Cash retentions post Carillion

Stephen Radcliffe of **Walker Morris LLP** considers the implications of the Carillion collapse and what it means for the practice of cash retentions. A Private Members' Bill might provide impetus for long awaited reform of retentions.

KEY POINTS

- Carillion's demise means increased focus on cash retentions and payment practices more widely
- Insolvency of a contractor can have a massive impact further down the supply chain
- In many cases retention monies are not ring-fenced, which means the chances of being paid on a contractor insolvency are effectively nil
- Government is consulting on cash retentions and will explore the appropriateness of a 'cap' on the proportion of contract value that can be held in retention (and the length of time it can be held)
- The effectiveness of alternatives to retentions will also be examined
- The costs and benefits of a 'retention deposit scheme' will be considered

'To ask Her Majesty's Government, in the light of the loss of retention monies by small firms following the insolvency of Carillion, what steps they are taking to provide protection against such losses in the future.'

This was the question posed in the House of Lords by Lord Aberdare on 21 February 2018. Just over a month earlier, on 15 January 2018, UK construction giant Carillion fell into compulsory liquidation after last-ditch rescue attempts failed. Its collapse poses many more questions and leaves a potentially devastating trail of uncertainty for the group's many thousands of suppliers, employees, customers, shareholders, lenders, joint venture partners, creditors, pension scheme members and overseas operations, and over the future of its public-sector contracts and key infrastructure projects.

Various inquiries and investigations were launched in the immediate fallout. The Business Secretary asked the Insolvency Service to fast-track its investigation into the cause of the collapse and to broaden the scope to include previously employed directors. He also asked the Financial Reporting Council to conduct an inquiry into the preparation and audit of Carillion's accounts. A wide-ranging joint pensions and business committee inquiry is looking at 'the management and governance of Carillion, its sponsorship of its pension funds, and the implications for company and pension scheme law, regulation and policy'; while a separate parliamentary inquiry is looking at 'how Government and the public sector makes decisions about how to source the delivery of public services, including the risks of concentrating a large number of contracts with a small group of large companies'.

One issue brought into particularly sharp focus following Carillion's demise is that of cash retentions – and payment practices more widely – in the UK construction industry. The practice of retentions is long-standing and widespread (as is the practice of delaying paying them out). A percentage of the value of the work, typically 5%, is withheld by the employer (under a main contract) or the contractor (under a sub-contract) until completion or rectification of defective work. The retention is usually released in two parts – half at completion, and half on expiry of the defects liability period, some time later. Following changes to the *Housing Grants, Regeneration and Construction Act 1996* (*HGRCA 1996*), any terms dealing with release of a retention to a sub-contractor must be linked to an event in the sub-contract (as opposed to an event in the main contract, outside the sub-contractor's control).

Retentions act as a kind of security against non-performance and, in the case of the employer/client, can protect against contractor insolvency. However, for sub-contractors and businesses further down the supply chain, it is upstream insolvency – of a contractor like Carillion – which can have a massive impact. In many cases retention monies are not ring-fenced, which means the chances of being paid on a contractor insolvency are effectively nil. According to Lord Aberdare, Carillion held some £700 million of retentions, which its suppliers have now lost.

What steps are the government taking?

On 24 October 2017, the Department for Business, Energy and Industrial Strategy (BEIS) launched a consultation seeking information on the practice of cash retention under construction contracts (alongside a parallel consultation on the effectiveness of 2011 changes to the *HGCRA 1996*). The consultation also sought views on the findings of supporting documentation – a research paper prepared by Pye Tait Consulting on behalf of BEIS ('BEIS Research Paper 17 – Retentions in the Construction Industry'). The consultation closed on 19 January 2018, just a few days after Carillion's collapse.

The government agreed to undertake a review following concerns over unjustified late and non-payment of retention payments, and a need to improve payment performance and practices in the construction sector more generally. It says that there is evidence that some payment practices prevalent in the industry, including cash retentions, are 'a barrier to investment, productivity improvements and growth'. There are particular concerns about the potential impact on small firms in the supply chain.

Among other things, the consultation aims to explore further: the appropriateness of a 'cap' on the proportion of contract value that can be held in retention (and the length of time it can be held); the effectiveness of existing alternative mechanisms to retentions; and the costs and benefits of a 'retention deposit scheme'.

