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## Retention Payments in the Construction Industry

Scottish Futures Trust (SFT) has been requested to provide evidence to an inquiry by the Economy, Infrastructure, Skills and Finance Committees of the National Assembly for Wales into 'Retention payments in the construction industry'.

SFT is working with Scottish Government to deliver recommendations from the [Independent Review of Procurement in Construction](#) carried out in Scotland in 2013. One of the recommendations of that Review was:

*“Cash retentions should be used only after careful consideration by contracting authorities, and not as a default measure. Whilst contracting authorities have a duty to safeguard public funds, they should also be mindful of the potentially detrimental effects of cash retentions on their contractors”*

SFT has reviewed the various practices used by client organisations to assure contractor performance both during the construction period and during a post-completion defects liability period. The review identified the key protections which Authorities require, and assessed the impact of various approaches to delivering these protections, including the use of cash retentions, on supply chains. It gives guidance on appropriate levels of protection and proposes an approach which does not require the use of cash retentions.

The Guidance, “Guidance on Contract Assurance and on an Alternative Approach Which Avoids Cash Retentions” is published on SFT’s [website](#) and included at Annex A to this paper.

This has not been made mandatory in Scotland with the focus having been on the separate but related issue of sub-contractor payment terms where [Project Bank Accounts](#) have been introduced. To date, Contracting Authorities continue to have a preference for applying cash retentions rather than adopting the proposed alternative approach.

We hope this paper is of use to the Committees in their Inquiry.

**Scottish Futures Trust**  
October 2019

**Annex A:  
Guidance on Contract Assurance  
and  
An Alternative Approach which Avoids Cash Retentions**

# REVIEW OF SCOTTISH PUBLIC SECTOR PROCUREMENT IN CONSTRUCTION

GUIDANCE ON CONTRACT ASSURANCE  
AND ON AN ALTERNATIVE APPROACH  
WHICH AVOIDS CASH RETENTIONS

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## 1. The Requirement for Assurance of Contractor Performance

### 1.1 Contract Assurance during the Construction Period

During the construction period the Procuring Authority needs protection primarily for:

- a) A main contractor insolvency event
- b) Default by the main contractor in performing his obligations. For instance, not diligently progressing the works, leading to the Procuring Authority terminating the contract.

This assurance has typically been provided by one or more of:

- a cash retention of between 3-5% of all interim payments;
- a retention bond for the same 3-5% of interim payments;
- a main contractor parent company guarantee;
- the value of work in progress depending on the timing of events;
- a main contractor performance bond for typically 10% of the contract sum. Bonds are sometimes “on-demand”, but mostly are conditional on the Procuring Authority demonstrating evidence of default to the bondsman;

For a default not involving insolvency, the Procuring Authority would normally also have recourse to pursue damages through the contract.

### 1.2 Contract Assurance during the Defects Liability Period

During the defects liability period the Procuring Authority needs protection primarily for:

- a) A main contractor insolvency event
- b) Default by the main contractor in the rectification of defects

This assurance has typically been provided by one or more of:

- retaining half, normally 1.5 – 2.5%, of the cash retention held during the construction period;
- an on-demand, or more likely conditional, retention bond;
- a main contractor parent company guarantee.

Comprehensive 10 year defects insurance products are also available, but can be expensive and are also often conditional on proving cause.

## 2. Why are Cash Retentions a problem for the Supply Chain?

The Review of Scottish Public Sector Procurement in Construction (the Review) focuses many of its recommendations on the opportunity for public sector procurement to better support the sustainable development of small and medium sized enterprises and their contribution to economic growth generally. It identified concerns with the use of cash retentions as a means of contract performance assurance. These concerns centred on the negative effect which retentions have on cash flow for all contractors, but particularly smaller companies operating as sub-contractors. Release of any retention by employers has been cited as often being delayed even if only minor defects were left unrectified. In turn, the main contractor often further delayed release to its supply chain for commercial reasons. Worse, in the event of a main contractor insolvency the supply chain received nothing.

Cash retentions have been used for very many years and were appropriate when main contractors directly employed a multi-disciplinary workforce and used few sub-contractors. It is now common for 70-80% of a contract's value to be sub-contracted. In such circumstances the release of retention by the employer is dependent on the performance of the last sub-contractor rectifying a defect. For example, a groundworks sub-contractor who has satisfactorily completed its work with no defects has to wait many months for half of its typical 5% retention to be released at practical completion – and then wait further depending on the payment terms of the main contractor. It may then need to wait another 12-18 months for the final release after the issue of a certificate of making good defects, even though it was other sub-contractors' defects awaiting rectification. 5% might represent the whole of a sub-contractor's profit on the contract.

Changes to the Construction Act in 2009 meant that payment of retention under sub-contracts entered into after 1 October 2011 could no longer be conditional on the performance of obligations under a separate contract. However, this has had the unintended consequence of many main contractors inserting retention release dates in sub-contracts an inordinately long period after retention release may normally be anticipated under the main contract. This is reflective of main contractors' experiences of some procuring authorities continuing to hold 100% of the outstanding retention against very simple, small value, issues; or where there is a long lead time for material replacement; or for seasonal work; or where access is constrained by the client themselves. Feedback from SMEs is that this change to the law has in many cases extended their wait for retention release rather than reduced it.

