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Construction retentions, collections and final payment - d054 - ho 259

Introduction - Payment as a lifeline

Lifeline has many definitions but one in particular strikes me as being most appropriate to the construction profession; "A lifeline is a line or rope for saving life".

Payment or money flow on a construction project can be just that - a line of strength that can preserve the life, vigor and integrity of a project; or a line of weakness that can cast the project adrift.

Successful firms are not often heard complaining about payment. This oddity bears close examination from those seeking to emulate these firms.

General nature of cash flow in the construction industry

Legal background for progress payments

Governed by the doctrine of conditions

Doctrine of conditions says that a party should not have to perform its promise without obtaining the other party's promised performance. The principle is central to any discussion of progress payments.

Who is required to perform first?

Common law requires that performance of services precede payment

Role and obligations of the payer

To maintain strong financial position that allows prompt pymt when deserved

Makes people want to work for you

Improves potential for future reductions in proposal prices

To pay promptly and within the context of the contract

Role and obligations of the payee

To perform well and in accordance with their contract

To bill accurately and promptly

To follow the ground rules by which payments are to be made

Points for the payee to consider

Too often we in the construction industry blame everyone but ourselves for not being paid what we think is owed us promptly.

Many times the cause of slow or reduced payment lies with the payee, not the payer.

Conditions surrounding collections and payments

Unsuccessful collections & payments often result from:

Mistrust - Inability to work honestly with unwritten standards

Cupidity - Inordinate desire to get something for nothing

Doubtful risk taking - A high risk has a corresponding high penalty

Ultra conservatism - Excites suspicion and slows cash flow

Incompetence - Produces a lack of desire to pay or work - no incentive

Stubborness - A balky mule cannot be depended on to pull the wagon

Dishonesty - Destroys incentives to play fair and pay promptly!

Claim prone environment

The contested claim brings out the worst in everyone, and most particularly makes the payer reluctant to pay.

Understanding how to reduce the dust, noise and confusion that surround contested claims often can encourage prompt payment even in difficult conflicts.

Common causes of contested claims and their frequency are:

- Directed change - 48%
- Constructive change - 42%
- Defective or deficient contract documents - 41%
- Delays - 41%
- Constructive acceleration - 35%
- Maladministration - 33%
- Differing site conditions - 31%
- Impossibility of performance - 18%
- Superior knowledge - 18%
- Termination - 7%

Successful collections & payments

Trustful relations

Construction is a give and take business. By the end of the job the gives and takes must balance out. The construction process is lubricated by the exchange of small favors.

Honesty

Honest people select their business associates carefully. Those who are honest and paying for services rendered generally recognize honesty in another company or an individual.

Competence

Competent people recognize competence in others. On most jobs, given the presence of a reasonable number of high value factors, the competent payee will be

compensated fairly and promptly. Financial check and balance systems ask too many "why" questions to allow competent parties to remain unrewarded.

A willingness to give and take

All taking and no giving by either the payer or the payee will sink a project in a swamp of paper and a sea of red ink. The mistrust that results from this lack of informal give and take will grow into a monster unless it is replaced by a mutual confidence by the parties to the situation.

Retentions

Often used for doubtful reasons

As a club to assure proper completion
To save interest payments for 10% of the job cost
To insure construction damage to completed work is repaired
To pay for anticipated contested claims

The problems of retention are old and will probably remain problems until:

Properly addressed by the parties involved
There is agreement among like parties as to its impact
All parties to a contract behave according to their contract

Attitudes and realities about retention

In 1976 a survey was made of the American Subcontractors Association (ASA)
- Showed average retention among members was $200,000
- Members said would reduce bid price 3.7% if retention was eliminated

A recent survey of the American Subcontractors Association indicates
- Subcontractors are willing to give lower bids to generals who
  - Pay them promptly
  - Offer them a fair and equitable contract
- Of 200 respondents
  - 89% said they give better bids to generals regularly or occasionally
  - 90% did so because the general had prompt payment policies
  - 91% said not paid within 3 days of billings
  - 69% said not paid within 7 days of billings

