

THE PERCEPTIONS OF RETENTIONS AS HELD BY CLIENTS, CONTRACTORS AND SUBCONTRACTORS

P. Raina , J. Tookey

School of engineering, Auckland University of Technology, Auckland, New Zealand

priyanka.raina@aut.ac.nz

ABSTRACT

The payment mechanism of construction projects is different compared to other industries. For every payment made to a contractor or subcontractor a sum of money is held back. This deduction is a phenomenon peculiar to the construction industry and is known as retention. Retentions are held by both clients and contractors and as such involve the whole supply chain. However the effect the practice has on each party varies significantly as a result of which there have been debates regarding the practice. The purpose of this paper is to study the effects of retentions on clients, contractors and subcontractors. The author has conducted an extensive literature review to find out the issues around the practice of retentions and how it affects the parties involved. The impact of the practice on contractors, subcontractors and clients have been studied and analysed. The study is a part of a bigger research conducted which aims to investigate the practice of retentions in the NZ construction industry. It has been concluded that there seems to be an imbalance of power with regards to the retention practice and it is about time that some alternatives be put into place to make the practice fair for all parties.

Keywords: Retentions, construction industry, New Zealand

INTRODUCTION

The retention system is an important and peculiar feature to the building industry. In the present day construction industry, retention is the most commonly used performance security (House of Commons, 2003). Retention serves as a regular means of protection for construction clients from contractor's insolvency and also provides the client an assurance that contractors complete their works on a job (Hughes et al., 1998). Retentions are held by clients as well as the contractors. Main contractors subject to cash retentions commonly apply retention down the contract chain to the subcontractors (Taylor Wessing, Spring 2003).

There has been debate and discussion on the merits and demerits of retentions (Fullerton 2000; Abeysekera 2002; Construction Manager

2002). Mainly subcontractors are of the opinion that retentions should not be charged and the owner/employer holds a diametrically opposite view. This has created some polarity between the parties and furious debates within the construction industry bodies such as contractors' and sub contractors' associations (Mazurkiewicz, 2001; National Specialist Contractors Council, 2007; Stand against unsecured retentions in Christchurch, 2013). Some countries such as US have abolished its use (in public contracts in some States) whereas in other countries such as UK they have tried and failed to have it abolished (House of Commons, 2003; Bausman, 2004).

The retention system is very well established in the New Zealand (NZ) construction industry. Anecdotal evidence suggests that in NZ too the problem of retentions is commonplace (Miller, 2008). However there is not much research carried out in this area to identify where the actual problem lies and what solutions could be put to place. The way forward in trying to appraise the pros and cons of retentions is to identify them first. The author through an extensive literature review has studied the effects of the retention system on the different parties involved i.e. clients, contractors and subcontractors. The author has then presented the issues around the practice in the NZ construction industry. Based on the literature reviewed some suggestions have been presented in the conclusion section of the paper. This study is a part of the bigger research project which aims at investigating the practice of retentions in the NZ construction industry.

RETENTION ISSUES AND IMPACTS

Retention mechanism impacts the whole construction supply chain starting from the client/employer to the contractor, subcontractor and the suppliers. There is much debate regarding the merits and demerits of the retention policy. The proponents of retentions argue that it acts as a form of financial protection for the owners and ensures performance while imposing minimal financial hardship on contractors. They are of the opinion that due to the difficulty in getting contractors back on site to remedy defects, retention is a good practice since it keeps the contractors on their toes and focussed on the job in hand (Boyes Turner, 1st March 2005). Whereas research shows that the opponents of the practice believe that retention reduces competition and increases project cost, provides a financial disincentive for timely completion of the work, and places a financial hardship upon contractors and subcontractors (Bausman, 2004). The opponents also believe that the system is often abused by employers who withhold payment unreasonably, their objective being either to speed up work and/or to achieve cost savings with only marginal interest placed in indemnifying the employer against defects. This unreasonable withholding of payment places significant pressure on contractor/subcontractor cash flow. It is well known that the margins in

the building industry are tight and unpaid retention funds can easily wipe out a contractors/subcontractors profit or even cause a loss on a project.

