

# *oppaga* Special Review



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## Inflexibility in Contracting and Retainage Practices Could Hurt Construction Industry

### *at a glance*

Retainage is a common construction contracting practice whereby a certain percentage of compensation is withheld by the project owner from the general contractor and, in turn, by the general contractor from subcontractors until the project is completed satisfactorily. Retainage is also used as leverage to assure timely completion.

Florida's subcontractors, who felt that retainage often creates undue financial hardships, asked the 2000 Legislature to consider limiting the allowable percentage of compensation that could be retained. In response, the Legislature requested OPPAGA to evaluate retainage and other construction practices identified by subcontractors.

OPPAGA determined that limiting retainage may have the harmful unintended side effect of thwarting the development of new business or retarding the growth of existing businesses. In addition, owners and prime contractors may use other means to minimize risk, which may be less favorable than retainage.

The fiscal impact of retainage on subcontractors can be lessened through the payment of interest on their percentage of compensation that has been retained. Although the Legislature could require payment of interest by law, ideally, this would be negotiated as part of the contracting process. Consideration of such legislation should take into account the fiscal impact to the state of Florida and other units of government.

OPPAGA also recommends the Department of Management Services identify and disseminate best construction practices that, if implemented, would facilitate final project completion and release of retainage.

### Purpose

During the 2000 legislative session, the construction industry proposed a limitation on the amount of retainage that could be withheld by the owner of construction projects in order to increase cash flow to subcontractors. The Legislature, in Ch. 2000-372, *Laws of Florida*, directed the Office of Program Policy Analysis and Governmental Accountability to conduct an independent study of various construction industry practices and determine whether Florida construction law should be revised.

### Current Contracting Environment

Retainage is a contractual provision that is commonly used in the construction industry. It allows the owner of a construction project to withhold a certain amount of each payment for completed work. Payments on construction projects are made on a periodic basis, generally monthly. When a payment request is submitted by a general contractor, the project owner or the owner's representative reviews, approves or modifies the request.

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This initiates a payment from the owner to the contractor that is reduced by the amount of retainage, usually 10% of the payment amount. The contractor then pays his or her subcontractors for work performed and withholds retainage on the subcontractors, usually in the same percentage as was held on the contractor by the owner.

The project owner holds retainage as leverage to help bring construction to completion in a timely manner. It is generally paid out at the time the project reaches final completion, although the owner may choose to release a portion of the retainage at an earlier time based on project progression or an earlier agreement. In addition to providing leverage, retainage serves as a safeguard against possible overpayment to the general contractor when the estimated percentage of project completion, used for periodic payments, exceeds the actual percentage completed.

Changes in the contracting environment have shifted a great portion of the risk associated with retainage from the general contractor to subcontractors. Historically, the majority of construction workers were employees of a single general contractor who held the majority of the contract risk. However, construction workers have shifted from wage-earning employees to independent businessmen who subcontract with the general contractor. As a result, they have also assumed some of the risk of retainage.

For example, major construction projects may take as long as two years to complete, leaving subcontractors who perform work early on the project waiting extended periods to receive retainage payments. While these subcontractors can and should plan for the cost of these monies in their bids, these earned funds are not available to pay ongoing costs and can cause cash flow problems for subcontractors. If project completion is unreasonably delayed the retainage period may be even longer than anticipated by the subcontractor.

Unanticipated or extended delays are common and may purposely or inadvertently benefit the party responsible for the delay. The owner, general contractor, or any individual subcontractor may cause these delays. For example, delays to final project completion can occur if a subcontractor fails to return to correct punchlist items or to provide necessary closeout documents. These delays harm subcontractors who have satisfactorily finished their work and have planned on project completion and the subsequent release of retainage within a reasonable timeframe.

## Industry Proposals for Change ---

Industry subcontractors suggested proposals to limit or replace retainage. Several of these proposals would decrease the amount of retainage that could be held by the owner and thus increase cash flow to the subcontractor. OPPAGA evaluated several of the proposals, including

- limiting, in law, the amount of retainage that can be withheld in construction contracts;
- improving the quality and frequency of periodic project inspections to limit the need for retainage; and
- depending on surety bonds to replace or limit the amount of retainage.