There have been a number of reports<sup>1</sup> published in recent years highlighting the problems caused to the cash flow of tier 2 and 3 supply chain members by cash retentions not being released timeously, or ever. These companies are often small and medium sized enterprises (SMEs). The Specialist Engineering Contractors Group (SECG) and the National Specialist Contractors Council (NSCC) have both been vociferous in raising the issue. Representations have also been made to the Scottish Cross Party Parliamentary Group for Construction.

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<sup>1</sup> *The NSCC Fair payment Campaign*

*Two SECG Scotland Reports on a Survey of Practices and Pre-Qualification in (i) Construction Procurement in the Scottish University Sector; and (ii) Public Sector Construction in Scotland*

The effect of retention on the cash flow of SMEs is undoubtedly significant. This is then exacerbated by sub-contractors essentially bearing the risk of Tier 1 contractor insolvency. In an insolvency situation, the sub-contractor would most likely lose all of its retention unless it had been placed in a trust account.

There are unintentional indirect benefits for the cash flow of both Procuring Authorities and Main Contractors in holding cash retentions. For Procuring Authorities, and for those main contractors who apply extended payment terms to their supply chain, the application of cash retentions will contribute to their working capital requirements, unless the retention is held in trust. The supply chain does not believe it should be their function to provide working capital to either the Procuring Authority or to the main contractor.

### 3. Consideration of options for contract assurance

#### 3.1 Cash Retention

Retention is a percentage (often 3-5%) of the amount certified as due to the main contractor on an interim payment certificate. It is deducted from the amount due and retained by the employer. The main contractor will also apply retention to its sub-contractors – the amount being determined by the terms of the individual sub-contract conditions which may or may not mirror those in the main contract. Half of the amount retained is normally released on completion of the works. The other half is normally released on the issue of a certificate after the end of the defects liability period confirming all notified defects have been rectified. As discussed in section 2, the use of cash retentions places risk and cash flow burdens on the supply chain. The Procuring Authority should not use cash retentions as a default measure and should only be used if other forms of contract assurance cannot provide adequate cover.

#### 3.2. Retentions held in Trust Accounts

Most contracts give the option for those contractors and sub-contractors providing retention to request that it is placed in a trust account. This gives protection to each contractor or sub-contractor providing it. By doing so, the cash cannot be used for working capital by an employer or main contractor, respectively. Nor can it be lost in the case of an insolvency event. Trust accounts on their own do not, however, address the essential cash flow problem of retention being held. Whilst it is common in private sector contracts for main contractors to exercise the trust account entitlement, it is a rare practice in the public sector where the risk of an employer default is very low.

#### 3.3. Cash Retention and Project Bank Accounts.

The adoption of Project Bank Accounts (PBAs) give some protection to Tier 2 and 3 contractors. PBAs prevent the practice of delayed release of cash retentions being used as a “profit centre” by main contractors, or used as free working capital provided by their supply chain. However not all Tier 2, and not most Tier 3, contractors are likely to be named beneficiaries of a project bank account if the value of their contract is small. A Project Bank Account also may not afford protection in the event of a main contractor insolvency event where the Procuring Authority itself uses the whole of the retention being held against the main contractor, as it is entitled to. Whilst Project Bank Accounts can address unfair payment terms down a supply chain, they do not of themselves address the essential cash flow problem of retention being held.

#### 3.4. Retention Bonds.

A retention bond is offered by the main contractor to the employer, and by each sub-contractor to the main contractor, in lieu of a cash retention. Many forms of contract, including the standard NPD and hub forms, make provision for a retention bond to be used in lieu of a cash retention. There are two issues with its use however. Firstly, bondsmen are increasingly requiring these to be asset backed



by contractors – even to the extent of a cash deposit being required, or by the forced reduction of borrowing facilities. Unsurprisingly therefore, some small tier 1 contractors and many tier 2 and 3 contractors find themselves in a worse financial position compared with the deduction of a cash retention. Secondly, the retention bonds are rarely of the “on-demand” type. This means that a Procuring Authority might typically need to achieve a third party judgement, perhaps via adjudication, in order to receive payment from the bond.

### **3.5. Defects Liability Insurance.**

Defects Liability Insurance policies are available to cover latent defects discovered up to 10-12 years after the end of the defects liability period. While such policies might possibly be considered as value for money to Procuring Authorities in certain circumstances, they do not normally respond to the non-rectification of patent defects notified to the contractor before the end of the defects liability period. They are therefore not an alternative contract assurance product.

### **3.6. Self-Insurance.**

If cash retentions were not used, one assurance solution for Procuring Authorities might be to self-insure. For example, the absence of cash retentions might reasonably lead to (say) a 1% lower tender price. The Procuring Authority pays 1% into a fund across its whole programme of projects to provide the finance to rectify defects in the event of the contractor refusing to do so. The Authority would still, of course, be able to pursue the contractor via dispute resolution or court proceedings, as is currently the case where a cash retention amount is not large enough to cover the cost of rectification. The risk with this approach is that it could easily drive the wrong behaviours in contractors. There would be less incentive to rectify defects – relying instead on the Procuring Authority’s natural reluctance to launch proceedings for perhaps relatively small amounts of money.

