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NEC and CLC Guidance for Dealing with Retention Payments Under NEC3 and NEC4 Contracts

1.0 Introduction

1.1 Retention payments are a longstanding contractual practice within the construction industry, intended to provide security against defective work, or the insolvency of construction firms in the supply chain. The principle of a retention is to secure performance and incentivise the elimination of Defects in an industry where the quality of work remains inconsistent. However, they can create problems for businesses throughout the construction supply chain due to the late and non-payment of retentions or through upstream insolvency resulting in the retention being permanently lost.

1.2 In the Government's 2018 consultation on the practice of cash retention under construction contracts[1], 71% of Contractors who were surveyed reported having experienced delays in receiving monies retained, whilst it is estimated that anywhere between £3.2 and £5.9 billion is retained annually in the construction sector in England alone[2]. This puts unnecessary cashflow pressure on an industry which is an important part of the UK economy, increasing the risk of insolvencies which can in turn disrupt the delivery of projects under construction. Further, the practice runs counter to what is generally considered to be procurement "best practice". This emphasises the importance of collaboration, early supply chain engagement and the involvement of a stable supply chain throughout the delivery phase of a project to manage quality and achieve best value for the Client.

1.3 There remains a range of views across the sector about the practice of retentions. Many amongst the industry are in favour of reform, with a growing consensus that retentions are no longer an effective mechanism for ensuring quality. Often, the need for retentions can also be avoided through good contract management, or (if security is required) the provision of a performance bond or parent company guarantee instead.

1.4 Considerable work has been undertaken and continues by both the Government and the industry to consider the issues surrounding retentions. Many of the current initiatives are being driven through the Construction Leadership Council ("CLC"), with the ambition of moving to zero retentions by 2025, through reducing or eliminating defective construction work and having a procurement and delivery model that recognises, incentivises and rewards consistently high-quality work.

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[1] Retention Payments in the Construction Industry: Summary of Responses, February 2020.

[2] Retentions in the Construction Industry: BEIS Research Paper 17, October 2017.

1.5 These initiatives include the Build UK 'Roadmap to Zero Retentions'[3] endorsed by the CLC, which has been developed and is supported by Build UK, the Construction Products Association and the Civil Engineering Contractor's Association. The Retentions Roadmap outlines a voluntary phased approach to moving towards the objective of zero retentions by 2023, and no later than 2025. Key milestones are set in order to achieve this objective.

1.6 Build UK has also published "minimum standards on retentions". This includes proposed amendments to NEC4 contracts, to provide for a single retention to be taken at Completion. It also includes provisions for enforcing the retentions policy on subcontracts. Whilst this Guidance Note deals with the published NEC clauses on retentions, the comments about the need for retentions would apply if this alternative model was adopted.

1.7 This Guidance Note relates to the use of retention clauses under NEC3 and NEC4 Engineering and Construction Contracts (and sub-contracts). It is written to reflect the terminology in NEC4 Engineering and Construction Contracts, but is applicable to Engineering and Construction Subcontracts and to NEC3 contracts generally. The aim is to explain how NEC deals with defective work and retentions, and to give guidance on why a retention fund may not, in fact, be needed.

2.0 NEC approach to retentions

2.1 NEC provides an optional clause (Option X16) to use a retention fund as security for the Client to protect it from the Contractor's failure to correct Defects. This contrasts with other contract forms where the use of a retention is prescribed rather than optional. Other options can however be used as an alternative. These include the option for a performance bond (Option X13) or ultimate holding company guarantee (Option X4). These may well be more appropriate and useful in providing protection against insolvency if that is judged to be necessary. If agreed by the Client or stated in the contract data, and as an alternative to withholding money, a retention bond can be provided by the Contractor. Option X16 should only be included if the Client considers there is a need for holding such a fund.

2.2 The amount held as retention is calculated by taking a percentage of the Price for Work Done to Date (payment for work completed) in excess of a retention free amount. This is halved when the works are complete or taken over and the balance returned at the issue of the Defects Certificate. The standard approach of linking retention to the value of work carried out recognises that early in the contract there is little need for security against defect correction. The delay between the time when the Contractor carries out work and the Client making payment for it, generally means that the Client holds sufficient money for works not yet done to offset against the cost of rectifying Defects.