While these proposals may benefit the subcontractors, they do not reduce the need for the owner to have financial leverage to complete the project.

### *Limiting retainage*

One concept proposed by industry subcontractors is to place a statutory restriction on the percentage of retainage that could be withheld by project owners. Thus, the law could stipulate that a maximum of 5% of a project budget could be withheld until the project was completed and accepted by the owner. This proposal is intended to provide some relief for individual subcontractors who

have completed their work but have not been fully paid.

The potential disadvantage of this option is that the construction industry is driven by competitive market principles, and differing types of construction projects have different contracting environments. For example, general contractors indicated that they sometimes use a higher retainage amount when using a subcontractor with specialized skills but prior performance problems. Legislation that limits contractual flexibility could interfere with the operations of the free market and harm the construction industry as a whole.

The owner should be able to negotiate a contract that he or she feels provides adequate leverage to protect their investment and provides for timely project completion. In turn, the general contractor should negotiate contracts with subcontractors that provide adequate leverage to help ensure that these persons complete their work on the project. Placing restrictions on retainage such that retainage becomes inadequate to protect the owner's investment or owner and general contractor's leverage, could have unintended consequences.

If retainage were capped at a level that was deemed to provide inadequate leverage to ensure timely project completion, it would only be diligent for the owner or general contractor to seek to protect their investment through alternate forms of leverage, which may be less favorable to subcontractors than the current system of retainage. For example, it has been suggested that owners might micromanage periodic payments in ways that would delay part or all of the payment thereby creating leverage that to some extent replaces lost retainage. Other potential methods of leverage, such as penalties for construction delays that could create a myriad of new legal problems, may be instituted.<sup>1</sup>

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<sup>1</sup> Legal challenges by the contractor may include challenges to the reasonableness of the contracted amount of damages, challenges to the time period for which damages should be collected and challenges as to their responsibility for the delay in project completion.

Another possible effect of restricting retainage might be to thwart the development of new businesses or the growth of existing business. Although a lower retainage amount may benefit new businesses by improving their cash flow, it may also cause owners and general contractors to be less willing to take the risk associated with working with a new subcontractor or with allowing an existing subcontractor to take on a project of increased size.

Many other states have statutory restrictions on retainage. We reviewed the laws of these states and spoke to state government representatives in an effort to evaluate the impact of these restrictions on construction contracting. Most representatives we contacted felt that legislated limits on retainage hinder their ability to leverage construction completion. Those representatives who were less concerned about the limitations on retainage were more likely to operate in a different contractual environment. For instance, New York and North Carolina are both "multiple prime" states. In such an environment, the public entity is required to contract directly with the major project contractors such as mechanical contractors, plumbing contractors and electrical contractors. As such, the owner has a direct relationship with "subcontractors."

### *Improving periodic inspections*

Increased or improved periodic inspections of construction have also been proposed by the subcontractors as a method to replace or compensate for a limitation in retainage. The project owner generally hires an architect to perform periodic inspections in conjunction with the approval of pay requests. These inspections are intended to determine whether the work is being completed in compliance with contract documents and to provide a reasonable evaluation of progress. Prior to approving payment, the architect assigned to the project reviews each item of pay for reasonableness. This is based on a physical inspection of the worksite and knowledge of the construction documents. Architects also provide inspection services to certify substantial completion and final completion.

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While periodic inspections by architects provide for a reasonable level of quality, they do not provide assurance to an extent that would replace or limit the need for retainage. The American Institute of Architects Standard Agreement provides that the architect is not providing for an “exhaustive and continuous on-site inspection.” Extending such agreements to provide for more intensive inspections or holding the architect to a higher level of liability may be costly.

