



Retentions

Striking out cash retentions



Given the doubtful benefits and the clear disadvantages of retentions, it would obviously be in everyone's interest for such an inefficient – and frequently harmful – practice to disappear.



House of Commons Trade & Industry Committee



HCC INTERNATIONAL
INSURANCE COMPANY PLC

NSCC
National Specialist
Contractors Council

Please note that this guidance is designed to give general guidance on best practice; it is not intended to provide legal advice. NSCC and the organisations responsible for its content do not accept any liability arising in any way from relying on this guidance. If you require advice on a specific issue, you should seek your own independent legal advice; NSCC Specialist Contractors can contact the NSCC legal and contractual helpline provided by Wedlake Bell on 0844 249 9871.

Wedlake Bell

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Introduction

Retentions remain a source of frustration for the majority of Specialist Contractors. An outdated practice which is out of place in the modern construction industry, cash retentions cost the specialist sector a substantial sum each year. The 2005 NSCC payment survey suggested that as much as £680 million was withheld in retentions against NSCC Specialist Contractors. The cost of chasing and in many cases ultimately writing off outstanding retention monies has a damaging effect on SMEs and on occasions it can even threaten their survival.

What's more, as a means of ensuring the required standards of workmanship, retentions are no longer an effective weapon. The best guarantee of quality lies in the choice of a competent and qualified Specialist Contractor and, in recognition of this, NSCC is calling for an end to cash retentions in favour of more modern and practical alternatives.

This guidance note is one of a series published by NSCC as part of its Fair Payment Campaign, which was launched in September 2007 to improve payment practices in the construction industry. The campaign has 3 objectives: certainty of payment, 30-day payment periods and the removal of retentions, which is dealt with in this guidance note. For advice on achieving certainty of payment or 30-day payment, you can download the appropriate guidance note from www.fairpaymentcampaign.co.uk.

By following the advice in this guidance note and implementing the campaign objectives within your business, you can help NSCC to change payment practices and make the construction industry a fairer place for all Specialist Contractors.

To show your support for the NSCC Fair Payment Campaign, sign up to the campaign at www.fairpaymentcampaign.co.uk and use the campaign logo on your company stationery and invoices.

What Is Retention?

Cash retention is the most prevalent form of protection against sub-standard work on a construction project.

The idea behind it is simple: as the works proceed, the client pays the contractor on a regular basis for the work that the contractor has done but he retains a percentage of the value of the works as a 'fund' to put towards the cost of the contractor not finishing the job or the cost of correcting any defects in the finished building. When the entire project is finished, half of the fund is returned to the contractor and the other half is retained by the client for a maintenance period of usually one year pending the completion of any remedial work required by the contractor.

Under a Fair Payment Charter to be implemented on public sector projects from 1 January 2008 (full details of which can be found in the guidance note on 30-Day Payment), the arrangements for retention agreed by the client must be 'replicated on the same contract terms throughout the supply chain'. This means that a contractor cannot hold more retention from his sub-contractors than the client is withholding from him. So if a public sector client is not holding retention from a contractor, the contractor cannot hold retention against you.

The Case Against Retentions

The main purpose of retention is to give a client certainty that the contractor will complete the work and fix any problems that emerge within an agreed period of time after this.

In the past, when main contractors employed direct labour for all but the most specialist trades, this made sense. On a £5 million project, the client would hold from the contractor 3% in retention (£150,000) until completion and half of this (£75,000) until a year later when the defects correction period expired. As the majority of this money actually belonged to the contractor (and constituted a large part of his profit), it was an effective incentive for him to complete the work and to repair any defects that might arise in it. It didn't matter what was defective: if there was a £20,000 problem with the plastering and painting, it was worth the contractor spending this to get the rest of his £75,000.

However, in today's industry, where 90% of construction work is carried out by the supply chain, retentions don't work because 90% of the retention held by the client doesn't actually belong to the main contractor; it belongs to the Specialist Contractors that have built the job for him! Taking the £20,000 plastering and painting problem: if the combined value of the specialist contracts for these 2 trades was 10% of the £5 million contract sum (£500,000), the contractor would only have £7,500 held against the relevant Specialist Contractors during the defects correction period. This, *of itself*, is clearly no incentive for the Specialist Contractors to come and spend £20,000, rendering the use of retention as a financial stick pointless.

A competent Specialist Contractor will always return to site to correct defects in his work because his professional integrity demands it and his reputation depends on it – not because the contractor has held retention against him.

