AN INDUSTRY DIVIDED: PROPOSED REFORM OF RETENTIONS IN THE UK

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Legal Briefings

The UK construction industry is currently engaged in a heated debate about the future of cash retentions in construction projects. Indeed, the issue of retentions is a hot topic throughout the construction industry globally, with a number of countries having taken steps to reform cash retentions in recent years, particularly in light of the related risks to contractor solvency.

For example, Mainzeal, one of New Zealand's leading construction companies, collapsed suddenly in 2013. Creditors were left with outstanding debts in excess of US$100m, and many of these included Mainzeal's subcontractors and suppliers against which it was holding retentions. This ultimately led to reform of the retentions system in New Zealand last year. A similar push for reform has now arisen in the UK following the insolvency of the Carillion group in January this year.

This newsletter discusses the issues with the current retentions system in the UK and the proposed reforms. It also touches on similar measures that have been put in place in other jurisdictions.

WHAT IS RETENTION?

The Department of Business, Energy & Industrial Strategy (the "**BEIS**") published a detailed research paper on the issue of retentions in the UK construction industry in October 2017 (prepared by Pye Tait Consulting). The BEIS paper defines retention in the construction sector as, "*a percentage of the value of a construction contract which is held by the client as an assurance of project completion and as a safeguard against defects which may subsequently develop and which the contractor may fail to remedy.*" "Client" for these purposes can also include a main contractor in relation to payments to subcontractors. The typical range for retentions is 3–5%; commonly held against sums due under interim payment certificates, with a requirement for half to be released at practical completion, and the other half at the end of the defects notification period, subject to the completion of any outstanding defect.

Retentions are intended to meet a legitimate need. They provide an incentive to the contractor to complete the works on time and without defects, as well as provide a fund for rectifying defects should the contractor not do so during the defects notification period. They also offer clients a degree of protection in the event of contractor insolvency. This may explain why 85% of clients surveyed for the BEIS research paper had held retentions on some or all of their construction projects in the previous three years (and why retentions are such a significant issue in the industry).

Contractors, however, tend to view retentions as an outdated practice that deprives them of funds which should rightfully be available to them to invest in their businesses and relieve pressure on cash flow. This is particularly the case for smaller subcontractors and suppliers further down the supply chain, who often have the greatest exposure to cash flow risk, since head contractors simply pass on retentions down the chain where they are retained by the ultimate client. Around half of the contractors surveyed for the BEIS research paper had experienced retentions being held against their work by the client or a lead contractor. This rises to around 70% of contractors where those who both had retentions held against their work, and did the same to subcontractors, are included.

Contractors suffer considerably where margins are low on a project. A 5% retention can represent a large portion, if not all, of the profit on a contract. Further, in addition to the retentions, contractors are often required to provide a performance security, designed to provide against the same risks as retention.

Some commentators suggest that the industry is partially to blame for the current situation, due to slipping standards. According to Mark Castle, Chairman of Build UK (a trade body representing in excess of 40% of the UK construction industry), if the work was delivered fully compliant with the client's requirements at practical completion, retentions wouldn't be necessary in the first place. Whilst expecting flawless work might be a little over-optimistic, it must be true that higher standards would – or at least should – lead to reductions in the amounts being held after the defects notification period.

PROBLEMS WITH THE CURRENT SYSTEM

However, a major problem with retentions is that they are all too often misused by clients and head contractors; indeed some employers on international projects are known for seeking to treat the retentions as an additional discount at the end of a project.

Delay in release of retention monies is commonplace in the UK construction industry according to the BEIS paper, with 71% of contractors experiencing delays in receiving retention monies that were rightly due and payable. The average length of delays varied, but was longer for subcontractors further down the chain as compared to main contractors.

In addition, more than half of the contractors reported instances of either partial or total non-release of retention monies (although some of those instances may have been justified). Despite difficulties in determining when non-release is justified, the qualitative evidence gathered for the BEIS paper suggested that late and non-release of retention monies was a significant issue for some contractors.