### **3.7 Key Performance Indicators**

For longer term contracts and for frameworks where there is a high probability of repeat work there may be an opportunity to replace measures to assure against the non-rectification of defects with a series of key performance indicators (KPIs). The measurement of such KPIs can then be used in assessing overall contractor performance in future mini competitions under the framework, or be linked to incentivised performance payments. Procuring Authorities should be aware that main contractors may find it difficult to replicate this approach through their supply chain and cash retentions will most likely still be used instead.

### **3.8. Parent Company Guarantees.**

The use of a Parent Company Guarantee (PCG) is often cited by large contractors as a form of assurance against the performance of, for example, their regional subsidiary companies. Unfortunately, not all contractors are part of a group structure and, even if they are, it is often the case that failure of the contracting entity will likely also lead to the failure of the parent group. Both from a competition perspective, and from an assurance perspective, it is therefore not thought that PCGs can be exclusively relied upon as a contract assurance measure.

### 3.9. Performance bonds

The contractor may be able to give a "default" (or "on default") bond to the public authority. This type of bond is conditional on performance of the contract or payment of damages by the bondsman if the contractor defaults. This bond is a guarantee because the bondsman assumes a secondary obligation to pay if the contractor fails to perform. The amount of the bondsman's liability is proportional to the damages sustained by the employer. Another type of performance bond is an "unconditional on demand" bond: however, it is Government policy not to use these. Maintenance bonds are also available, which provide limited security for performance of the contractor's obligations during the defects liability period. These can be of use where there has been a performance bond which has expired on practical completion or the works comprise a specialist installation demanding a high level of care after practical completion. Just as for retention bonds, the surety often insists on a third party decision, eg adjudication, before payment which can result in delay and incur legal costs.

### 3.10 The Avoidance of Cash retentions

Whilst not directly applicable to Scotland, the UK Government Department of Business, Innovation and Skills, via the Construction Leadership Council, published the Construction Supply Chain Charter in April 2014.

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/306906/construction-supply-chain-payment-charter.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/306906/construction-supply-chain-payment-charter.pdf)

Amongst other fair payment commitments, those signing the Charter agree :

- a) To eliminate cash retentions by 2025
- b) Not to apply cash retentions in the supply chain where there is none in the Tier 1 contract

The three large UK contractors on the Construction Leadership Council have signed the Charter, along with a number of UK Government Procuring Authorities.

Eliminating cash retentions would meet the objective of improving cash flow for all contractors in the supply chain. Section 4 contains a possible solution to maintaining an appropriate level of contract assurance at a predicted neutral cost.

## 4. Guidance on an alternative approach to contract assurance

### 4.1 Applicability

If a programme of pilots to trial this new alternative is successful, it is recommended that this approach of eliminating cash retentions should be applied to works contracts above the OJEU threshold, and that after a period of successful operation it should be applied to all regulated works contracts in Scotland.

It is recognised that the use of retentions on low value and short term projects do not cause the same extent of cash flow problems. In such circumstances cash retentions may still be appropriate. It is also recognised that in some remote project locations procuring authorities assess there is a high risk of non-rectification of defects without a significant financial incentive and may also elect to continue to operate a cash retention system. However, the wider benefits of using public procurement to support the cash flow of small companies should also be taken in to account.

Section 5 contains guidance on contract assurance for projects not using this alternative approach.

### 4.2 Principles

It is proposed that a combination of all the following measures would provide a realistic basis for satisfactory contractor performance assurance whilst at the same time eliminating cash retentions. This would provide a financial boost to SME's working on public sector projects thereby supporting economic growth. Legal implications are addressed in more detail at Annex A.

#### During the Construction Period

##### No Retention in the main contract

- A main contract condition which precludes cash retentions being applied through the whole supply chain
- A 10% Performance Bond for the main contract, expiring on issue of a Completion Certificate, thus providing assurance against an insolvency event.

#### At Completion

- Adoption of the BSRIA Soft Landings<sup>2</sup>, or similar approach, where it is judged appropriate, and value for money, for the type and scale of the project.

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<sup>2</sup> <https://www.bsria.co.uk/services/design/soft-landings>

- Incorporation of a rigorous practical completion test
- The formal valuation at practical completion of incomplete work or work subject to snagging

#### During the Defects Liability Period

- Introduction of a 1% Project Specification Performance Payment (PSPP), payable at the end of the defects liability period, and linked to a range of tests of performance.
- Alternatively, instead of a PSPP, the use of Key Performance Indicators and Track Record Tests for long-term contracts, e.g. frameworks, and the hub programme.

### **4.3 Further Details – During the Construction Period**

#### 4.3.1 No Retention in the main contract

- Neither cash retentions on interim payments, nor retention bonds, will be used.
- Minor amendments may need to be made to standard forms of contract that specify the use of such retentions.
- Annex A includes a commentary on the likely legal considerations - which are not thought to be a barrier.

4.3.2 A main contract condition precludes cash retentions being applied through the whole supply chain.

- In order to achieve the objective of improved cash flow throughout the supply chain, the head contract must contain a new clause which prevents retention being applied by main contractors in their sub-contracts. Legal advice on the drafting of such a clause will be required and will be project specific depending on the form of contract chosen.
- It is also envisaged that the head contract would contain a provision that sub-contracts must give the sub-contractor a right to make representations, perhaps anonymously, directly to the Procuring Authority if the main contractor still seeks to impose retentions.

