HOW DO YOU SOLVE A PROBLEM LIKE RETENTIONS?

WRITTEN BY KATE HOLLAND

The use of retentions in construction contracts is culturally ingrained in the industry but it is increasingly seen as an outdated and unfair practice. In the UK, there have long been calls to abolish or regulate retentions, but little progress has been made to date. The UK Government recently announced that it will compel large companies in the construction sector to report on and publish information about their retention payment practices. In this article we look at the problem with retentions, the progress of reform in the UK, and the approach which New Zealand has taken.

What are retentions?

Retention clauses are very common in construction contracts. It's where a head contractor holds back a percentage of the value of a construction contract (usually 5–10%) as a form of performance security until any outstanding works or defect remediations are completed.

Retentions are widely used in construction across the UK, Australia, New Zealand, Canada and the US, but the regulation and legal rules governing the practice in each country are different.

"Waiting for the retentions culture to change on its own could be like waiting for Godot."

A thorny issue

→ Retentions are increasingly seen as outdated and unfair to small firms, but attempts to regulate or abolish them in the UK have repeatedly failed.

The problem with retentions
Once a project is finished, it can be difficult to get a busy subcontractor back on site to rectify any defects. So, on the one hand, retentions are a good way to ensure subcontractors get the job done on time and to standard, and fix any defects quickly so they can get paid. They also provide protection for principals and head contractors in case a subcontractor goes insolvent before the work or defect rectification is finished.

While retentions may encourage efficiency and timely defect rectification, they also have serious negative impacts. For small business subcontractors with little bargaining power and no control over their withheld payments, retentions cause cash flow problems and can be uncertain, opaque and open to abuse.

Retentions can be large amounts of money, and late or non-payment is common and crippling for small businesses. Crucially, how can subcontractors be protected from losing withheld payments if the withholding party or a company further up the supply chain goes bust?

What are the rules in the UK?
In the UK, there have been calls to abolish or reform the use of cash retentions for more than 50 years to date. However, little progress has been made so far, and the practice remains largely unregulated.

Lack of regulation
There is currently no statutory requirement to ring-fence withheld retention sums. Retention money can be commingled with other funds and there is no prohibition against it being used as working capital.

The UK's largely unregulated practice of unprotected cash retentions has been criticised as creating an industry where small business subcontractors are subsidising principals and main contractors with unsecured, interest-free loans, and carrying all the risk.

2011 changes to the Construction Act
In 2011, amendments were made to the Housing Grants, Construction and Regeneration Act 1996 so that the release of retention payments could no longer be conditional on the performance of obligations or payment under another contract. These changes were intended to prevent subcontractors further down the supply chain from having to wait for payments to be released further up the chain.

However, research conducted in 2017 found that despite

the statutory prohibition, this type of unjustified delay continues to be prevalent. This has been attributed to lack of knowledge about the new rules, and subcontractors' fears of damaging relationships and jeopardising future work.

The research report was commissioned as part of the Government's review and consultation on retention payments. It concluded that the feasibility of alternative measures needed to be investigated further.

Alternatives to cash retentions

Options for reform involve the use of alternatives to unprotected cash retentions, or mandatory safeguarding or ring-fencing of withheld sums to prevent them being used as working capital or, potentially, lost in insolvency.

Some alternative measures include the use of project bank accounts, retention bonds, performance bonds, insurance policies, or holding the money on trust.

The 2017 research report found that there is not much use of alternative measures in the UK. Principals and head contractors still rate retentions as the most effective form of security against performance and defects, and they see the cost of using alternative measures as a barrier.

Failed attempts at legislative reform

In 2018, UK construction giant Carillion collapsed, owing more than £800 million in unpaid retentions to subcontractors.

This prompted Lord Aldous to introduce a draft Construction (Retention Deposit Scheme) Bill. Had it passed, it would have required retention payments to be paid into a statutory deposit scheme similar to the scheme for tenancy deposits. However, the Bill failed to progress through Parliament before the end of the Parliamentary sitting.

In October 2021, Lord Aberdare went further by introducing a draft Construction (Retentions Abolition) Bill. Had it passed, it would have amended the UK Construction Act to prohibit the use of retentions, and would have required a move to alternatives such as retention bonds. Lord Aberdare remarked:

> *The government still hasn't decided on a legislative approach to tackling retentions, claiming to be waiting for the emergence of an industry consensus, which seems less likely to arrive than Godot.*

However, that draft Bill also failed to make any progress, and further attempts at legislative reform have stalled.

Reporting on Payment Practices and Performance Regulations 2017

In a recent development, in November 2023 the UK government announced that it will extend and amend the Reporting on Payment Practices and Performance Regulations 2017 to introduce mandatory reporting of retention payment practices in the construction sector. The reporting obligations will only apply to large companies.

These amendments are part of the government's Prompt Payment and Cash Flow Review – a wider effort to support small businesses and improve the culture of late and non-payment of invoices generally across all sectors.