Another serious concern is that the majority of clients and lead contractors holding retentions did so in their main bank account, without any use of separate accounts or ring-fencing. Therefore, while clients obtain some protection against contractor insolvency, contractors further down the supply chain have no protection from insolvency up the chain. As a result, almost half (44%) of contractors in the UK who had retentions held against their work experienced non-release of retention monies due to insolvencies further up the supply chain (in just the three years prior). It is this risk which has received particular attention following the Mainzeal and Carillion insolvencies.

ALTERNATIVES TO CASH RETENTIONS

There are a number of possible alternatives including the use of project bank accounts (provided for in JCT and NEC3 contracts), retention bonds (although contractors may consider retention bonds cost as much as retentions), and more fairly-staged retention releases for subcontractors (e.g. half at completion of their scope of works and half at completion of the project works). The BEIS paper concluded that it was necessary to investigate further the feasibility of such alternatives – in particular recommending holding retention monies in trust accounts and retention deposit schemes as promising options.

RECENT REFORMS IN AUSTRALIA AND NEW ZEALAND

Amongst various other countries that were reviewed, the BEIS paper focused in particular on Australia and New Zealand. In 2014, the government of New South Wales (Australia) ("**NSW**") proposed a regulation to establish a retention deposit scheme to prevent clients and lead contractors using retentions as their own working capital. Accordingly, retention money withheld for projects exceeding AU$20m in NSW must now be held in a trust account with an authorized institution.

In the wake of the Mainzeal insolvency, New Zealand passed legislation effective since last year requiring retention money to be held on trust in the form of cash or other liquid assets (unless a financial instrument is purchased with strict requirements to ensure repayment of the retention money). Although New Zealand has adopted a slightly different mechanism than NSW, the fact of both jurisdictions acting to reform retentions in such a short space of time is significant, and has not been ignored in the UK.

THE CURRENT PROPOSALS IN THE UK

The Construction (Retention Deposit Schemes) Bill 2017-19 was introduced to the UK Parliament by former chartered surveyor Peter Aldous MP in January 2018. It has come to be known as the "Aldous Bill" and proposes to replace cash retentions with a retention deposit scheme similar in principle to the system in NSW. The Aldous Bill passed its first reading and is due to receive its second reading on 26 October 2018.

The proposals are considered controversial and highlight the stark divisions of opinion amongst UK construction industry bodies and commentators. Many are in favour of the Aldous Bill, including more than 75 trade bodies (representing around 350,000 businesses) and more than 100 members of parliament. Others, including Build UK, believe it does not go far enough in reforming the retentions system, preferring instead to abolish retentions completely. Some commentators, such as Peter Hibberd (former chair of the JCT) defend the current retentions system, believing that it is preferable to focus on preventing abuse of the existing system rather than seek a legislative solution which might create as many problems as it solves.

Those opposed to the Aldous Bill reforms are quick to point out that, though a retention deposit scheme has some appeal, the administration of such schemes will necessarily increase bureaucracy and associated costs. The release of such deposits must also depend on some form of mechanism (not detailed in the Aldous Bill), which they suggest might be as equally open to misuse as the current system in terms of delay, for example. Others have queried whether third-party deposit holders would be competent to decide whether retention monies should be released given the complexity of issues that can arise in construction projects, although in the author's view this could be resolved by way of providing for release against an adjudicator's decision.

COMMENTARY

Although a significant percentage of the industry would rather abolish cash retentions, this may be harder than it seems given that previous attempts at prohibiting the practice by certain industry bodies in the UK were ruled as anti-competitive. It is quite possible that regulation of retention deposits by an independent third party would help reduce some of the abuse of the current system (once the fine details of the retention deposit scheme have been worked out). While the recent reforms in New Zealand and NSW are arguably too recent to make any concrete conclusions as to their success, certainly the UK should be able to learn from any early feedback.

Any changes to retentions legislation will likely be binding only in relation to projects in those jurisdictions. However, clients and contractors on international construction projects should take heed of these developments and consider whether an alternative to traditional cash retentions may be more appropriate for their projects. Reducing or removing cash retentions may ease cash flows on a project throughout the supply chain, reduce pressure on contractors' balance sheets and improve working relationships and trust between contractors of all tiers.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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