Retentions have attracted criticism over the past few years especially in the US and UK. It may be worthwhile to understand what and where the real problem lies. According to Hughes et al (1998), the retention system has a significant negative impact on the efficiency of the construction industry. Uncertainty and risk are multiplied by non-payment or long delays of retention disbursement. The industry is thus deprived of funds, which could have been put into better use. Unfortunately late payment and refusal to pay remains a common means of securing additional short term cash flow. A considerable delay in the release of retention is commonplace and continuing to cause difficulty in the construction industry. This is particularly the case in the event of insolvency of any party in the payment chain, when the retention may be lost altogether.

Another issue is associated with sub-contractors whose work gets completed at the early stages of the construction. These subcontractors are particularly disadvantaged by retentions because their retentions are usually held until the main contract is completed. In addition to this there is exposure to the danger of late payment or non-payment. Uher (1991) observed that the practice of general contractors holding retentions on all subcontractors, regardless of the nature of their work, is unnecessary and unfair. Indeed retentions for subcontractors such as demolishers, excavators, land cleaners and similar, whose work by its nature is either finished or free of maintenance the holding of retentions is an unfair practice (Uher, 1991).

It can be summarised that the sub-contractors are suffering most from the practice of retentions. They are the main opponents of the retention practice as against clients or the main contractors for whom retentions is a source of extra capital, which they could use for other purposes e.g. financing other projects. This is an unfair practice of holding other people's money and using it for one's own benefit, although it could be debated. One might be of the opinion that it may be practicable to put the money to some use as an investment to gain better returns as against keeping it in a bank or a trust.

Retentions in New Zealand

Anecdotal evidence suggests that the problem round the practice in the New Zealand construction industry is not any different from other parts of the world. Investigation reveals that the main issue is around lost or unpaid retentions and the worst affected are the sub contractors (Steeman,2013). The problem in New Zealand is worse due to the size of the economy and thus the small size of the industry. Most of the work is carried out on the basis of relationship building and sub-contractors being at the end of the supply chain do not have much control. There is a

significant imbalance of power between a large head contractor with administrative staff specializing in contractual matters, and a small subcontractor who may be a competent tradesman, but without the resources to negotiate specialist matters such as legal and contractual (Abeysekera, 2002).

Another issue in New Zealand is around the differential retention regime used for contractors and sub-contractors. With sub-contractors carrying out up to 85% of the construction work and most of the sub-trades are limited to the value of \$200,000. The holding of 10% of the value of all the sub contracts can provide contractors with a substantial positive cash flow. The logic being that the total of retentions held on the head contractor are normally on a sliding scale and although they may start at 10% of the first \$200,000 they reduce progressively and may average less than 5% of the contract value (Abeysekera, 2005). On a contract of \$10,000,000 if the head contractor is holding 10% of the value of subcontracts it will amount to \$850,000. If the average retentions held on the head contractor are 5% of the contract value that amounts to \$500,000 and leaves the head contractor a \$350,000 surplus funded by subcontractors. This from the point of sub-contractors is an unfair practice.

There seems to be another problem attached to the practice here in NZ and that is to do with the management and recovery of retentions. In many cases contractors and sub-contractors are not well educated and aware of the contract itself. In such a case the retention monies sits there for long periods of time without being recovered (Degerholm, 2012).

RETENTIONS: ADVANTAGES AND DISADVANTAGES

Retentions impact, directly or indirectly on all stakeholders within the industry with the direct impact being on the clients, contractors and the subcontractors. Tables 1, 2 and 3 respectively list out the advantages and disadvantages of retentions for a client, contractor and a subcontractor organization. The tables suggest that retentions always act as an advantage to the clients, most of the times to the contractors except for a few issues and always impact negatively on the subcontractors. The analysis suggests that the current retention regime is technically doing what it was designed to do i.e. protect the client. The client is advantaged the most from this, the contractor by passing the buck down manages to neutralise the negative effects and sometimes gain a slight advantage of positive cash flow. The sub-contractor however being at the bottom of the ladder ends up with all the negative effects of retention. Therefore retentions clearly act as an advantage to one party and a disadvantage to the other. The question arises that is retention a fair practice in its present form or whether other ways need to be explored to change the current retention system to make it more effective and fair for all parties.