If the contractor does *not* select competent Specialist Contractors and the relevant trades don't return to correct defects in their works, the retentions system is undermined completely. This is because the contractor doesn't get *any* of the retention until the defects have been put right (either by him or an alternative Specialist Contractor) and in the meantime neither do *any* of his Specialist Contractors, the majority of whom have done nothing wrong!

Why retentions don't add up

On a £5,000,000 project where a problem arises with the plastering and painting work:

Value of plastering and painting work	£500,000
Retention held against plastering and painting Specialist Contractors during the defects correction period	£7,500
Cost of rectifying plastering and painting problem	£20,000
	– £12,500!

For competent Specialist Contractors, cash retentions are both ineffective and unfair with the key problems including:

- **Overdue retentions** – The main problem for Specialist Contractors is overdue retention payments, which are held for longer than the contractual retention period. This unfair withholding of retentions by contractors, often for no other reason than to maintain their own cash flow, clearly has an adverse impact on the cash flow of SMEs in the specialist sector. This is exacerbated by the costs involved in actually having to chase overdue retentions, a significant overhead for the majority of Specialist Contractors, who often have no idea if or when the retention has even been released to the contractor.
- **Lost retentions** – An equally big impact is caused by lost retentions. Retention monies are either not returned in their entirety due to spurious claims against the retention fund, lost through the insolvency of the companies holding them, or simply written off by Specialist Contractors because the cost of recovery is disproportionate to the amounts withheld. The combination of these factors can equate to substantial sums belonging to SMEs in the specialist sector being written off, which eats into already small profit margins.
- **Costs of remobilisation** – As already explained, cash retentions do not fulfil their intended purpose as the amount withheld is often less than the actual cost of remedying defects. This is particularly true for specialist trades that have high costs of mobilisation, because, in the event that defects are found, the retention sum does not even cover the cost of returning to site.
- **Outdated** – The biggest argument against retentions is that they are out of place in a high quality modern construction industry where relationships are based on trust. The imposition of retention indicates distrust in the other party's ability to perform to a high standard. The best guarantee of quality lies in the choice of competent and qualified Specialist Contractors such as those within NSCC, whose professional integrity will bring them back to site in the event of a defect being discovered – not the possibility of losing their retention sum.

A change in the way that the construction industry operates, increased collaborative working, and improved quality amongst Specialist Contractors mean that the need for retentions has largely been removed.

Striking Out Retentions

The NSCC Fair Payment Campaign is calling on all Specialist Contractors to 'strike out' the cash retention clauses in their contracts.

Negotiating with the contractor

Before you start work, let the contractor know that you are a member of a recognised trade organisation and what that stands for. Explain that you were vetted prior to joining and whether you are vetted periodically on an ongoing basis. Make it clear that you would prefer not to accept cash retention and offer an alternative such as a retention bond (see Alternatives To Cash Retentions on page 8).

You may find that a lot of contractors are reluctant to accept this – after all, it may mean them having to pay you cash that they have not actually received themselves! The best remedy is perseverance; however, there are a few things you can offer to overcome the contractor's financial problem of having to fund the retention and should make the pill easier to swallow:

- > Issuing the bond in favour of the contractor's client if he will agree to release the value of your retention to the contractor
- > A discount in the sub-contract sum equal to the cost of financing the retention that the contractor has to pay you before he gets it himself, which can be calculated at roughly 0.5% per month on the amount of retention for the period that it would have been held.
- > If the contractor still insists on cash retention, a discount in the sub-contract sum in return for a reduced rate of retention or a reduced rate which is only deducted from the last few payments rather than throughout the works. The less cash retention required, the greater the discount you can offer whilst still gaining a financial benefit from getting your money earlier.

Amending your contract

Having hopefully agreed with the contractor an alternative form of security to cash retention, make sure that your contract reflects this and the cash retention clause does not apply. In the majority of the standard forms such as JCT, NEC and ICE, the best way of doing this is to write '0%' in the appropriate box in the articles in the sub-contract:

JCT Design and Build Sub-Contract 2005

8. Retention Percentage (Clause 4.15)

The Retention is per cent
(The percentage is 3 per cent unless a different rate is stated)

FPS Retention Policy

In the mid 1990s, Specialist Contractors in membership of the Federation of Piling Specialists (FPS), an NSCC member organisation, implemented a 'no retentions' policy, which was re-adopted in 2003. The cost of outstanding retentions coupled with the fact that, on the majority of piling projects, the amount withheld did not cover the cost of mobilisation back to site if defects were found led to FPS members deciding to offer alternatives to cash retentions. The result has been emphatic: it is now accepted within the industry that retentions will not be withheld for piling work.

