

RETENTIONS

1. WHAT ARE THE RETENTIONS?

Retention monies are, in theory, money earned that is held back by the client to insure against contractors' failure. The purpose of the retention is to ensure that the contractor properly completes the activities required of them under the contract.

However, the reality is often that the contracts that include retentions do not link the deduction of the retention monies to the identification and resolution of defects other than by coincidentally identifying the release date for the second half of retentions as being the expiry of the defects liability period – known as 'pay-when-certified'. Instead, they rely on the right in general law of the paying party to set-off any losses incurred as a result of non-performance by the supplier from monies owed by the paying party to the supplier, i.e. the retention monies.

Usually, retention is set at 3% or 5% of the total work value – although cases of 10% have been seen in the past. The retention monies are deducted from payments made to the supplier. The retentions are then released to the supplier in two stages during the project cycle:

STAGE 1

First half of retention monies released on sub-contractor's practical completion

STAGE 2

Second half of retention monies on expiry of defects liability period, which usually, but not always, lasts anywhere from 6 months to 2 years

The first half of the amount retained is released on certification of practical completion¹ and the remainder should be released upon the certification of the making good of defects so called 'final statement' in design and build contracts such as JCT.

Interim certificates should specify the amount of retention held back at each interim payment and a statement should be prepared showing retention owed for sub-contractors.

Construction contracts during the 1980s required that retention was kept in a separate bank account and that was confirmed to suppliers.

In construction management contracts, a separate certificate of practical completion must be issued for each trade contract and so there are number of defects liability periods. This means that retention must be released as required for each individual trade contract. The same applies to management contracts where it must be certified individually.

¹ In Institution of Civil Engineers or ICE it is known as substantial completion.

2. COMPLICATIONS

Retention can be a large amount of money and may cause cash flow problems for suppliers and is rarely released on time or in accordance with the contract. In a situation where the money is withheld long enough, the subcontractor often stops trying to collect the retention money and it becomes a de facto secondary discount. On a macro level, those retention monies end up as a further discount and source of profit to the paying party instead of to the sub-contractor, even if the reason for failure isn't related to that sub-contractor.

Ordinarily, if the paying party alleged non-performance by the supplier it would have to prove its case before being able to recover any resulting loss. The inherent unfairness of this system is that the paying party has a direct pecuniary conflict of interest in that it holds the retention monies within its bank accounts and is able to decide subjectively whether it is entitled to claim against them in lieu of alleged losses it has incurred or release them

In value terms, if the retentions system is not fulfilling its true purpose due to a lack of objectivity, then it detracts from added value to the procurement and construction process and becomes unnecessary overhead, i.e. waste.

The most common problems sub-contractors face include:

- ▶ The amount of retentions is disproportionate to the costs of recovery.
- ▶ Weaker cash flow
- ▶ Administrative problems
- ▶ Increased risk of non-payment due to contractor insolvency

3. CHANGES

After 1 October 2011, the Construction Act was amended to include provision that release of retention to sub-contractors could not be linked to an unrelated occurrence within a main contract but must be triggered by a specific occurrence related to the subcontract.

This change outlawed the practice of 'pay-when-certified' on retentions, but nevertheless those holding retention monies immediately began exploiting gaps and finding other ways to avoid paying retention in a timely manner.

4. HANDLING RETENTION IN CONTRACTS

JCT CONTRACTS

JCT subcontracts were amended to reflect the changes that came into effect with the Construction Act.

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| Min retention amount is £250 | Default retention percentage is 3% | Stage 1 & 2 retentions | Outstanding amount due in next interim payment within 2 months once release date reached | Final payment becomes due 28 days after, if no defects found | The release date can be put on hold if defects still exist, until they are addressed |
|------------------------------|------------------------------------|------------------------|--|--|--|

It is often that main contractors amend these amounts and dates to better suit their own purposes. For example, the 3% is almost always raised to 5% (and can in some cases be as high as 10%), and stage 1 of retention date is amended to lengthen the time the contractor can hold the monies.

NEC3 CONTRACTS

These contracts do not have retention as a primary clause in their contracts. If the main contractor wants to hold retention money, they must submit a secondary option X16, which links retention release to the issue of the defects certificate.