Policies on retention
- § Recent AGC, ASC and ASA policy calls for payment within 7 days of billing
- § In 1974 GSA went to zero retention
- § At one time Department of Defense eliminated retentions
- § EPA once wrote retention requirements out of its grants
- § About 1984 Michigan Dept of Mgmt & Budget adopted zero retention
  - Was required by the legislature
  - Department had 2 choices

- Put money in escrow
  - Problem - couldn't use state treasury for holding vehicle
  - Problem - private holding would have too complicated
    - Would have thousands of accounts
    - Prohibitively expensive and cumberson
- Adopt a policy of total payment for completed line items
  - Each line item was to be explicit
    - On recent $2,000,000 job
      - Had about 1100 line items
      - Listed on 27 pages
      - Ranged in cost from $100 to nearly $70,000
- Adopted zero retention route
  - Some state officials like it, some hate it
  - Some contractors like it, some hate it

§ In 1983 the Office of Federal Procurement Policy decided that

- A uniform government wide policy should be implemented
- Retainage was not to be used as a substitute for good contract management
- An agency cannot withold funds without good cause
- Determinations on retainage are to be made on the basis of:
  - Contractor's past performance
  - Liklihood that such performance will continue in the future
- Suggested that:
  - Retainage not exceed 10%
  - That it be adjusted downwards as the contract approaches completion
  - When contract is complete all retainages be paid promptly

Summary - there is no single attitude or reality re retentions!

Collections, or better yet, payments

Direct payment from the owner

Conventional method on self financed projects

Success of method depends on the integrity and compentence of the owner

Direct payment from another contractor

Evolved when general contractor did most of their own work

The secondary payment process may be used as a club rather than a tool

Direct payment from another party

Usually called the title company method

Steps in the title company disbursement method

A. Monthly draw requests received from the contractors

B. Supporting documents reviewed by the appropriate tier of contractor

C. Job inspected by inspecting architect retained by payer

D. Payment made to the contractors directly

Sometimes direct to subs
Sometimes to general contractor for disbursement to subs

Advantages
Insures prompt payment to contractors
Provides third party evaluation to gage performance
Gives financing source full control of the money flow
Tends to diminish tendency to front load or unbalance billings

Disadvantages
Removes some of prime contractor's leverage to get work done
Creates excessive dependency on attitudes of financing source
Owner plays secondary role in motivating performance
Poorly qualified inspecting architect can create havoc
Bad attitude toward contractors
Jealousy between architect of record and inspecting architect

Final payment

Elements of record used in closing out the job

The punch list and the certificate of occupancy
Usually these provide the rationale behind final payment being made
You should decide early how the job is to be punched out
Who is to do it?
When is it to be done?
What standards of performance are to be used to measure acceptability
When is the contractor's punch list to be prepared?
When is the owner's punch list to be prepared?

The operating and maintenance manuals
Inadequate O&M submittals may be cause for non payment
Get them done and get them submitted!

Where successful collections and payment start

The agreement

The starting point for cash flow success is preparation and execution of a well understood contract agreement.

Often contractors take jobs that specify impossible performance

Leads to getting into a position where the owner, or the architect engineer feel they can withold payment for personal, subjective reasons, using the impossible clause as a legal reason.

Example: the witholdiing of payment because the contractor did not submit a acceptable schedule within a given period of time.

Infeasible schedules
Inadequate contract documents
Unworkable contract agreements
Excessive multiple primes

Installation of unknown systems
Undefined responsibility patterns

The client - either owner or contractor

Most payment-successful contractors profile a prospect before proposing on a job. This is done with any new client, and sometimes on previous clients with doubtful records.

Profiling a client should follows a basic pattern
What factors describe how a client will pay?
- § Personal integrity
- § Business integrity
- § Past payment record with you
- § Past payment record with others
- § Current financial strength
- § Nature of assembled project financing
- § Process used for approving payment and releasing funds
- § Attitudes of the architect/engineer toward you and paying
- § Methods of closing out jobs

The project

As with the client, the project must also be profiled. Not every job is for everyone. Be selective so as to optimize your opportunities for success.