UK industry led efforts at reform

The Construction Leadership Council

The Construction Leadership Council (**CLC**) aims to phase out retentions by 2025 and is collaborating with other industry bodies to achieve this.

In November 2022, the CLC and NEC published guidance on alternative approaches to drafting construction contracts to avoid the need for retentions clauses. NEC's suite of construction documents does not include retentions in its standard clauses, although there are optional retentions clauses. Where retentions are used, there are optional clauses to safeguard them by using project bank accounts.

In October 2023, the CLC announced a pilot project to phase out the retentions culture by tackling the real source of the problem – the underlying culture of defective work. The CLC will collect data about defects from completion certificates in real projects, the reasons those defects arise, and how they could have been avoided. The aim is to develop long-term solutions to improve standards and prevent and eliminate defects in the future so that retentions will no longer be needed.

Build UK

Industry body Build UK is also committed to delivering zero retentions by 2025. It has developed and published minimum retentions standards for its members, along with drafting guidance for amending JCT and NEC contracts to implement them. Under these minimum standards, retentions can be retained from permanent works only, as security against defects only, and deducted at the end of works only – not from interim payments from the start.

In August 2021, Build UK published a Roadmap to Zero Retentions setting out how to eliminate retentions by 2025. It also collects and publishes information which allows small businesses to get an idea about companies' retentions and payment practices before deciding to do business with them.

How do retentions work in New Zealand?

In New Zealand the use of retentions is allowed, but is regulated by the statutory regime in the Construction Contracts Act 2002 (Subpart 2A- Retention Money). Retention sums are ring-fenced by being held on trust. The party withholding the money must also comply with the regime's accounting, disclosure and reporting requirements and there are penalties for non-compliance.

New Zealand's first retentions regime

New Zealand's retentions regime was first introduced in 2017, after the collapse of construction giant Mainzeal. As with Carillion in the UK, the collapse resulted in huge losses of retention payments for subcontractors.

Under the regime, retention money is held on trust to ring-fence it for the subcontractor and prohibit it being used as working capital. The money can only be used to remedy the defects. The regime applies to retentions in all commercial construction contracts, unless an alternative instrument is being used (such as a bond, guarantee or insurance policy).

Defects in NZ's new retentions regime come to light

However, there were problems with the drafting and operation of the statutory retentions regime which undermined its intended purpose. It was found that retention money was still at risk where the party withholding it became insolvent or commingled it with its other funds.

Commingling and lack of transparency

In the interest of mitigating compliance costs, the legislation did not require retention money to be held in a separate bank account and did not prohibit intermingling with other funds. The money also did not have to be held as cash.

There was also a lack of transparency, as the party withholding the retention money was not required to provide information to the subcontractor about the retention money, unless the subcontractor specifically requested it.

No automatic deemed trust

Another major problem was identified by the High Court in 2018 after several large construction companies became insolvent owing retention money to subcontractors. The High Court ruled that due to deficiencies and imprecise language in the new legislation, it did not have the intended legislative effect of creating a deemed trust for subcontractors' retention money, it only created an obligation to hold the money on trust.[1]

NZ's rectified retentions regime

In order to close these loopholes and better protect subcontractors, in April 2023 the NZ Parliament passed the Construction Contracts (Retention Money) Amendment Act 2023 (the **Amendment Act**). The changes recently came into force on 5 October 2023.[2]

Automatic creation of a trust

The legislation was redrafted so that retention money is now automatically held on trust by the party withholding it. The creation of a trust is triggered at the time when the money becomes retention money under the terms of the contract.

1 *Bennett v Ebert Construction Limited (in receivership and liquidation)* [2018] NZHC 2934 at [62]–[63].

2 For full details of these recent changes, please see our article Parliament passes sweeping amendments to construction payment regime.

If the party withholding the retention money wants to use it to remedy defects, it must give the subcontractor 10 days' advance notice.

No commingling and new transparency

Retention money must now be kept separate from the retention holder's other funds in a separate bank account (or by way of a financial instrument such as insurance or a guarantee/bond).

Clear accounting ledgers must be maintained and the party withholding the money must report to the subcontractor after the money becomes retention money, and at least every three months thereafter.

Offences and penalties for non-compliance

The amendments also introduced penalties for non-compliance. There are cumulative penalties for each breach of the rules, including fines for failing to keep retention money as required, keep accounting records or provide regular reports. Company directors can also be held personally liable and fined.

Conclusion

So how do you solve a problem like retentions? New Zealand has chosen to regulate them by creating automatic statutory trusts to ring-fence retention money. But the teething problems with the new legislation show that creating a retentions regime that actually works is no easy task.

The UK legislature on the other hand seems to be taking a less interventionist approach in the hope that industry-led efforts will mean that the use of retentions will gradually die out by itself. While the introduction of mandatory reporting on retentions is a welcome development, it is hardly the radical reform that many in the industry are calling for. As Lord Aberdare quipped, waiting for the UK's retentions culture to change on its own could be like waiting for Godot.

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