NSCC is calling on all Specialist Contractors to follow the lead of the FPS and its members, and strike out cash retentions in favour of more practical forms of protection against non-performance.

FPS Retention Policy

In line with the House of Commons Trade and Industry Committee report on the use of Retentions within the Construction Industry, the FPS agrees that the withholding of retention is an outdated practice which should not be necessary in a modern, productive industry which delivers a high quality product.

In line with this ambition the FPS Registration System ensures that member companies achieve and maintain the highest standards in Safety, Quality and Technical performance. It is FPS policy that Members are free to negotiate their own contract terms and that they should continue to offer alternatives to cash retentions.

***Adopted by the members of the Federation of Piling Specialists
13 February 2003***

Alternatives To Cash Retentions

Although the best guarantee of performance lies not in financial leverage but the selection of a properly qualified Specialist Contractor that is able to carry out the required work to a high standard, it is accepted that clients require a form of monetary protection in the event of defects being discovered in their supply chains' works.

However, you can offer substantial security to clients and contractors for the work that you carry out without providing cash retentions.

Retention bond

A retention bond is an agreement between a contractor, a Specialist Contractor and a third party known as a surety or guarantor. In simple terms, the agreement states that, in return for the contractor agreeing not to hold cash retention, the surety will undertake to pay the contractor up to the amount that he would have had by way of retention should the Specialist Contractor fail to carry out the works or remedy defects. The bond is usually a conditional or 'default' type bond where the surety is an insurance company.

Contractors often now view Specialist Contractors as critical partners in the delivery of projects and understand that making cash retentions available to them improves their financial stability. Indeed an additional benefit to the contractor of retention bonds is that a company which is able to offer them will have had its financial standing vetted by the surety. This is increasingly being recognised by clients, many of whom are now happy to accept retention bonds in place of cash retention.

The circumstances under which conditional retention bonds can be called are limited to prevent abuse. A bond can only be called where there is a proven default or defect and where the Specialist Contractor is unable or unwilling to remedy it.

On demand retention bonds

There is another type of retention bond called an 'on demand' bond. This, as its title suggests, allows the contractor to demand payment under the bond without having to prove that a defect is present or that the Specialist Contractor is unable or unwilling to correct it. In the case of on demand retention bonds, the surety is usually your own bank and the bonded amount is set against your borrowing capacity, which will reduce your overdraft limit until such time as it is returned.

Banks may also provide a bond which is on demand but 'subject to satisfaction of stated conditions'. However, such conditions are likely to fall short of those contained in a conditional bond issued by an insurer. Beyond checking that the conditions have been met, the bank will not carry out any further investigation to ascertain that the Specialist Contractor has defaulted.

You should be extremely cautious about offering on demand bonds as they can be called without good reason and it is you (not your bank) that will be responsible for recovering the money. In making payment to the contractor, the bank will also reduce your bargaining position.

Before agreeing to provide an on demand retention bond, you are strongly advised to contact the NSCC legal and contractual helpline provided by Wedlake Bell on **0844 249 9871**.

Getting a bond

All NSCC Specialist Contractors have access to a guaranteed retention bond facility as a result of NSCC's partnership with HCC International Insurance Company plc. With a retention bond from HCC International, you can offer your clients the same level of security that they would get from a cash retention. HCC International will not require cash collateral in all cases but, where they do, the collateral held by them will earn you interest rather than your client. In such cases, the premium on the majority of retention bonds with HCC International will be less than the interest lost on withheld cash retentions and, as the HCC International bond is a conditional bond rather than an on demand bond, your borrowing capacity will not be affected.

For further information, call **0844 249 5901**.

Points to remember

When providing a retention bond, there are a number of things that you should remember:

- > **Condition precedent to payment** – Look out for any clauses in your contract documentation that make agreement or execution of the bond a condition precedent to payment. Unless it is entirely within your power to agree the wording and provide the bond before you start work on site, you could find that a delay in doing so will mean that you don't get paid.
- > **Bonds bound into contracts** – You should always beware of the wording of bespoke bonds bound into contracts as they may be unacceptable to sureties and, if the bond is a condition precedent to payment, it could give the contractor reason not to pay you if you cannot get the bond as drafted.
- > **Expiry date** – As retention bonds normally incur an annual charge rather than a one-off fee, you should make sure that any bond you offer contains a fixed expiry date and doesn't rely on the issue of the certificate of practical completion (or sometimes the expiry of the rectification period) to release it.