While the architect may responsibly review completed work and identify problems, the inspections are periodic and limited and are not designed to and cannot be expected to catch all construction errors. Undetected errors may cause problems as future segments of construction are added on top of poor design, faulty workmanship, or improper materials. For instance, a building at the University of South Florida was to have an exterior stucco finish placed on an underlying block wall. After completion of the project, the stucco began deteriorating because the underlying masonry material was not suitable. This is something that regular inspections were not designed to identify. Retainage is designed to minimize the financial impact on the owner of such errors.

### *Depending on surety bonds*

Depending on surety bonds to replace or compensate for a limitation in retainage has also been proposed by the industry. While both bonding and retainage are financial tools designed to insure project completion, they serve different purposes. Retainage serves as an economic incentive for the general contractor to complete the construction project in a timely fashion. Surety bonding is used to ensure the eventual completion of a project when a contractor defaults or fails to perform his or her contractual obligations.

The basis of this proposal appears to be the misperception that a surety bond acts as an insurance policy, paying the owner immediately when a claim is filed. In fact, a surety bond, while often sold by insurance companies, is not the same as an insurance

policy and may not pay out until after extensive litigation. As a result both project completion and final payment to subcontractors may be long delayed.

The surety, unlike an insurer, has not pooled the risk of multiple policyholders, but protects himself from loss through extensive prequalification evaluation.<sup>2</sup> The surety remains involved in bonded projects to protect his or her financial interest. If contractor problems, such as a failure to pay subcontractors, come to the attention of the surety, the surety will generally intervene in an attempt to keep the project on course. However, if the contractor defaults, or fails to perform his or her duties under the contract, the surety will generally not fund the project until he or she completes an extensive investigation or responsibility is determined in the courts. If the surety is made to pay on losses he will proceed against the bonded party to recover any monies paid.

Government entities are not risk-taking entities and depend on a surety bond to relieve the risk associated with construction contracting. In addition, the extensive pre-bonding evaluation by the surety provides some additional assurance that the contractor can be expected to perform. This prequalification process by the surety includes both quantitative and qualitative factors. In contrast, a governmental entity is generally limited to quantitative prequalifying criteria. In addition contractors may be hesitant to provide business information to the owner of a construction contract. As such the surety is able to perform a more extensive review of the contractor and have greater assurance about his or her ability to complete the project.

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<sup>2</sup> The prequalification procedures may include an examination of the contractor’s professional and educational background, trade references, an evaluation of the firm as an ongoing concern on the loss of a principal, accounting methods and any additional information or observations that the surety deems necessary to evaluate the contractor.

## Barriers to Final Project Completion

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Delays frequently occur between substantial and final completion. A project has reached “substantial completion” when the facility can be occupied or used as intended. At this time, a punchlist or list of items that need correction is prepared, which are assigned to the appropriate subcontractor for completion. In addition, any construction documents and warranties must be provided to the owner. Final completion occurs when punchlist items are accomplished and necessary closeout documents are provided. Delays that occur between the time the project is substantially complete and final completion appear to cause the greatest contention during construction projects. The most problematic causes of delay include

- approving change orders;
- completing punchlists;
- obtaining closeout documents; and
- creating a rolling punchlist.

**Change orders.** Change orders are often the source of disputes on construction projects and delays in final completion. Reasons for change orders may include new project requirements, resolution of conflicts in plans or specifications, or problems with materials availability. Frequently the decision to make a change must be made on-site to prevent work stoppage. However, the owner’s representative must formally approve the change before payment can be authorized. Delays can occur between substantial and final completion when the value or authority to approve change orders is questioned.

**Punchlist items.** Delays to final completion can also be caused when a subcontractor does not return to complete a punchlist item in a timely manner. The delay may be purposeful, as when the cost to complete the punchlist work exceeds the contract balance or when the subcontractor

is earning a greater rate of return on a new project. However, delay by any one subcontractor in completing punchlist items can delay the payment of retainage to all parties.

**Closeout documentation.** Another barrier to final completion is the failure of the general contractor or a subcontractor to provide required closeout documentation in a timely manner. The owner must have warranty documents on all equipment installed as part of the construction project. In addition, there are other construction documents, such as revised construction plans, that are needed to properly maintain the facility. Failure of any one party to provide these documents can also delay the payment of retainage to all parties.

