this practice that has been so deeply engrained in the construction culture. Future research which

would be helpful in bridging the gap between these varying perspectives is the same interview methodology conducted with general contractors and owners/developers. This way, the varying perspectives of these parties can be assessed and compared to the subcontractor's responses so a potential solution or middle ground can be reconciled. Fortunately, as demonstrated through the interviews conducted, it seems that there is negotiation taking place in the commercial concrete sector of the industry regarding ways to alter the traditional aspects of retainage to be more equitable. One such example was demonstrated to be a reduction in the amount retained as the project progresses presumably because more trust is established. Despite this, most interviewees stated that retainage, regardless of these negotiated variations, is still harmful to their business practices and financial health. However, the negotiations and recent legislation that has passed in favor of those who are hurt by retainage is a sign that the industry is moving in a direction that is in the best interest of subcontractors. Trust is at the center of this issue and the key to solving the retainage problem. Trust based relationships are hard to establish especially when there is no work history existing between general contractors and subcontractors. Thus, in order to alleviate the problems brought about by retainage that still exist even with the negotiations mentioned, alternatives to retainage should be explored. This is most feasible in scenarios where a work history does exist, and, therefore, prior trust established. In these scenarios, retainage bonds and performance bonds can be explored in replacement of retainage. It was also determined that the scale of the company does make a difference in the extent of the effect that retainage has on the company since larger companies have greater access to capital and larger lines of credit at lower interest rates. Therefore, future research should be conducted in this area to further analyze the correlation between burden of retainage and scale of company.

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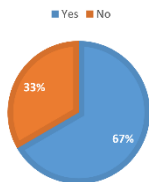
Appendix A- Interview Questions Provided to Interviewees

- 1) Has retainage ever required you to borrow funds from third party financial institutions?
- 2) Do you see retainage as part of the contract terms of most jobs? Can you provide a general idea of how common it is based on your own best estimate (if the known amount is not currently available)?

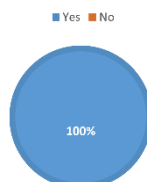
- 3) Do you think there is any correlation at all between your project success rate and retainage and can you elaborate on that? Do you think the GC would agree with that opinion? If you have ever subcontracted out part of your scope have you noticed this correlation?
- 4) Has retainage ever stopped you from bidding on jobs that you otherwise would have bid on if you had the amount of the outstanding retainage from other jobs available as a liquid asset/cash?
- 5) Has retainage ever been originally proposed in the contract only to be replaced with an alternative negotiated method of establishing trust? What was this method, and did it prove effective?
- 6) Can you provide a specific replacement for retainage that your company has used or considered using in order to fulfil the purpose of retainage in place of retainage?
- 7) Do you think retainage does more harm or good and why?
- 8) Have you ever felt the need to voluntarily comply with the general contractors wishes outside of your contractual duties for the purposes of preventing a power struggle that could complicate timely receipt of retainage?
- 9) Have you ever felt that a general contractor has intentionally leveraged that withheld sum of money to force compliance with tasks outside of your contractual duties/obligations?

Appendix B- Diagrammatic Results from the Interview

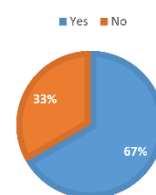
HAS RETAINAGE REQUIRED YOU TO BORROW FUNDS FROM THIRD PARTY FINANCIAL INSTITUTIONS?



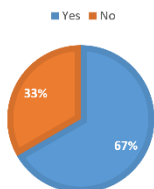
DO YOU SEE RETAINAGE AS PART OF THE CONTRACT TERMS ON MOST JOBS THAT YOU BID?



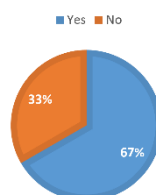
IS THERE ANY CORRELATION AT ALL BETWEEN YOUR PROJECT SUCCESS RATE AND RETAINAGE?



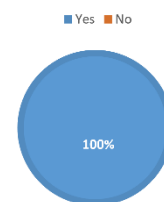
HAVE YOU EVER SUBCONTRACTED OUT PART OF YOUR SCOPE AND NOTICED THIS CORRELATION?



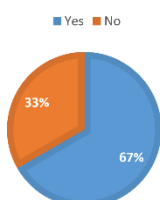
HAS RETAINAGE EVER STOPPED YOU FROM BIDDING ON JOBS THAT YOU WOULD HAVE BID ON?



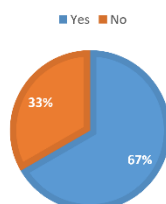
HAVE YOU SEEN RETAINAGE REPLACED WITH NEGOTIATED ALTERNATIVES?



IN YOUR EXPERIENCE HAS RETAINAGE DONE MORE HARM THAN GOOD?



HAVE YOU EVER COMPLIED WITH A GC'S ORDERS OUTSIDE OF YOUR CONTRACT BECAUSE OF RETAINAGE?



HAS A GC EVER LEVERAGED RETAINAGE TO FORCE COMPLIANCE WITH TASKS OUTSIDE YOUR CONTRACT?