#### 4.3.3 A 10% Conditional Performance Bond for the main contract

- The maximum cover is 10% of the contract sum, subject to demonstration of the actual loss incurred by the Procuring Authority.
- “On-demand” bonds, whilst common for international construction contracts, are not available for even medium sized contractors at reasonable cost, or at all. It is also not Scottish

Government policy to use them. A “conditional” bond will, therefore, need to be relied on for insolvency events. However the use of careful wording in the bond on what evidence would constitute such an insolvency event should ensure that a third party decision is not required prior to payment. Annex A contains further commentary on this, and Annex B contains sample bond wording.

- For other defaults, for example the failure to rectify defects, it would again be a “conditional” bond where the Procuring Authority would have to provide satisfactory evidence of the default to the bondsman. It is acknowledged that this often requires a third party decision (eg adjudication). This has historically often been the case where there is a dispute as to the cause of the defect, for instance in a traditional contract where the Procuring Authority might be responsible for the design.
- The bond would cease to exist on a specified date or event – it is recommended this be the issue of the practical completion certificate.
- The cost of such a bond will be passed on to the Procuring Authority as part of the contractor’s tender. Depending on the financial standing of the contractor this could be between 0.5% - 25% of the bond amount, but more typically in the range of 4% -10% which equates to between 0.4%– 1.0% of the contract sum.
- It is vital that the bondsman is reputable – as measured by a rating agency, and the bond is put in place with the appropriate wording at the same time the contract is awarded. The legal jurisdiction governing the bond’s operation should also be considered.
- A legal commentary is included at Annex A and sample bond wording at Annex B.

#### 4.4 Further Details – At Completion

##### 4.4.1 Adoption of the BSRIA Soft Landings, or similar approach, where it is value for money

- The Building Services Research and Information Association (BSRIA) has developed a process called Soft Landings. In simple terms Soft Landings requires clients to insist that the individuals from designers and constructors stay involved with their new building beyond practical completion and into the critical initial period of occupation. This will assist building managers during the first months of operation, it will help fine-tune and de-bug the systems, and ensure the occupiers understand how to control and best use what they have been given. This is followed by a longer, less intensive period of aftercare lasting for up to three years, to monitor energy use and occupant satisfaction, and to check on the operation of systems that might need seasonal fine-tuning. At the end of three years the building’s steady performance can be fairly judged against the targets set at design, and any discrepancies accounted for.
- By specifying Soft Landings, Procuring Authorities can significantly mitigate against the risk that teething problems with their new building become disputes over alleged defects.
- A link to further information:  
<https://www.bsria.co.uk/services/design/soft-landings/>
- This becomes even more powerful if Soft Landings is combined with the specification of Building Information Modelling, Level 2.
- Soft Landings can be expensive and would only be appropriate on large, complex projects.
- Further legal commentary is included at Annex A

#### 4.4.2 Incorporation of a rigorous practical completion test

- Undoubtedly the best time to ensure that the works are built as specified is prior to the issue of a certificate of completion.
- Incorporating a formal set of completion criteria in the contract leaves the contractor in no doubt that he will not achieve completion – and therefore release his liability to pay liquidated and ascertained damages for any delay – unless the criteria are satisfied.
- To get the best from this, Procuring Authorities must better plan overall development programmes such that there is time float between a contractual completion date and the date when occupation is scheduled. The practical completion test can then be rigorously applied without pressure from the eventual building users to achieve occupation.
- Further legal commentary is included at Annex A.

#### 4.4.3 The formal valuation at practical completion of incomplete work or work subject to snagging.

- With there being no retention in the contract, it is important that at the time of practical completion/building handover the Procuring Authority does not pay the value of any incomplete or defective work. The Architect/Quantity Surveyor/Contract Administrator, as appropriate, must only include in their payment certificate the value of defect free works.
- Payment is then only made once those items have been satisfactorily attended to.
- It is recognised that care must be taken to avoid certifying defective works in one interim valuation only to omit it at practical completion. Such an approach could lead to a main contractor needing to seek repayment from a sub-contractor.
- Further legal commentary and a suggestion for a mechanism covering how this valuation would work is included at Annex A.

### 4.5 Further Details – During the Defects Liability Period

#### 4.5.1 Introduction of a 1% Project Specification Performance Payment (PSPP), payable at the end of the defects liability period, and linked to a specified range of tests of performance.

- The PSPP should be described in the tender pricing document as an activity, and mandated to be priced at 1% of the total of the main contractor's other pricing.
- It is not a deduction from interim payments.
- It is added to the main contractor's tender and forms part of the overall contract sum.
- It should not exist in any sub-contracts.
- The range of tests of performance should be created on a project specific basis but might include a number of post practical completion matters. For example: the issue of the Certificate of Making Good Defects; the issue of BREEAM, EPC or similar certificates; satisfactory air tightness testing; satisfactory thermal imaging testing; compliance with any energy performance testing; completion of as-built records; completion of operation manuals; issue of all BIM data; compliance with any maintenance obligations.
- There should be no breakdown of the 1% figure between the various tests. If any test of performance is not met, the Procuring Authority would have the right to deduct from the PSPP

the cost of carrying out any of the other outstanding works themselves. This would include any outstanding defect rectification.