**Rolling punchlists.** Final project completion can also be delayed by what has become known as the “rolling” punchlist. Sometimes, several punchlists are created in addition to the required punchlist submitted by the owner or the owner’s representative. The creation of these additional punchlists requires subcontractors to return to the project multiple times after they have completed all contracted work. For instance, due to the specific time requirements associated with the school year, a school facility may be issued a Certificate of Occupancy at substantial completion. Once occupied, the representative of the school board may prepare a punchlist, the school principal may create another punchlist, and individual classroom teachers yet another. Frequently, these needed corrections may have been caused during the move to occupy or through use and would have more appropriately been classified as maintenance or warranty items. Project closeouts should be restricted to only those punchlists designated pursuant to contract. Requiring that subcontractors, who have moved onto other projects and who are of the understanding they have completed their work, return to correct newly created punchlists is economically costly and delays the payment of retainage.

## Good Contract Management Is the Key

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In an ideal construction project, each party to the project would complete their work to the owner's satisfaction, in a timely manner, the owner would pay immediately, and there would be no need for retainage. However, the complexity of construction projects rarely allows such a situation to occur, resulting in the need for contracts that provide the owner adequate leverage to protect his investment and to have his project completed in a timely manner.

Several events have converged to magnify the problems of the construction industry. The growth of Florida and the strength of Florida's economy have resulted in a tremendous demand for construction. New contractors and subcontractors have entered the industry, adding almost 2,000 licensed contractors and construction businesses in Fiscal Year 1999-2000. Smaller governments, especially school boards, with limited construction experience are now in the position of managing large building projects. Many subcontractors believe that competition has forced them to enter into contracts with low profit margins and unfavorable retainage.

However, contract terms remain a negotiable business decision. Contracts should be negotiated which benefit the owner, general contractor, and subcontractor. The Department of Management Services could disseminate information about best practices in contract negotiation and construction management to state and local governments as a matter of technical assistance. These could include several best practices identified by OPPAGA that could be employed by the industry to limit the barriers to final project completion and facilitate the equitable release of retainage.

### *Approving change orders*

To prevent delays in payment due to the value or approval of a change being questioned, it is

important that procedures for authorizing and approving change orders be established and communicated prior to the beginning of construction. This includes identifying the individual authorized to approve change orders and any limits on that authority, the form of the change order, any costs to the contractor that may be included in the change order, and the impact of time delays.

### *Completing punchlists*

There are ways to mitigate delays in final project completion caused by the failure of any one subcontractor to return to complete a punchlist item in a timely manner. Contracts can be negotiated to provide that punchlists items be completed within a specific period of time. For example, Virginia's Department of General Services is now recommending that agencies send a "cure notice" when the project is delayed. This notice requires that the general contractor provide a plan for completion. Ohio can give a contractor notice to "catch up" or the state will hire someone else to do the work and back charge the contractor.

### *Requiring documents*

The documentation requested to support the financial value of work completed varies and is based on the determination of each governmental entity as to what is necessary to fulfill its role as a steward of public monies. Documentation requirements should be reviewed for reasonableness and necessity. For instance, for some projects, a general contractor employed as a contract manager is paid general conditions costs, such as on-site utilities and telephone, according to a negotiated amount. In other instances, the general costs are paid on a reimbursement basis, which requires the submission of detailed invoices and statements for multiple items. As long as it has been determined in advance that the negotiated general conditions costs are reasonable, the contracted amount should meet the conditions of stewardship.

### ***Eliminating rolling punchlists***

The problem of “rolling punchlists” can be resolved through early agreement or contractual designation that a single punchlist will be prepared and provided by the owner’s representative, requiring that subcontractors return once to complete their work on the project. Parties can agree to consider as warranty items any items found to require correction subsequent to the submission of the punchlist, including those that may occur when a facility is occupied prior to final completion.

### ***Structuring retainage***

Variations in the percentage of retainage withheld and the timing of the release of those funds are in effect throughout Florida and other states. These variations are based on many considerations including the prior relationship of the parties to the contracts, contract size, and the type of project.