[3] Build UK Roadmap to Zero Retentions

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3.0 Correction of Defects under NEC

3.1 The Contractor has a contractual obligation to correct Defects (defined as being a part of the works which is not in accordance with the Scope, or a part of the works designed by the Contractor which is not in accordance with applicable law or the accepted design) whether or not it is notified of them. Before Completion, the Contractor corrects the Defect at a time which suits its programme. After Completion, Defects found must be corrected within a specified defect correction period. As an alternative to correcting the Defect, Client and Contractor may agree to a reduced payment for accepting the defective work.

3.2 The definition of Completion is that all the work which the Scope requires to be done by the Completion Date has been completed and that any notified Defects which would prevent use of the works (or others doing their work) have been corrected. Carefully specifying the requirements for Completion within the Scope should help avoid there being Defects in the work at Completion and means there is little need for holding a retention fund. If the Scope does not specify the requirements for Completion, the contract requires that all notified Defects which prevent the use of the work must be corrected. Again, provided the work is properly reviewed before Completion there should be no need for a retention even if the Scope is silent on Completion.

3.3 In some circumstances, there may be pressure to accept defective work in order to issue a Completion Certificate and take over the work. In such a case, a payment to be retained in respect of those Defects could be agreed at the time. In that case, the Scope would be changed to remove the need to correct the Defect before Completion, and a Completion Certificate could then be issued.

3.4 If Defects are found after Completion or remain uncorrected at Completion, they must be corrected within a specified defect correction period. A Defect Certificate is issued after the end of a specified period, and if a Defect remains uncorrected at this date it is identified in the certificate and addressed in the final payment due under the contract.

4.0 Payment for work after notifying a Defect

4.1 The NEC approach to payment for work which is found to be defective varies according to the option chosen. For a priced contract (Options A or B), payment for work which incorporates a Defect is excluded if the correction of the Defect would delay following work. An example might be a Defect in the foundation which prevents the wall construction being done until it is corrected. The price for the foundation would not become due until after the Defect is corrected.

4.2 In a contract where payment is made for the Defined Cost of work done (Options C, D or E), no deduction is made for the cost of correcting defective work except in two circumstances. The first is that no payment is made for the cost of correcting Defects after Completion – providing a strong motivation for the Contractor to be free of Defects at Completion. The second is that no payment is made for the cost of correcting a Defect which results from the Contractor not complying with a constraint of how it is to provide the works stated in the Scope. This would include a Defect resulting from a failure to follow a prescribed method of working, or from carrying out work at a time when it was not permitted. In addition, under Options C and D any additional costs incurred by the Contractor in remedying Defects will reduce the Contractor's Share and potentially result in the Contractor going into "pain".

4.3 All of these approaches can be adopted without the necessity of a retention.

5.0 Conclusion – need for retentions

5.1 The need for a retention fund, and the amount to be retained, depends on a number of factors such as the:

- likelihood of Defects arising,
- stage in the contract at which they arise,
- belief in the willingness and capability of the Contractor to make good the Defects and
- robustness of the Contractor's financial position more generally.

5.2 On many contracts, a retention fund should be unnecessary if there is:

- careful drafting of the requirements for achieving Completion, and effective quality management during the contract and a Contractor is in robust financial health and
- selection of a Contractor with a reputation for the quality of its work and/or with which the Client has a wider commercial relationship, which may remove doubts as to the willingness of a Contractor to make good any Defects that are outstanding at Completion and/or emerge after it.

5.3 In the absence of any solvency concerns, retentions should only really be necessary in circumstances where the Client:

- does not believe it will be possible to achieve an acceptable standard for the works at Completion (i.e. it does not believe that it will be able to effectively operate quality management during the works) or
- does not have confidence that its selected Contractor will be willing to correct those Defects which do arise at, or following, Completion.

5.4 There is also a wider potential commercial benefit for the Client if they make it clear a retention or alternative security will not be required from the outset. Typically, Contractors will make an allowance for providing retention fund or bond when tendering for the works. Accordingly, if this is not sought – and that is made clear from the outset - the works may be provided at a lower cost to the Client than would otherwise be the case.

For the avoidance of doubt, this Guidance Note provides general guidance and does not constitute legal advice and specific legal and/or commercial advice should always be sought in relation to contracts before they are entered into and in relation to any of the issues discussed above. No liability or duty of any sort is accepted as arising as a result of this Guidance Note.

If you have any comments or feedback please email: construction.enquiries@beis.gov.uk

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