- The PSPP is specifically not a bonus payment for works that should be performed in any event. It is part of the Contract Sum, and is a defined activity.
- Further legal commentary is included at Annex A.

4.5.2 Alternatively, use Key Performance Indicators and Track Record Tests. e.g. for frameworks and the hub programme.

- For long term contracts a Procuring Authority might wish to consider the use of targeted key performance indicators and track record tests instead of a PSPP.
- The KPI's would need to be made project specific and closely mirror the tests of a PSPP.

#### **4.6 Benefits for Industry**

- Significant cash flow benefits to all contractors with specific benefit to the Tier 2 and 3 supply chain, often SMEs.
- Opportunities for contractors to demonstrate reputation enhancing behaviours post practical completion.
- A clear financial incentive (the PSPP) for the main contractor to remedy any defects even if a sub-contractor defaults.
- An opportunity to discount the value of the PSPP in a tender price to reflect their confidence in a well-managed and motivated supply chain to comply with contract obligations without the use of cash retention
- No resource needed to pursue the payment of outstanding retentions or to administer them.
- Sub-contractors will no longer be treated as effectively jointly waiting for the last defect to be rectified up until the retention release date specified in their sub-contracts.

#### **4.7 Benefits for Procuring Authorities**

- Retains the essential assurance for insolvency or other default up to the end of the defects liability period.

- The adoption of Soft Landings increases the probability of defect free handovers, albeit at an additional cost.
- A clear financial payment (PSPP) linked to a range of tests at the end of the defects liability period
- Less contract administration, especially compared to dealing with the placement of retention in to trust accounts.
- Compatible with the use of Project Bank Accounts
- Significantly increases the project's attraction for SMEs to tender the project, raising the level of competition.
- Opportunity for the receipt of lower tender prices
- Eases the accountancy treatment of retentions for public procuring authorities which can be difficult at financial year end.



## 5. Guidance for projects not using the alternative approach to assurance

### 5.1 Applicability

This guidance is for non-regulated Projects (below £2m) and for those circumstances where the Alternative to Cash Retention Assurance Model is not adopted.

The procuring authority must still consider the options which exist for contract performance assurance, and not select the use of cash retention as a default measure. The selected strategy must address both the risks of a main contractor insolvency event (the impact is more severe if it occurs before completion) and of a failure to rectify defects.

### 5.2 Proportionality

The procuring authority should not require more than one assurance tool unless a risk assessment points to a need to do so. Two examples: If a performance bond is in place which adequately assures against an insolvency event, there should be no need for a higher retention percentage during the construction period – and consequently there would then be no release of half of the retention at practical completion. After practical completion, there should be no need for both a performance bond and a retention bond, or both a performance bond and a cash retention.

An essential consideration must be the effect of the assurance strategy on the whole supply chain. For example, the use of a bond or key performance indicators between employer and main contractor may still result in cash retentions being applied between the main contractor and its sub-contractors.

### 5.3 Alternatives to using cash retentions

Alternatives include:

#### 5.3.1 Retention bonds

Under a typical retention bond, the contractor's performance of its obligations to complete the works as contractually-specified is guaranteed by a third party, or surety, which undertakes to pay damages sustained by the employer in the event of any default on the part of the contractor. Normal practice is to provide conditional retention bonds that increase in value as payments are made (in full i.e. no cash retentions applied) in accordance with the contract. The surety's liability is limited to the sum which would otherwise have been held by the employer by way of cash retention at the time of any breach and is automatically reduced by half upon issue of the certificate of practical completion. The surety often insists on a third party decision, eg adjudication, before payment which can sometimes cause delay and incur legal costs.

#### 5.3.2 Performance bonds

The contractor may be able to give a "default" (or "on default") bond to the public authority. This type of bond is conditional on performance of the contract or payment of damages by the bondsman if the

contractor defaults. This bond is a guarantee because the bondsman assumes a secondary obligation to pay if the contractor fails to perform. The amount of the bondsman's liability is proportional to the damages sustained by the employer. Another type of performance bond is an "unconditional on demand" bond: however, it is Government policy not to use these. "Maintenance" bonds are also available, which provide limited security for performance of the contractor's obligations during the defects liability period. These can be of use where there has been a performance bond which has expired on practical completion or the works comprise a specialist installation demanding a high level of care after practical completion. As for retention bonds, the surety often insists on a third party decision, eg adjudication, before payment which can result in delay and incur legal costs.

### 5.3.3 Parent company guarantees

This form of guarantee is given by a parent company (or holding company) to guarantee the proper performance of a contract by one of its subsidiaries (the contractor), and can only be given where the contractor is owned by a parent company or is the subsidiary of a larger group. Because the financial strength of the parent company may be linked to that of the contractor, a parent company guarantee will be acceptable only if the parent company (or holding company) is financially strong and its financial resources are largely independent of those of the contractor. Such a guarantee is free of cost to the client, but may give less certainty of redress than a bond because it is not supplied by an independent third party.