What factors describe a good pay project for you
- § Your past experience in building such facilities
- § The client's past experience in building such facilities
- § Funding sources
  - Individuals
  - Syndicates
  - Trust funds
  - Pension funds
  - Political entities
- § Payment method
  - Direct payment
  - Title company payment
  - Inspecting architect
  - Payment method specified to be used for sub contractors
  - Retention specified

Evaluating the job

Once the client and project factors are identified, it is necessary to analyze them for a decision as to whether the job is potentially a good job or a bad job. Good and bad is evaluated as to the risk and the return on investment.

A. Weigh each factor
   Weight each from one to ten as to its importance to you
   - One - totally unimportant to being paid
   - Ten - most critical to being paid

B. Assign values to the client and the project which you are proposing upon

Values should be from one to ten
One - Client and project produce worst pay potential situation for factor
Ten - Client and project produce best pay potential situation for factor

C. Multiply the factor weight by the value to get a profile number

+ Example of profiling

How you might profile the payment potential of a new prospect.

Factor weights multiplied by value for client Jones
Honesty in business - 10 x 08 = 80
Past payment record with you 10 x 06 = 60
Past payment record with others 07 x 03 = 21
Current financial strength 07 x 05 = 35
Nature of assembled financing 05 x 07 = 35
Process for approving payment and releasing funds 08 x 09 = 72
Attitudes of the architect/engineer - 06 x 06 = 36
Method of closing out jobs 07 x 05 = 35

Factor weights multiplied by value for Jones project

Your past experience in building such facilities 05 x 08 = 40
Client past experience in building such facilities 04 x 04 = 16
Funding sources 08 x 08 = 64
Payment method 07 x 05 = 35

Total = 529 out of a total possible of 740, or a 71% potential for good payment relationship

Rules for getting paid promptly

- **§ Be certain of your agreement and understand what it says**
- **§ Be honest in your dealings and your intent**
- **§ Fulfil your contract**
- **§ Avoid legal entanglements and threats**
- **§ Be willing to use the lubricating oil of small favors exchanged**

If you aren't entitled to it don't try to get it!

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Common Causes of Contested Claims

Contested construction claims have increased over the past few years and now must be recognized as a serious hinderence to proper and profitable construction procedures.

The reasons for the increase in contested claims are many and must be understood in the sense that our society has become somewhat legalistic. That is to say that the recourse to legal resolution, as opposed to interpersonal, technical or administrative resolution of problems has become a common occurance. This is a relatively recent development, and fortunately shows some signs of diminishing as costs and time involvement in legal matters has increased astronomically.

However, there are claims, there always have been claims, and there will probably always be contested claims that those in construction should understand well.

Specifically, contested claims lead to resolution by an administrative settlement, litigation, arbitration, or mediation. There are some common causes of conflict and it is these that stimulate the parties to go to a formal settlement by outsiders. It is important for those in construction to understand how to avoid the mistakes that cause wasteful contested claims.

Several years ago a firm specializing in construction claims and their settlement studied some of the most common causes of disputes. Of two hundred occurrence of contested claims the following percentages were found.

1. Directed Change - 48%

A directed change is a legitimate change within the contract scope for which the owner must pay.

Examples

- owner changes the door color after door is painted.
- owner revises size of electrical room door opening.

Advice

- Required extensions of time should be stated in writing.
- Costs for extended general conditions should be agreed upon early.
- The client or owner is obligated to pay for the change, if there is a charge.
- Payment for the work should be explicitly agreed upon before starting.

2. Constuctive change - 42%

An owner's action or inaction that has the same effect as a written order.

Examples

- Shop drawing corrections, showing additional work not covered in contract documents.
- Owner's representative tells a superintendent to relocate a wall with no payment intended.

Advice

- Don't assume changes will be free. Find out if there is a cost.
- Don't enrich contract documents.
- Don't enrich shop drawings.
- Make certain the scope and costs of additional work is clearly understood.

3. Defective or deficient contract documents - 41%

Contract documents which do not adequately portray the true contract scope.

Examples

- A retaining wall shown dotted on the contract documents and expected by the architect/engineer and the owner to be built as part of the contract.
- Dimensional errors that cannot be resolved by verbal clarification.
- Contract documents that expect performance by default. For instance, specifing a miscellaneous iron ladder but not showing it on the drawings.