Many contracts provide for retainage rates lower than 10%. The percentage retained is sometimes based on the financial value of the construction project or type of contracting. Extremely large contracts may require a lower percentage retainage because the absolute dollar amount retained will be very large. For instance, the Connecticut Department of Public Works recommends 10% on open bid projects up to \$2 million and 5% on negotiated projects over \$10 million.

Another policy common in governmental contracting is to allow the government’s project manager the option of reducing the percentage retained on the second half of the project if the general contractor is working on schedule. For example, 10% retainage may be withheld until the project has reached 50% completion, at which time retainage will be reduced to 5% until final completion.

The nature of the project may also allow for a portion of retainage to be released at certain intervals, such as at completion of specific phases or activities. When a project design identifies specific phases, which are each similar to independent construction projects, retainage

can be released with little risk to the owner. For example, a project, such as a dormitory with two identical towers, may be completed in two discrete phases. When a single tower is completed, that phase of the project could be closed out and retainage released.

Retainage can also be released in conjunction with the completion of specific activities or divisions of work, such as carpentry and woodwork. This type of release is commonly referred to as the “line-item release” of retainage. The line-item release of retainage is based on the activities identified in the general contractor’s “schedule of values,” a document that summarizes the dollars earned on a project, by activity. For instance, a renovation at Florida State University included in its schedule of values such items as rough carpentry, concrete, interior woodwork, roofing, wall/ceiling, flooring and painting. The total of invoices for materials and labor for each activity are taken against the scheduled value to estimate the percentage of work completed.

## **Legislative Alternatives** ---

Contractual provisions that allow for lower retainage or release of retainage prior to final project completions can provide some relief for subcontractors. However, situations will continue to occur that allow retainage that has been earned by the subcontractor to continue to be held by the owner, providing a financial benefit to the owner in terms of interest earned on those funds. It is the general consensus within the industry that, once earned, amounts held in retainage should benefit the subcontractor. This can be accomplished through contractual provisions that provide that earned retainage be deposited by the owner in an interest bearing account with the interest earnings distributed to the appropriate subcontractor on final payment.

Ideally, this would be negotiated as part of the contracting process. However, if the Legislature feels some form of intervention is necessary, it could provide in law that earned retainage be deposited by the owner in an interest-bearing

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account and that the interest earnings be paid to the general contractor for subsequent distribution to the appropriate subcontractor on final payment.

Consideration of such legislation should take into account the fiscal impact to the state of Florida and other units of government. Currently, interest that accumulates on earned retainage that is being withheld provides a financial benefit to the owner. Requiring that any interest be distributed to the benefit of the general contractor or subcontractors will have a corresponding and opposite impact on the owners or government entities in the form of reduced revenues.

## Recommendations

There are many challenges within the construction industry, as well as opportunities for improvement. However, as the construction industry is market driven and operates as much of the competitive market operates, legislation that limits contractual flexibility could interfere with the operations of the free market, limit the entrance of new business or the growth of existing businesses and have a negative impact on the construction industry as a whole. Therefore, OPPAGA believes any adjustments to the industry would better occur through improved contracting practices rather than through legislative mandate.

Due to the tremendous growth in the demand for construction in Florida, many new owners, general contractors, and subcontractors have entered the industry with limited experience in contract negotiation and management. To facilitate improved contract negotiations within the construction industry, OPPAGA recommends that the Department of Management services identify best practices that could be employed to limit the barriers to final project completion and facilitate the equitable release of retainage and provide this information to state and local governments through its technical assistance efforts.

Although improved contracting will provide some relief for subcontractors, situations will continue to occur that allow earned retainage to be withheld from subcontractors beyond a reasonable period of time. The fiscal impact to subcontractors can be lessened through the payment of interest on these earned funds. Although, ideally, this would be negotiated as part of the contracting process, the Legislature could provide in law that earned retainage be deposited by the owner in an interest bearing account and that the interest earnings be paid to the general contractor for subsequent distribution to the appropriate subcontractor on final payment.

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