Why it's worth it

The cost savings to be made by offering retention bonds in place of cash retentions are substantial. One NSCC Specialist Contractor retained the use of £37,500 on just one project by offering a retention bond in place of cash retention. On the company's biggest order to date, which was in the region of £750,000, he managed to negotiate placement of a retention bond for £1,300 in lieu of a retention, which would have had an impact on his cash flow of almost 30 times that! Most importantly this was achieved without damaging the relationship with his client – and in the face of an initial reaction of 'take what's on offer or we'll get someone else who will'!

The clear and well reasoned advice that I received at an NSCC payment seminar empowered me to approach my clients in an informed and firm manner regarding the issue of retentions. We have since negotiated the removal of retentions on 3 new orders and put retention bonds in place on 2 of these. So far this means that around £60k remains in our cash flow rather than in another company's interest bearing account.

Gordon Harris, Advanced Roofing & Flooring, a SPRA member.

Defects rectification period

If your contract does not include a defects rectification period, you can offer one in return for no retention. Point out to the contractor that, in the event that a defect appears in your works, the retention is not likely to be sufficient to cover his costs and he would be better served by a defects rectification period during which you will return to remedy any defects. If you can agree this upfront, it can be recorded in your contract; if you have already completed your works or are in the process of doing so under a contract which does not have a defects rectification period, you can issue a letter signed by a Director on behalf of the company requesting release of retention in return for confirmation that you will return to remedy any defects which arise within a specified period of time.

Letter 1 –

Offering defects rectification period in return for release of retention

<Insert address of your client>

<Insert date>

For the attention of: *<Insert name of your client contact>*

Dear Sirs

Re: Defects Rectification Period

We confirm that in consideration of you releasing retention monies held against the sub-contract works, we shall, within a reasonable time of receipt of your written instructions to do so, make good at our own cost any defects, shrinkages and other faults within the sub-contract works, which appear and are notified to us within *<insert appropriate period e.g. 1 year>* of the date of this letter.

Yours faithfully

<Insert signature of Director>

<Insert name of Director>

Parent Company Guarantee

In certain situations, it may be appropriate to offer a Parent Company Guarantee (PCG) instead of cash retention. Where a Specialist Contractor is part of a larger group, its parent (or holding) company may be willing to guarantee that the Specialist Contractor's works will be completed and any defects corrected in the event that the Specialist Contractor does not perform or goes bust.

A PCG is similar in principle to a defects rectification period; however, it may be preferable to a contractor as the undertaking is made by a third party which is often a more substantial entity than the Specialist Contractor.

Nevertheless, many parent companies are reluctant to provide PCGs and it is not common for them to be used in this way, so you should always check with your parent before offering this as an alternative to cash retention.

Joint bank account

It is possible to set up a bank account in the joint names of all of the parties that have retention deducted against them which is used to hold in trust each party's retention until it has fulfilled its obligations under the contract. The advantage of this is that if, for example, the contractor goes bust, his Specialist Contractors can still get their money once they have remedied their own defects.

However, joint bank accounts cost money to establish and administer, and the triggers for the release of the money have to be carefully set out otherwise the money can be difficult to recover. For these reasons, they are generally only for use on large projects where there is a Project Bank Account, although there is nothing in principle to prevent them being used more widely. The Fair Payment Charter actively encourages the use of Project Bank Accounts, and it is likely that high street banks will start to offer a standard service for this once they are convinced there is a market need.

Securing Your Retention

If you cannot strike out the cash retention clause in a contract in favour of an alternative form of security such as a retention bond, it is essential to make sure that you secure the release of your cash.

Getting your contract right

- > **Agree a date** – The easiest and most effective way of securing your cash is to agree up front with the contractor a calendar date for the release of your retention and then write this into your contract (see below). The date should be based on the completion date for the project plus an appropriate period of time to allow for any delay and disruption, extensions of time etc. If you cannot agree a calendar date, you must ensure that there is a clear way of calculating the date on which your money will be released.

Provided that any defects in the sub-contract works, which have been notified in writing by the contractor to the sub-contractor prior to <insert date>, have been rectified and, notwithstanding any other provision of this agreement, it is agreed that any retention held under this agreement shall become due and payable to the sub-contractor on <insert date>.

- > **Automatic release** – The JCT sub-contracts adopt a good model for the release of retention by requiring the contractor to automatically release the second half of the retention to his sub-contractor unless he has notified his sub-contractor of a defect in the works. By including a similar clause such as the one below in your contract, you can ensure your retention automatically becomes due for release on the expiry of the rectification period under the main contract. If the contractor fails to release your retention and has not notified you of any defects in your works, he will be in breach of contract and you will be able to bring a claim against him for damages.