The research conducted by Pye Tait Consulting is revealing. Here are extracts from its findings:

- Half of all contractors surveyed had retentions held against their work in the past three years. A further 19% had held a retention from a contractor further down the supply chain, as well as having retentions held from them in relation to their own work.
- The majority of clients and contractors surveyed who have held retentions in the past three years do not segregate the monies into a separate account, but retain the funds within their main bank account. This means that retention monies owed (at a future date) to contractors and sub-contractors can be used in other ways.
- Survey data show there are five main impacts of the practice of holding retentions throughout the construction sector supply chain, notably: higher business overheads; administrative time incurred as a result of dealing with retentions (for instance time spent obtaining payments); costs of construction sector works are deemed generally higher; and weakened relationships with a) clients; and b) the rest of the supply chain.
- Around 40% of respondents to the client survey with experience of retentions in the last three years think overall project costs are higher because of retentions, and 18% of contractors surveyed with experience of retentions in the last three years say they increase tender prices by an amount equal to or higher than the retention.
- Survey evidence finds delays in paying retention monies are commonplace in the construction sector. Around 71% of contractors surveyed with experience of having retentions held in the last three years have experienced delays in receiving retention over the same period.
- The extent of the delay is more pronounced for sub-contractors (ie tier 1 and 2 contractors) compared to main contractors, in relation to the average time period over which retentions are actually held, compared with how long they are intended to be held, after practical completion. Survey data show tier 1 contractors experiencing on average delays of nearly 3 months, compared with delays of almost 7 months for tier 2 contractors, and delays of just over 9 months for tier 3 contractors.
- Not all retention monies are fully paid. Survey evidence suggests it is more likely that retentions are not repaid either fully or partially at tiers 2 and 3 of the supply chain. Survey data find tier 2 contractors did not receive retentions back in full upon practical completion in 37% of all tier 2 contracts, while tier 3 contractors did not receive retentions back in full upon practical completion in 35% of all tier 3 contracts.
- The risk of non-payment of retention monies as a result of upstream insolvencies is increased because of the length of time for which the retention is held (ie typically paid back late or can be held for a long period of time during the defects liability period even if no delay in paying the retention).
- Around 44% of contractors surveyed with experience of having retentions held from

them in the last three years had experienced non-payment of retentions, due to upstream insolvencies over this period which suggests there could be a case for ring-fencing the retention in some way.

- Multiple contractors within the supply chain could be affected by insolvency of one large main contractor or client. This is because one client or main contractor could be involved in a high number of construction contracts at a given point in time. There is no strong evidence to suggest that holding retentions is a direct cause of insolvencies, although they may be a contributory factor particularly in a difficult economic climate.
- Evidence obtained from in-depth interviews and workshops also pointed to perceived problems with payment practices being time consuming and complex generally in the construction sector – indicating that retentions are just one aspect of what may be a more significant general issue.
- The 2011 changes to the *HGCRA 1996* mean that it is no longer possible to make payment conditional on the performance of obligations under another contract. There is an indication that a number of businesses in the sector do not yet understand, or have no knowledge, of this change and the greater certainty of entitlement to payment it should bring.

In a joint response to the government's consultation, Build UK, the Civil Engineering Contractors Association and the Construction Products Association have called for legislation to abolish cash retentions entirely, supported by an industry-led roadmap to aid the transition to zero retention by 2023 and drive the cultural change needed. This includes adopting a series of minimum retention standards on new contracts by 2019. Among other things, they say that where retention is not recovered, there can be a significant impact on a company's profit margin on a project, which is already likely to be under pressure; and this reinforces the need to change the construction business model as current operating margins are not sustainable for the level of risk that companies are taking on.

Where are we now?

There are a number of potential alternative mechanisms, including project bank accounts, trust funds/accounts, retention bonds, performance bonds, parent company guarantees and escrow stakeholder accounts. However, they each have their advantages and disadvantages. Pye Tait Consulting concludes that the potential alternatives warranting further investigation are those which appear to be applicable to the whole of the sector, eliminate some of the critical issues associated with retentions (notably the risks of unjustified delayed or non-payment of retention moneys, and the impacts of insolvency) and provide the surety against defects as retentions do. These are retentions held in trust and a retention deposit scheme.

In its consultation, the government seeks to explore the design, costs and benefits of introducing a retention deposit scheme (similar to the Tenancy Deposit Scheme), with the retention monies being held in trust in a separate, ring-fenced account. It says that any measure to require the use of trust accounts for retention money needs to be simple, consistent and transparent, particularly if it is to benefit small firms in the construction supply chain. Both Australia and New Zealand have introduced ring-fencing legislation.

The government is under added pressure in the form of a Private Members' Bill – the Construction (Retention Deposit Schemes) Bill 2017-19 – which is sponsored by former chartered surveyor Peter Aldous MP and aimed at protecting retention deposits in connection with construction contracts. The Bill had its first reading in the House of Commons on 9 January 2018, just days before Carillion's collapse. Its second reading debate is scheduled for 27 April 2018.

Conclusion

In the words of Lord Henley, BEIS Parliamentary Under-Secretary of State:

> 'My Lords, I agree with some of the noble Lord's analysis about problems related to retention, a practice that is common within the construction industry but which has negative impacts. That is why we had the consultation, as I think he knows. We obviously want to consider the results of that consultation and in doing so we will look, as he has suggested, at Peter Aldous's Bill and see whether it is appropriate that we can take further steps. But the consultation having been completed, we need to consider it first.'

Watch this space. **CL**