Table 1: Advantages and disadvantages for a client organization

	Advantages	Disadvantages
1	Retentions act as a means of financial protection to the principal or the client organisation that employs contractors or subcontractors. It helps the owner/contractor with a fund to pay the mechanics lien claims of unpaid suppliers, in case of a contractor/subcontractor abandoning the work (Fullerton, 2000).	“Retentions can produce cash flow problems for contractors and subcontractors , resulting in substantial borrowing at a sometimes hefty rate, which results in higher construction costs for owners or the client” (Arditi and Chotibhongs, 2005)
2	Retentions ensure for the prompt completion of the project for the client and also help motivate sub contractors to come back and rectify otherwise unprofitable small items of work. Also in case the sub contractor abandons the work or becomes insolvent it leaves the client with funds to pay for any incomplete or defective work and also pay for supplier items.	
3	Retentions act as partial finance for the project wherein the client receives the material and labour early on in the project but does not pay until month’s later (Fullerton, 2000).	
4	Improves the owner’s cash flow at the expense of the contractor and sub contractors. The client can enjoy the interest earned over the retention money.	
5	Retention funds acts as an advantage for the principal or owner for bolstering their reserves or for extraneous purposes such as financing their capital programmes or investment.	
6	Retentions take care of the project performance for the client; delivery of a defect free project from the contractor.	

Table 2: Advantages and disadvantages for a contracting firm

	Advantages	Disadvantages
1	Retention money encourages the contractor to complete the project as early as possible so as to get back a part of the retention money earlier after the issue of certificate of practical completion.	The retention mechanism acts as an opportunity cost to the contractor, which is equal to the loss of interest on the amount of money that is retained (Hughes et al, 2000).
2	The remaining part of the retention sum which is held up till the end of the defects liability period encourages the contractor to deliver a defect free and complete project at the end of the defects liability period.	Payment risk- payment delays-principal or the client refuses to reimburse retention under the guise of shortcoming in the project. Big loss for the contractor.
3	The current retention regime in New Zealand is an asset to the main contractors and acts as a positive cash flow and helps in investment opportunities due to surplus cash. As a result of this the contractors do not have to rely upon commercial banks for work in capital. The known fact being that construction business has always been perceived as risky by commercial banks This is especially true for the contractors who mainly outsource bulk of their work (Abeysekera, 2007).	Disadvantage for those contractors who produce complete and defect free projects as their portion of the retention money is held up till the end of the defects liability period.

4	Improves the contractor's cash flow at the expense of the sub contractor. The contractor can finance his other projects with the accumulated retention money.	
---	---	--

Table 3: Advantages and disadvantages for a subcontracting firm

	Disadvantages
1	The subcontractors whose works usually takes place early on in the project e.g. a piling subcontractor experiences delays in the release of the retention money. It adds on an excessive burden to such subcontractors. Reason being that the release of the sub-contractors retention is tied to the main contractor's final payment (Hughes et al, 2000).
2	The subcontractor bears the burden of the retentions in the sense that his money is held up for long thus restricting him from undertaking other jobs which is unfair as compared to the suppliers who require prompt payment that too in full. This payment is also a burden on the subcontractor (Fullerton, 2000).
3	The contract terms in New Zealand are such that retentions for sub contractors are released only when the head contractor's retention is released and not when the subcontractors complete their works.
4	Big risk for the sub contractors in the event of the head going insolvent. In the following case it can be very difficult for the subcontractor to obtain his retention funds unless any special arrangements have been made (Hughes et al, 2000).
5	Payment risk for subcontractors- sometimes the main contractors pay very late or even do not pay at all. It is an unfair practice of withholding retentions by the main contractors, often for no reason than to maintain their own cash flow. This has an adverse impact on the cash flow of the specialist contractors. This cost is even more added up by the cost of actually chasing the overdue retentions.
6	Subcontractors face another disadvantage when compared to head contractors in being at a greater risk with respect to interim payments and retention moneys. Reason being that they do not have access either to Payment bonds or retentions bonds when compared to main contractors (Abeysekera, 2003).