5. ARE THERE ANY ALTERNATIVES AVAILABLE?

There are several alternatives to conventional retentions, but these are rarely utilised because they do not offer the same level of financial control, or worse, the alternative methods of security are used in addition to retentions as a method of maximising contractual security.

PCG

A parent or sibling company guarantee serves as a way of getting a financially stable and affluent parent company to guarantee the obligations of the contractor. In well-worded PCGs, the recipient must prove the contractor has failed to perform and prove the loss resulted from that failure and was reasonable, in order to recover that loss.

PERFORMANCE BOND

In well-worded performance bonds, the recipient must prove the contractor has failed to perform and prove the loss resulted from that failure and was reasonable, in order to recover that loss.

RETENTION BOND

A retention bond serves as a formal agreement between the contractor, the subcontractor, and a third party serving as guarantor (usually a bank). The guarantor's role and obligations will depend upon the bond, but in well-worded bonds, the recipient must prove the contractor has failed to perform and prove the loss resulted from that failure and was reasonable, in order to recover that loss:

- ▶ With a guarantee bond, the contractor must legally prove breach of contract by the subcontractor before the guarantor is required to issue payment.
- ▶ With an on demand bond, the guarantor is obligated to pay in any situation where the subcontractor has failed to perform, whether the contractor has legally proven breach of contract or not.
- ▶ A defects liability bond is where defects liability period begins upon certification of practical completion and typically lasts 6-12 months. During this time, it is the contractor's responsibility to rectify any defects that become apparent in the works.

In England and Wales, the retention bond is where the bond amount reflects the amount that would have been held back. At the point of practical completion, the bond is reduced to reflect the amount that would be retained during the defect liability period. In situations where, the sub-contractor fails to correct any defects in the work, the guarantor pays the contractor the amount required to correct any defects and then pursues the sub-contractor for that amount. Thus, the main contractor is still covered should something go wrong, while the sub-contractor gets to hold onto their money, improving cash flow and eliminating the threat of non-payment.

TRUST ACCOUNT

The retention money can be put into a trust account with a separate entity, which protects the contractor from risk by allowing the cash to flow to an impartial and independent agent. By using this option, the retention money is still withheld, the sub-contractor is assured of payment in accordance with the contract.

The trust account option is getting mixed responses from industry professionals and the government.

NEW ZEALAND

After the Mainzeal collapse – in which the former property and construction company was placed into liquidation in February 2013, with their subcontractor's retentions being condemned as unsecured debt – changes were deemed necessary to protect payment of retention monies to those who were owed the monies.

As a result, key changes in legislation are going to be introduced, which will come into force from 31 March 2017 to transform the way retentions would be held. Some important changes will include; retention fund trusts, which must be reported and recorded on the accounts; new provision preventing amendment of construction contracts to avoid non-compliance; new provisions of repayment to be conditional only on performance of the other party's obligations under the contract.² The down side to this system is that the monies co-mingle with existing funds within the corporate entity, i.e. if the buyer holding the retentions fails to comply with the legislation and becomes insolvent the supplier is left in the same position of being an unsecured creditor.

AUSTRALIA

In Australia, the retention trust scheme came in to force from 1 May 2015 in NSW as part of the Fair Trading Government's response to the Collins Inquiry that left subcontractors more than £1bn out of pocket. The key changes that were introduced were limited to retentions between tier one and tier two contractors only engaged on projects with a value of over \$20m AUD.

Other measures included first retention scheme in the country to protect sub-contractors; a shorter time schedules for payments (15 days for main contractor and 30 day for sub-contractors); an education program targeting subcontractors to improve business and financial management skills in the industry.³

6. SUMMARY

The retentions system does not fulfil its purpose and is open to abuse because of the subjectivity of the process. There are other better suited methods of obtaining security against defects, but these are rarely used because: (a) the comingling by the buyer of retention monies with existing working capital can be used as an additional source of financing a construction contractor; and (b) the scope for abusing the retentions mechanism allows financial agility when ensuring projects are delivered within budget and profit margins are protected.

The UK Government is about to consult industry on the abuse of retentions and the potential solution of a retentions trust scheme.

² More information about retentions in New Zealand can be found here: [Retentions in New Zealand guidance](#)

³ More information on retention in Australia can be found here: [Security of Payment discussion paper](#)