### 5.3.4 Key performance indicators in frameworks

Where long term relationships are established, for example in a framework, it may be appropriate to replace that element of a cash retention which is provided against defect rectification with a series of key performance indicators. The measurement of such KPIs can then be used in assessing overall contractor performance in future mini-competitions under the framework, or be linked to incentivised performance payments. KPIs might be set for: the number of defects at completion; the time to rectify defects; the number of defects at the end of the defect liability period; the time taken to investigate a defect etc. A procuring authority will still need to have an assurance strategy for a main contractor insolvency event. It may be difficult to replicate this approach through the supply chain.

## 5.4 If Cash Retentions are used

The amount of retention to be held should be considered on a project specific basis, and be both reasonable and proportionate to the project's characteristics. Professional advice should be taken on the amount to be specified on a project by project basis.

In normal circumstances, building projects should not exceed 5% retention during the construction period, and 2.5% retention during the defects liability period. Consideration should be given to reducing the maximum retention to 3% and 1.5%, respectively, for projects valued above £5m. For civil engineering projects the figures would normally be 3% and 1.5% respectively. Particularly low value civil engineering contracts may warrant slightly higher retentions.

	Prior to completion		Defects period	
	< £5m	>£5m	<£5	>£5m
Building	5%	3%	2.5%	1.5%
Civil Engineering	3%	3%	1.5%	1.5%

Fig 1 Typical levels of cash retention. Subject to project specific risk assessment.

After the end of the defects liability period, consideration should be given to reducing the cash retention held to reflect the total rectification cost to the procuring authority of any outstanding defects. The retention should not, by default, be held in full until the last (sometimes minor) defect is complete and the overall defects completion certificate is issued.

Procuring authorities should also be aware that standard forms of contract sometimes have different rules on retention. For example, the NEC3 form does not include retention as a core clause. Secondary Option Clause X16 needs to be chosen and this also contains the concept of a “retention free amount”. Retentions are not applied until the gross interim valuation reaches a chosen threshold. The Procuring Authority decides on the amount. This is designed to assist the main contractor’s cash flow in the early stages of a project but may not be similarly applied through the supply chain.

## 6. Feedback

Please contact Martin Blencowe, Procurement Review Director, at Scottish Futures Trust.

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## Annex A – Legal Commentary

The following legal narrative has been provided, however this is not legal advice. Procuring Authorities will need to satisfy themselves on commercial arrangements, risk management and on any amendments to standard forms of contract.

### A.1. No Retention in the main contract

It is common place to amend standard form contracts to suit the requirements of a particular project. We do not anticipate that it will be unduly onerous to eliminate cash retentions from the conditions of most standard form contracts.

In most of the commonly used standard forms it will be sufficient to specify in the contract particulars (or equivalent) that the retention is not applicable and/or to insert zero% if the retention percentage is to be specified, or 100% if it is the percentage of the total value of the works which is to be specified.

In the alternative, the key areas that will need to be addressed are as follows (note that key areas may vary across the range of standard form contracts):

- (a) Retention – removal of clauses providing for retention percentage (including retention of sections) and associated definitions;
- (b) Retention bonds – removal of clauses providing for retention bonds, associated definitions and forms of retention bond (if applicable);
- (c) Interim payments – removal of clauses granting the right to the employer to remove a retention payment from each interim payment and any final payment;
- (d) Practical completion certificate - removal of obligation to make payment of retention monies on issue of the certificate of practical completion; and
- (e) Certificate of making good defects – removal of obligation to make payment of retention monies on the issue of the certificate of making good defects.

## A.2. A 10% Performance Bond for the main contract

Subject to the points below, we can see no legal barriers to procurement of a 10% performance bond as additional security for performance. These are commonly procured for significant construction projects already. An amended version of the Association of British Insurers' ("ABI") form of performance bond is widely accepted in the current market by most major banks and insurance companies.

The Paper notes that, ideally, the bond would operate in a similar manner to an "on demand" type of bond in the case of insolvency. It is likely that banks and bondsmen will be comfortable with the principle of a conditional bond with on-demand provisions in respect of insolvency (rather than a full on-demand bond), and this is a position that has already been accepted in the current market. A proposed form of performance bond is included at Annex B.

As the demand for conditional bonds with on-demand provisions for insolvency increases, it is likely that the bond market will naturally follow suit with the cost of the on demand call arising from insolvency being built into the bond price from the outset. Following such re-calibration, the availability of these types of bond will increase, and with greater availability the eventual costs of these bonds should decrease before reaching a market level.

In the event of any resistance from the bondsman, a possible solution is inclusion of a provision for the on demand payment under the bond in the case of insolvency to be revisited when the losses suffered by the employer can be properly calculated. So, following a pay out on demand, there is a reconciliation process at a later point in time and any excess paid out initially under the bond is paid back by the employer. This is certainly a more palatable option for the "conditional bondsman" and may prove helpful in what will inevitably be a transitional period in the bond market. Moreover, this compromise can also be beneficial from an employer perspective if the reconciliation process results in a deficit rather than any excess. In such circumstances, any deficit in losses actually incurred can be paid by the bondsman to the employer. Again, refer to Annex B.

A key practical issue of note is governing law and execution formalities in Scotland where the relevant law is Scots law. As the main providers of bonds in the United Kingdom are English, often Scots law bonds do not contain the correct 'kilted' provisions and are not executed in accordance with Scots law requirements. It is important that relevant checks are in place to ensure any performance bonds granted as alternatives to a cash retention are worth the paper

they are written on and events of default that are understood to be covered by a call on the bond, can actually be the subject of a valid call.

