

# A RETAINAGE EXPERIMENT:

## Uncovering the Issues to Find a Solution

by Rick Hampton, RA, Senior Vice President, Construction Administration

Have you ever been able to partially pay for an airline ticket when you purchase it and pay the rest when the trip is completed to your satisfaction? Or pay some of the cost of a car to an auto dealer who knows he will get the balance if you are happy with your new vehicle? Chances are fairly good the answer to both of those questions is a resounding "no." Yet this concept of retainage has been not only accepted in the construction industry, but also contractually agreed to by contractors and companies for decades. Retainage is, in fact, included in many corporate construction contracts, including standard American Institute of Architect (AIA) contracts. (The only AIA exception for not requiring retainage is for purely Construction Management contracts such as the A132 Standard Form of Agreement Between Owner and Contractor, Construction Manager as Advisor).

Here is how retainage works: If the contractor legitimately earns \$100,000 of in-place work on a project, he bills for that \$100,000 less the percentage of retainage contractually agreed to by the parties. If the retainage percentage is 10%, the contractor would be paid \$90,000 with the owner withholding the remaining \$10,000. On larger projects, the retainage may be placed in escrow with the contractor receiving both principle and interest at project closeout.

Why hold the contractor's fairly earned money? The answer to that question depends on the perspective:

- From the contractor's viewpoint, retainage:
  - Is a method of project financing for the owner (unless escrowed).
  - Withholds legitimately earned money from the contractor.
  - Delays payments to key sub-contractors (e.g., excavators) who may have to wait until the entire project is complete to get their pay.
  - Penalizes contractors unfairly by keeping back a higher percentage than the profit margin on the work. (For example, a contractor's profit margin target may be less than 5%, but the owner holds 10% retainage).
  - Causes contractors to have to borrow money to keep much needed cash flow.

**"Retainage:** a percentage of a contract price retained from a contractor as assurance that subcontractors will be paid and that the job will be completed."

*Merriam-Webster's Dictionary of Law. Merriam-Webster, Inc. 1996*

- From the owner's viewpoint, retainage:
  - Helps reduce capital spending risk because it can be used to hold the contractor accountable for proper and timely completion of the project.
  - Protects owners from contractors that may "front-end" load project billing.
  - Provides an incentive for the contractor to close out the project.
  - Helps protect owners from liens, claims and defaults.

The irony in this is that the arguments, complaints and points of both sides are valid. Holding retainage:

- Has been a common practice for many years and has not visibly affected the overall industry.
- Helps protect the owner from some of the issues that the contractor may cause.
- Is part of the contract of which the contractor is fully aware - and able to plan for - when bidding or negotiating.

Our challenge as an industry is to solve the up-until-now unsolvable dilemma. Of course, eliminating retainage altogether is one possibility...one that has most notably been undertaken by the federal government, particularly on transportation projects. Published reports indicate the government is seeing no (or very minimal) problems from this policy, although the government has the False Claims Act to help protect their projects. Another way to safely eliminate retainage is to purchase a bond. However, in that case the owner is simply trading the cost impact of retainage for the cost impact of a bond. Should corporate America follow the government's lead and start eliminating retainage? Would doing so really solve the problems?

To test this theory, Hixson conducted a retainage experiment in August 2009. Hixson had a multi-million dollar project with 100% drawings bid as a stipulated (lump) sum. The experimental project Bid Form had the typical line-item cost breakdown format, along with two additional columns:

1. Bid withholding 10% retainage.
2. Bid withholding NO retainage.

Bidding contractors were provided with all of the information in the contract documents and had ample access to the project site. The results of this experiment were surprising: Only one of the five bidders indicated any cost advantage to the owner by not holding retainage. This contractor offered a whopping .001 percent savings for the privilege. Bidders were questioned as to why they bid this way. Surprisingly, each said basically the same thing: In August 2009 interest rates were well below 5%. The contractors were not concerned with retainage since the cost of money was so low. If they had to borrow money for cash flow shortfalls due to withheld retainage, the cost was insignificant.

Our take-away from this experiment is that interest rates, not retainage, may instead be the issue, since the cost of borrowing money is what reduces the contractor's profit and causes contractors to complain. Hixson plans to run this experiment again in the future and continue to investigate whether interest rates truly are the culprit. Knowing the answer may provide a better solution for all.

### Protecting Your Project: Hixson Construction Administration

Hixson's Construction Administration (CA) group is another way to protect an owner's interests. The CA group has over 110 collective years of experience working in the construction industry with both design- and construction-related organizations. Hixson's CA group helps validate that the contractor's billings are legitimate and enables the client to pay only for the work actually performed, not "front-end" loaded costs. This fact may allow the client to feel comfortable enough to forego requiring retainage for the contractor. In addition to monitoring the contractor's billings, the CA group also:

- Verifies the work indicated on Change Orders is legitimate and due the contractor,
- Helps ascertain the project is being built per the plans and specifications, i.e. the client gets what the client has paid for,
- Serves as the focal point and clearinghouse for all contractor questions and monitors both project quality and schedule.

### **Advocacy: Hixson is a "No-Bias" Company**

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