THE PERCEPTION OF RETENTIONS

Clients or owners do not believe that there is any possibility to complete the work without holding retentions (Ahmad and Barnes, 1991). Abeysekera (2003) contends that retentions are a must in construction contracts as long as the construction industry produces defective work with performance related problems. This is in line with the findings of Dodsworth (2003) that clients feel that until quality and efficiency in the industry have improved the system of retentions is the most effective way at present open to clients to ensure defect rectification before payment of final account. In New Zealand the general opinion of clients is that contractors have proven time to time that financial retentions imposed upon them are necessary as "a handshake and promise is simply not enough" (Gurton, 2008). In the opinion of one of the consulting organizations in New Zealand the sub-contract retentions should be held right to the end of the project and the client should be protected at any cost. The general view is that holding back money has a much more

material incentive for the contractor to meet his contractual obligations. The retention system is well established and when managed properly as set out in the various contract conditions works reasonably well (Prakash, 2008).

Clients and main contractors alike believe that retention is necessary to ensure on-time completion and satisfactory delivery of the project (Fullerton, 2000). However according to Dodsworth (2003) main contractors' perception were diverse with clients favouring the system of retentions, preferring the abolition of retention except against their subcontractors in situations where they were themselves subject to retentions. In New Zealand industry sources say that while many main contractors say that retentions are not theirs to use the reality is that many do. Contractors hold the view that subcontractors are very slow at attending to remedial work and a monetary incentive is the only reasonable approach. They believe that the issue of unscrupulous main contractor taking advantage of the system has been taken care of by legislation by the introduction of the Construction Contracts Act in 2002 (Miller 2008).

Subcontractors in NZ in general feel that retention is an unfair practice. They define retentions as unsecured interest free finance provided for an unfixed term to debtors of uncertain credit worthiness (Building finance needs ground rules, 2013). They can probably be seen as the most vulnerable party involved in the retention system. As a general rule, main contractors forward the retention burden to subcontractors, while construction material suppliers demand prompt payment in full. Thus, the subcontractor is caught in the middle and usually bears the financing burden of the retention system. Evidence suggests that the issue of retentions with regard to subcontractors in NZ is a major one. In NZ the sub contractors contend that at least \$500 million of industry funding is provided by sub contractors and builders interest free and unsecured (Miller 2008). Moreover it is also found that clients tend to abuse the power of retentions and extend the retention period as far as possible and a separate legal action has to be entered in to counter claim.

CONCLUSION

It can be concluded here that retentions are a powerful means of providing protection to the owner or the client and are fair from the point of a business perspective. However the ways by which they are used by the clients and the contractors for their own personal benefits puts a question mark on the fairness of this practice. Studies are being undertaken to establish means or ways of dealing with retentions so that it follows the principles of fairness and is beneficial to the whole construction supply chain. Countries like Mexico, Korea, and Srilanka have already addressed this issue by creating special funds, banks and the like for the exclusive use of the construction industry. It is time for other

countries to address the issue and establish ways and means that will be advantageous to the industry as a whole.

The construction industry is being directed towards an all encompassing, non-adversarial approach as stated by Michael Latham in 1994 and later furthered by John Egan in 1998. Whilst the need for a mechanism to address construction defects is acknowledged, the use of retentions has proven to be contrary to this way of thinking and as such their use must change. There is a need to find out through further research the solutions or alternatives to the existing practice. The only way forward is to address these issues through amendment to existing legislation.

REFERENCES

Ahmad, I., & Barnes, W. (1994) Retainage Policies of Public Agencies, Findings of a Questionnaire Survey, *Symposium conducted at the meeting of the Proceedings of the Annual Meeting of the Associated School of Construction*, April 1994, Peoria.

Abeysekera, V (2002). Financing construction: The case for a construction guarantee fund. *The meeting of the Environmental and economic sustainability: Cost engineering down under, ICEC Conference*, 14-18 April 2002, Melbourne.