Where cash retentions are precluded through the whole supply chain, performance bonds will likely be more common place in the case of sub-contractors.

### **A.3. Adoption of the BSRIA Soft Landings, or similar approach, where appropriate.**

Soft Landings is a collaboration process between the client, contractor, designers and sub-contractors lasting for the whole of the construction period and 3 years after completion, with the aim of producing a building that meets both the design specification, and also the service outcomes of end users. In essence, Soft Landings is a platform for continuous improvement so that subsequent and successive procurements of similar projects (schools are a good example) can draw on that collective knowledge to achieve a higher quality and more cost effective build.

The cost for the extended aftercare period (1-3 years) could be managed by specifying levels of attendance post completion and the extent of reporting requirements.

For Soft Landings to work properly, ideally the end users will be involved from the outset.

It is anticipated that the key contractual obligations on any contractor, consultants and sub-contractors to deliver Soft Landings objectives will come principally from the scope of services or specifications documents, so only limited revisions to the contract terms and conditions should be required. Furthermore, the Soft Landings services are designed to supplement the existing standard form services, so no major revisions to industry standard forms should be needed.

For Soft Landings to work most effectively, it is recommended that it be a central requirement at the tendering stage, so that the contractor and consultants are tendering on the basis of Soft Landings being a key element of the contract, rather than an added extra. If Soft Landings is incorporated correctly at procurement stage, the shared responsibility and collaborative working aspects are clear from the outset.

We recommend that there is an express obligation on contractors and consultants to co-operate in a spirit of collaboration to identify improvements in design, building performance, energy consumption and environmental functionality. Some other specific drafting considerations may include obligations on contractors to ensure that any sub-contractors are engaged on a Soft Landings basis and are obliged to co-operate in the main contract Soft Landings process. Sample drafting:

*“1.1 The Contractor shall co-operate in a spirit of mutual trust and collaboration to identify improvements in design, building performance, energy consumption and environmental functionality.”*

*“1.1 The Contractor shall procure that in any contract appointing sub-contractors, sub-consultants and/or suppliers in relation to the [Works], there is an obligation on the such sub-contractors, sub-consultants and/or suppliers to comply with the Soft Landings Requirements.*

*“Soft Landings Requirements” means [ ● ]”*

#### **A.4. Incorporation of a rigorous practical completion test**

No standard forms envisage such rigorous standards at completion so a key issue will be in projects where un-amended standard form contracts are used unless this requirement is built into the technical documents which make up the contract. In the case of amended standard form contracts, it is relatively common to see additional conditions/requirements to practical completion being imposed so we do not see any barriers to the principle of adoption of a rigorous practical completion test.

The key issue for contractors of any tier is that their route to practical completion is fully transparent and all tests or requirements to get there are clearly defined so that they can fully understand what is being asked of them to achieve completion.

In many standard form contracts the requirements to achieve ‘practical completion’ are not stated. Looking, for example, at the SBCC Design and Build contract for use in Scotland 2011, practical completion is undefined and so in effect determination of when the works are complete in accordance with the contract is down to the professional judgement of the Employer’s Agent. Often an unwritten ‘rule of thumb’ means that works are judged complete, for the purposes of achieving practical completion, if they are substantially complete and in a state in which the end user may enjoy beneficial use ignoring snagging items which don’t prejudicially affect that occupation.

So called snagging lists are often appended to the practical completion certificate and whilst they are recognised by general usage in most standard forms they have no contractual status unless issued as a formal instruction which invariably they are not.

We propose that one of the simplest ways to ensure a more rigorous practical completion test is to include a list of criteria that will be required to be met in order to achieve practical completion. This rigorous list could be included in the Employer’s Requirements or Specification so that it can be used in the case of both amended and not amended standard form contracts. However, to ensure the practical completion test is an absolute requirement to achieving practical completion under any contract, we would strongly recommend that reference to this is included in the contract terms and



conditions. A pro forma list could be produced with a check-box system to allow the parties to select the appropriate practical completion requirements by simply ticking them.

An amendment needs to be made to the practical completion provisions in any contract which makes practical completion conditional on satisfaction of everything noted in the practical completion list contained in the technical documents. Proposed drafting:

*“It shall be a condition to practical completion in accordance with clause [ ● ] of this [Contract] that all of the practical completion requirements contained in the [Employer’s Requirements/Specification] have been met and fully satisfied by the [Contractor].”*

#### **A.5. Formal valuation at practical completion of incomplete work or work subject to snagging.**

Although this is a formal valuation of the actual incomplete work at practical completion, it could be viewed by the contractor as effectively a form of cash retention unless there are detailed provisions governing how the outstanding work/snagging is to be valued.