Advice

- Expect to pay your architect and engineer for good quality assurance in the production of contract documents.
- Select your design team on the basis of performance not cost.
- Clearly define design and construction delivery methods to be used.
- Don't expect your contractor to design the job unless it is a design/build project.
- Don't make unrecorded corrections to contract documents.

4. Delays - 41%

A delay situation beyond the control and not the fault of

the contractor.

Examples

- Rock encountered that delays the job but was not shown on the contract documents.

Advice

- Be as thorough as possible in defining physical conditions of the site upon which the facility is to be constructed.
- Specify weather standards when it is necessary to clarify time extensions that might be caused by inclement weather.
- Determine delay costs quickly and eliminate them as soon as possible.
- Don't stop field work without proper authority and a very good reason.

5. Constructive acceleration - 35%

More work with no time extension or the same work and a shorter time period in which to do it.

Examples

- Owner refuses to grant time extension for work that will take longer to perform.
- Owner makes unauthorized use of critical path time without extension.
- Owner makes use of float time with the expectation that the contractor will not request or require a time extension.

Advice

- Never assume the contractor will do extra work within the contract time.
- Work out an early agreement on the use of float time in the network model.
- Never assume a field order is a no cost, no time extension change.

6. Maladministration - 33%

Owner interference with the contractor's right to enjoy least cost performance.

Examples

- Owner directs contractor to provide a certain space in a facility early without such early turn over having been specified.
- Owner directs contractor to start work on an

encumbered site.
- Architect/engineer unresponsive to legitimate requests for information.

Advice

- Always allow the contractor to select construction methods and means.
- Make certain the site is fully available to the contractor before the job begins.
- Promptly process submittals.
- Clearly define the time frame and the sequence by which submittals are to be processed,f and do it early in the job.

7. Differing site condition - 31%

The actual site differs from that represented on the contract documents or deviates from ordinary or normal expectations of such a site in that area.

Examples

- Artesian water encountered in sand seam outside of where soil boring were taken.
- Existing basements encountered but not indicated on contract documents.
- Restrictive easements or assessments on the property not made known to the contractor before contract execution.

Advice

- Expect to pay for and get a good sity survey.
- Make certain soil borings are adequate to show any unusual conditions.
- Locate and define all easements.
- Check the site history for unusual or restricted conditons.
- Take photos of any unusual conditions encountered.

8. Impossibility of performance - 18%

A situation where it is impossible to carry out the contract work.

Examples

- Expecting a contractor to work on an encumbered site.
- Owner refuses to move interfering utilities he is supposed to move by contract.
- Specifying installation of above ceiling work that won't fit in the space provided.

Advice

- Expect the design team to check their work thoroughly for interferences.
- Accept your legitimate duties and responsibilities and take care of them.
- Resolve dimensional differences early.
- Do your homework to presolve expected problems and interferences.

9. Superior knowledge - 18%

Witholding data or information during the precontract period that affects construction on matters of importance.

Examples

- On a steel erection contract not telling the bidders that the steel had been refabricated from a previous job.
- Failing to tell bidders that there is a cost cap on the first two month's costs.
- Not telling bidders that there is a high pressure gas line through the site that must be accommodated during construction.

Advice

- Be certain all bidders know as much as they must know to propose properly.
- Be certain demolition contract documents specify all work to be done.
- Locate, to the best of your ability, all site obstructions before bidding.
- Don't expect the contractor or the architect and engineer to read your mind.

10. Termination - 7%

Dismissal from the project for convenience or default.

Examples

- The section of the project is no longer needed and is removed from the contract.
- The contractor is behind schedule.
- The contractor's performance is unsatisfactory.
- The owner doesn't like the way the superintendent talks back to him.
- The contractor doesn't manage submittals promptly and accurately.

Advice

- Be certain the cause for dismissal is legitimate and well defined.

- Don't dismiss for minor reasons. Dismissal is serious business.
- If dismissing be certain proper notice is given.
- Insure the contract documents give you the right to dismiss.

Avoiding lawsuits,d161, ho 228