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Retainage: Rethinking Our Financial Structure

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For roughly 175 years, retainage has been a preferred method in the construction industry for insuring the completion of a project. At its simplest, retainage is the practice of withholding a percentage of the agreed upon fee for service until the project is complete or nearly complete.

The goal of retainage is two-fold. First, retainage is used by project owners and/or developers to guarantee that contractors and subcontractors fulfill their obligation by leveraging the withheld fee. Second, the withheld monies are intended to protect the owner and/or developers against any liens, claims or defaults that arise during or toward the end of a project.

This paper will both describe this practice and explore whether it is still a useful method for conducting construction business. Though it has long historic roots, it could be time to adopt another method for insuring the fruition of build projects.

A Brief History of Retainage

In the 1840s, a great railway system was constructed in the United Kingdom. The project was so vast that it was necessary to bring in contractors which created a whole new segment in the labor market. As with any burgeoning market though, there was a steep learning curve to be had when so many players were inexperienced, unqualified and therefore unable to complete the project.

Initially, this meant great losses for the railway companies, leading to the idea of retainage. By withholding as much as 20 percent of the contractors' payments, railway companies incentivized follow-through from the contractors and allowed themselves funds for completion costs for instances in which contractors defaulted.

As retainage was adopted with the growth of the contracting industry, a range of practices evolved, including arrangements such as:

- Retaining 10 percent of the agreed upon contract until the work is "substantially complete," a vague definition that can easily lead to litigation; this is the most common arrangement in today's industry
- Starting with 10 percent retainage that is then reduced to five percent once the project is 50 percent complete based on some measured parameter.
- Deducting materials costs from the percentage retained as many suppliers will not accept retainage provisions, making materials an undue burden for contractors and sub-contractors

From imprecise milestones for retainage reimbursement to the role of materials cost in retainage agreements, the potential stumbling blocks in this insurance methodology are significant.

The Retainage Players and Impact

In the cost-rich world of construction, financial institutions are generally involved in the chain of financing, lending owners and developers the necessary capital for their construction projects. Naturally, these financial firms have a vested interest in protecting their investment and insuring the return of the loaned sum plus interest. This is where the chain of retainage normally begins.

Similarly, the owners and developers have a need to protect their position and insure that they get the facility they have contracted to build. They, too, will withhold funds from the contractors they employ.

General contractors and construction managers (hereon referred to jointly as GCs) who are tasked with building the structure hire specialty contractors to construct the various aspects of the building. Each of these specialty contractors will have funds withheld from their monthly draw during the course of the project by the GC to insure they complete their part of the project according to the specifications and stated schedule.

Specialty contractors will, in turn, hire sub-subcontractors for specific installations. Continuing the chain of retainage, specialty contractors will also retain fees from the sub-contractors.

With the practice of retainage impacting a project from initiation to completion, and from the project initiators to the most specialized of sub-contractors, we find an entrenched system of bookkeeping maneuvering initiated with the best of intentions but potentially leading to unsustainable practices down the chain.

While each player is seeking to protect their ability to earn a fair return for fair work, the question lingers: In order to give each member of the chain some semblance of control and security within the marathon that is construction, what is a reasonable amount of money to be withheld and for how long?

First, we must acknowledge that the fact that it takes many firms and individuals to construct a building is a risk in itself. Excavators, foundation contractors, steel erectors, framers, carpenters, glazers, insulators, masons, roofers, flooring contractors, painters, mechanical and plumbing contractors, electricians and landscapers are just some of the specialty contractors needed to bring a building to life.

A well-planned schedule will have the individual specialty contractors on the project at the appropriate time. That said, the duration of a project can be a real issue for these contractors when it comes to payment and retention. Contractors that are on the project early, such as the excavator and foundation companies, may complete their work a year or more before a building is complete. If retainage is withheld until the owner takes occupancy, these contractors will not be paid in full until long after they satisfied their contractual obligation, meaning a significant delay in their ability to reinvest in their own firms.

Other contractors, such as the plumber and electrician, are on the project from start to finish. They, too, can suffer from having their funds withheld for extended periods of time.

Specialty contractors are obligated to pay their employees on a weekly basis. And while payment terms to vendors may vary, most suppliers require payment within 30 days of delivering materials and equipment to the job site. No retention can be held on either material vendors or workforce wages.

For subcontractors, the norm is a monthly day on which billings are due, often the 20th. On a well-paying project, 45 to 60 days are a standard lapse between the billing date and receipt of payment. A specialty contractor that has labor and material expenses in week one of any given month will not get paid for those expenses for seven to eight weeks. When that payment is received, 10 percent (assuming a standard agreement) is withheld as a guarantee that the work is performed correctly until final acceptance by the owner.

Thus, the specialty contractor must use his or her credit line to finance the retainage portion of the payment of the work he or she provides until the project is finished, regardless of when that specialized segment of the project was completed.

The cumulative total of retention withheld can be significant. On a $3,000,000 project, the Retainage alone will be in the 100s of thousands of dollars. On a $30,000,000 project were talking millions. Add that to the timing issues regarding billing and payment the financial burden on the specialty contractor can be enormous. Again, the question is how much is truly a reasonable amount to be held and for how long?