Abeysekera, V (2003). Exploring the case for a construction guarantee fund in New Zealand. *The Joint Symposium on Knowledge Construction (CIB Working Commissions W55: Building Economics, W65: Organization and Management of Construction, W107: Construction in Developing Countries)*, 22-24 October 2003, Dept. of Real Estate and Building of National University of Singapore, Singapore.

Abeysekera, V (2005). Harnessing the power of retentions: The Case for a Retention Based Fund for financing Construction Work, *Construction Quarterly Information. The Journal of the Chartered Institute of Building UK*, 7(1), 10-13.

Arditi, D., and Chotibhongs, R. (2005). Issues in Subcontracting practice, *Journal of Construction Engineering & Management*, 131(8), 866-876.

Bausman, D. C. (2004). *Retainage Practice in the Construction Industry*. Alexandria, VA: Foundation of the American Subcontractors Association Inc.

Bayley, G., & Kennedy-Grant, T. (2003). *A guide to the Construction Contracts Act*. Auckland: Rawlinsons Media Limited.

Boyes Turner. (1st March 2005). Why retain retention clauses? Retrieved 15 January, 2010, from <http://www.boyesturner.com/news-article.html?id=67>

Building finance needs ground rules. (2013, 5th March). *Construction news*. Retrieved from <http://subby.co.nz/index.php/decisions/government/145-building-finance-needs-ground-rules>

Construction Manager. (2002, June). MPs to look at scrapping of retentions. *Construction Manager, The Magazine of the Chartered Institute of Buildings*. Retrieved March 13, 2009 from <http://www.construction-manager.co.uk/storyprint.asp?storycode=1018733&feature>

Fullerton, J. D. (2000, November/December). R.E.T.E.N.T.I.O.N. *Business Credit Magazine, National Association of Credit Management*, pp 22-24.

Gurton, B. (2008). Assignment 1A, management in the construction industry. Unpublished paper, School of Engineering, AUT University, New Zealand.

Hughes, W., Hillebrandt, P., and Murdoch, J. (1998). *Financial Protection in the UK Building Industry*, London: E & FN Spon.

Hughes, W., Hillebrandt, P., and Murdoch, J. (2000). The impact of contract duration on the cost of cash retention. *Construction Management and Economics*, 18, 11-14.

House of Commons (2002). *The use of retentions in the UK construction industry*. London: House of Commons: Trade and Industry Committee.

Latham, M. (1994). *Constructing the Team Final Report of the Government / Industry Review of Procurement and Contractual Arrangements in the UK Construction Industry*. London: HMSO.

Mazurkiewicz, G. (2001). Subcontractors Press for Reform. (cover story). *Air Conditioning Heating & Refrigeration News*, 213(16).

Miller, R. (2008, July) Yawning gulf in retentions interpretation. *NZBSF UPDATE*. Retrieved from <http://www.nzbsf.org.nz/newsletters/jul08.pdf>

Prakash, G (2008). Assignment 1A, management in the construction industry. Unpublished paper, School of Engineering, AUT University, New Zealand.

Specialist Engineering Contractors' Group (2004). *The Use of Retentions in Local Authority Construction Procurement*. Retrieved from <http://www.secgroup.org.uk/pdfs/act/04/secretenapr04.pdf>

Stand against unsecured retentions in Christchurch. (2013, 25th March). *Construction news*. Retrieved from

<http://www.subby.co.nz/index.php/ethics/dr-monika-pradhan/158-stand-aganst-unsecured-retentions-in-christchurch>

Standards New Zealand. (2003). *NZS 3910:2003 - Conditions of Contract for Building and Civil Engineering Construction*. Wellington: Standards Council.

Steeman, M. (2013, 21st February). Mainzeal owes 'millions' in retentions. *Business Day*. Retrieved from <http://www.stuff.co.nz/manawatu-standard/news/business/8335703/Mainzeal-owes-millions-in-retentions>.

TaylorWessing. (2003). Retention monies - retain or release? *Construction & Engineering Review* (Spring).

Uher, T. E. (1991). Risks in subcontracting: Subcontract conditions. *Construction Management and Economics*, 9(6), 495-508.

Wyatt, D. J. (2003). Specifying Retainage Requirements, *The Construction Specifier*, 56 (12), 36-37.