Subject to there being no defects in the sub-contract works or such works in a section on the date of the expiry of the rectification period of the main contract for the main contract works or relevant section, the balance of any retention deducted and retained by the contractor shall be included in the next interim payment following the expiry of the applicable rectification period.

If there are any defects in the sub-contract works or such works in a section on the date of the expiry of the rectification period of the main contract for the main contract works or relevant section, such defects shall be stated in a list issued by the contractor to the sub-contractor. The balance of any retention deducted and retained by the contractor shall be included in the next interim payment following the making good of all such defects on such date as may be agreed (which agreed date shall be confirmed in writing by the contractor to the sub-contractor) or as may be determined by adjudication or, in the absence of such agreement of determination, following the issue of the notice of completion of making good defects under the main contract for the main contract works or relevant section.

- > **Developers** – Look out for a developer appointing one of its group companies as contractor. The developer may be a shell company with no equity which can be put into liquidation at the end of the project. In this event, getting paid your retention is highly unlikely – especially if there is a clause in your contract stating that the contractor does not need to pay his Specialist Contractors if the developer goes bust.

Obtaining payment

If you have agreed a date for the release of your retention, chasing it when it becomes overdue is quite straightforward:

- Diarise the release dates of your retentions and write to the appropriate contractor a couple of weeks before a retention is due for release to remind the contractor that it is due for payment (see letter 2 on page 16).
- If you do not receive your retention on the date that it is due, you should write again to the contractor requesting its immediate release (see letter 3 on page 17). You are asked to send a copy of this letter to NSCC to assist NSCC in compiling evidence on contractors that unfairly withhold retentions from their supply chains.
- If the contractor doesn't reply or refuses to pay the outstanding sum, you have a 'dispute' which you can refer to adjudication or the Small Claims Court. For further information on adjudication, NSCC has published its Top 10 Tips for Adjudication; for a free copy, call NSCC on **0844 249 5351** or visit www.nsc.org.uk. To find out more about the Small Claims Court, go to www.hmcourts-service.gov.uk.

If you don't agree a release date for your retention and don't know for certain when it is due, chasing it is much more difficult. However, you shouldn't give up – it is your money and you are entitled to it.

- Contact the architect on the project to enquire whether the Certificate of Making Good Defects has been issued
- Send a letter to the client with details of the project to find out if he has released the retention to the contractor and tell him that you haven't had your retention yet
- Write to the contractor every month, claiming interest on the outstanding sum if you believe it is overdue
- Make a nuisance of yourself!

Letter 2 –

Reminding a contractor about an imminent retention

<Insert address of contractor>

<Insert date>

Dear *<Insert name of contractor>*

Re: Release of Retention – <Insert name of project>

As agreed in our contract dated *<insert date of contract>* for the above project, the retention held against our works is due for release on *<insert date agreed in contract>*.

As we have received no information from you to suggest otherwise, we assume that no defects have been found in our works and we would be grateful if you could arrange for payment of our retention to be made on this date.

If you have any queries regarding our retention, please do not hesitate to contact us, otherwise we look forward to receiving payment in due course.

Yours sincerely

<Insert signature>

<Insert name>

Letter 3 –

Chasing a contractor for payment of an overdue retention

<Insert address of contractor>

<Insert date>

Dear *<Insert name of contractor>*

Re: Outstanding Retention – <Insert name of project>

Further to our letter dated *<insert date of letter 2>*, our retention on the above project was due for release in accordance with our contract dated *<insert date of contract>* on *<insert date agreed in contract>*.

However, we note from our records that payment remains outstanding.

Should we not receive payment within 7 days of the date of this letter, we reserve the right to take appropriate action to recover the debt without further reference to you.

If you have any queries regarding this, please do not hesitate to contact us.

Yours sincerely

<Insert signature>

<Insert name>

cc. NSCC
Royal London House
22-25 Finsbury Square
London
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Checklist

1. Explore **alternatives** to cash retentions such as retention bonds – all NSCC Specialist Contractors have access to guaranteed retention bonds from HCC International Insurance Company plc; for further information, call **0844 249 9871**.
2. **Negotiate** with the contractor about accepting an alternative to cash retention, offering an incentive such as a discount if necessary
3. Check your contract and **'strike out'** cash retention by inserting '0%' in the appropriate box
4. If you can't strike out cash retention, make sure you **secure** it by writing a release date into your contract
5. Don't give up on outstanding retentions – it is your money and you should always **chase** payment of it.



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