While the monthly payment issue can be stressful enough for a specialty contractor, the definition of when a project is "substantially complete" can also be very problematic. For example, an owner may decide to hold all retainage because one specialty contractor has work that needs to be corrected or has not turned in proper close out documents such as lien releases or owner and maintenance manuals. This can delay final payments even for specialty contractors unassociated with the incomplete work or documentation. Truly unscrupulous owners may even find many things unacceptable to hold up final payment. While this is not the rule, it does happen.

The Alternative to Retainage

In the United States, ten out of the fifty states have legislated statutes which restrict how much, when and how retainage is released. That is one way to grind out change. Instead of legislating our way out of this quandary, wouldn't it be better for the industry come up with a solution?

It is understandable that with so much money on the table, each player in the chain would want to guarantee his or her investment. There are, however, other ways.

First and foremost, owners and developers should set the stage by hiring only prequalified General Contractors. In turn, the GCs should prequalify their specialty subcontractors.

Prequalified contractors already have the qualities that insure a construction investment including:

- Strong reputations for good project management
- A culture of taking care of their people with appropriate pay and benefits
- Strong safety records
- Specific plans for the project
- A company-wide commitment to quality control and realistic scheduling

Remember, retainage was created during a railway construction project marked by inexperienced, unqualified contractors, not GCs and specialty contractors with the qualities listed above. Experience and commitment to quality alone will go a long way in reducing the need for substantial withholding of payment.

Another critical step in moving away from retainage involves owners or their representatives participating in a meaningful way during the course of construction. Having strong owner involvement can result in better communication throughout the project. It will also allow them the opportunity to use the specific clauses in a contract to withhold funds from the GC or specialty contractors should there be any failures to meet expectations. Utilizing these clauses protects the owners while also reducing the need for a large amount of long-term retainage.

These additional clauses usually refer to specific conditions that, if not met, are justifiable grounds to either withhold or permanently deduct money.

Some of these clauses cover areas such as:

- Indemnification
- Payment use verification
- Lien waivers
- Failure to perform
- Bankruptcy
- Liquidated damages
- Consequential damages
- Back charges
- Damages to other trades work

While I will not delve into these separate areas, if used properly, these substantial clauses can hold a specialty contractor responsible if he or she is not performing to the subcontract requirements. They also strongly suggest that, along with 45 to 60-day payment term, retainage may be overkill.

Other steps and details in moving away from retainage should include:

- General contractors no longer accepting blanket retainage clauses. If possible, retainage should be reduced to a reasonable amount, such as five percent, either across the board or reduced to zero as each specialty reaches 50 percent completion of their portion, and their work is accepted.
- In lieu of full retainage, appropriate language may be included in the owners' contract to only withhold a multiple, such as two times the value of the uncompleted work or nonconforming work for a specific specialty contractor.
- Quality control planning from all members of the construction team that are used diligently to insure that work is ready to be inspected and accepted by the owner as it is completed.
- Strong project close out procedures for specialty contractors and the GC.
- Adequate plans for specialty contractors to manage lien releases from their suppliers and vendors on a monthly basis.
- Negotiation of retainage term when specialty contractors receive their contract. The old adage "if you don't ask for it, you won't know if you can get" it applies here.
- The release of Retainage should be tied to a specific event. Examples of this include the completion of a specialty contractors scope of work, a well-defined substantial completion date and method of acceptance, or the final Certificate of Completion.
- Ending the practice of postponing payment of the retainage from all specialty contractors when one or two have not performed.

While these steps require a significant paradigm shift away from a long-held practice, I believe it would lead to healthier outcomes along every step of the construction chain.

In Conclusion
That retainage has been in use for 175 years doesn't necessarily make it the right tool for the future of the construction industry. The impact it has on all construction firms is significant. The majority of construction companies are considered small business and thus most have very tight lines of credit. In combination with the inherent risk of running a construction company and the wide-array of demands - such as BIM, prefabrication, zero tolerance safety programs, recruitment and training costs, drug free work environments and the high level of competition - the cost of operating a construction company has increased while profit margins have remained stagnant.

Technology in many areas of construction has advanced well into the 21st Century leading to innovations that offer the potential ability to grow more effectively and profitably. In order to continue with that growth, we must be willing to take our innovative thinking and ability to shift with the times into our payment processes as well.

About Craig Clark
Craig, a third generation electrician from New Jersey, started his electrical industry journey in 1974. He worked his way up through the ranks in various field and management positions prior to becoming President and CEO of Dynalectric Colorado in 1999.

In addition to his responsibilities at Dynalectric Colorado, Craig holds the position of 2015 Chairman for the Associated General Contractors of Colorado as well as the 2015-2016 Chairman of AGC America’s Specialty Contractor Council. Craig is the past President and current Governor of the National Electrical Contractors Association (NECA) Rocky Mountain Chapter and Chairperson for the Chapter’s Labor Management committee. Craig also sits on the executive committee of the Metro Denver Economic Development Corporation.