Relevant amendments to the standard form building contracts would need to be introduced to provide for a formal valuation process at completion and some amendments may be required both to the terms and conditions and scope of services agreed with relevant professional team members involved in that certification process e.g. Architect, Quantity Surveyor, Contract Administrator or Employer’s Agent. Sample drafting:

*“1.1 At [practical completion], minor items of incomplete work and/or minor defects, shrinkages or other faults, the existence, completion or rectification of which in the opinion of the [Contract Administrator] would not prevent or interfere with the use and enjoyment of the completed [Works] shall be valued as follows:*

*1.1.1 consistent with values of work of similar character to that set out in the Contract, making due allowance for any change in the conditions under which such work is carried out; or*

*1.1.2 where no comparison can be made to the works carried out under the Contract in accordance with clause 1.1.1, a fair valuation shall be made”*

**A.6. Introduction of a 1% Project Specification Performance Payment (PSPP), payable at the end of the defects liability period, and linked to a range of tests of performance.**

The policy approach to PSPP's needs to be carefully managed, to avoid the perception that this regime amounts to no more than a bonus for works which should be contractually done in any event. Having specified clearly defined requirements to achieve the PSPP will prevent the risk of this perception.

It is envisaged the 1% PSPP will form part of the amounts payable under the building contract and to avoid the inference that it is an additional performance related sum (a bonus) it should form part of the contract sum but be paid subject to separate payment provisions, which will closely mirror the provisions related to interim payments. Sample drafting:

*"1.1 The Contractor shall satisfy the [PSPP Tests] in all respects as soon as reasonably practicable following the [Date of Completion] and in any event not later than expiry of the [Rectification Period] in return for the [PSPP]. Not later than [ ● ] month[s] after the end of the [Rectification Period] in respect of the [Works] the [Contract Administrator] shall issue the [PSPP Certificate] which shall state (i) whether or not the [PSPP] is due to be paid to the Contractor (if it is due, it shall state the PSPP, and, if it is not due, it shall state zero) and (ii) whether the Contractor has complied sufficiently with clause [ ● ] i.e. the basis on which that sum is calculated. The due date for payment of the [PSPP] shall be the date of issue of the [PSPP Certificate], or if the [PSPP Certificate] is not issued within the timescale noted above, the last date of that period and, subject to clause [ ● ] the final date for payment shall be 28 days from the due date.*

*1.2 If the Employer intends to pay zero, contrary to what is stated in the [PSPP Certificate], he or any other person so authorised shall not later than 5 days before the final date for payment give the [Contractor] a pay less notice which shall specify that he considers zero to be due at the date the notice is given and the basis on which that sum has been calculated. If such a pay less notice is given the payment to be made on or before the final date for payment shall be zero.*

*1.3 If the [PSPP Certificate] is not issued in accordance with clause [ ● ] above:*

*1.3.1 the [Contractor] may at any time after expiry of the [ ● ] month[s] period above give notice to the [Employer] with a copy to the [Contract Administrator] stating that the [Contractor] considers the [PSPP] to be due to him under this [Contract], stating that sum and the basis on which the sum has been calculated and, subject to any pay less notice issued in accordance with clause [ ● ] below, the final payment shall be the [PSPP];*

*1.3.2 if the [Contractor] gives notice in accordance with clause [ ● ] above, the final date for payment of the sum specified in it shall be for all purposes be regarded as postponed by the same number of days as the number of days after expiry of the 2 month period that such notice is given;*

*1.3.3 following the [Contractor's] notice in accordance with clause [ ● ] above, the [Employer] may not later than 5 days before the final date for payment give a pay less notice in*

*accordance with clause [ ● ] above and, if he gives such notice, the provisions of clause [ ● ] above shall apply.”*

*“PSPP means [ ● ] [1% of tendered sum] which may be payable to the Contractor in accordance with clause [ ● ]”*

*“PSPP Certificate means the certificate to be issued by the [Contract Administrator] following expiry of the [Rectification Period] in relation to payment of the PSPP [ ● ]”*

*“PSPP Tests means [ ● ]”*

## Annex B

### **SAMPLE FORM OF PERFORMANCE BOND**

**THE GUARANTEE BOND** is **BETWEEN** the following parties whose names and [registered office] addresses are set out in the schedule to this Bond (the "Schedule"):

The "Contractor" as principal

The "Guarantor" as guarantor, and

The "Employer"

### **WHEREAS**

By a contract (the "Contract") entered into or to be entered into between the Employer and the Contractor particulars of which are set out in the Schedule the Contractor has agreed with the Employer to execute works (the "Works") upon and subject to the terms and conditions therein set out.

The Guarantor has agreed with the Employer at the request of the Contractor to guarantee the performance of the obligations of the Contractor under the Contract upon the terms and conditions of this Guarantee Bond subject to the limitation set out in clause 1.

**NOW IT IS AGREED** as follows:

1. The Guarantor guarantees to the Employer that in the event of a breach of the Contract by the Contractor and/or the Contractor becoming Insolvent (as defined in the Schedule), the Guarantor shall subject to the provisions of this Guarantee Bond satisfy and discharge the damages sustained by the Employer as established and ascertained pursuant to and in accordance with the provisions of or by reference to the Contract and taking into account all sums due or to become due to the Contractor. Save where the Contractor has become Insolvent (as defined in the Schedule), a certified copy decision of an Adjudicator duly appointed in accordance with the Contract, in favour of the Employer, in respect of such event of breach of the Contract or failure by the Contractor to fulfil its obligations under and pursuant to the Contract, in the sum sought by the Employer in terms of this Guarantee Bond shall be sufficient evidence of establishment and ascertainment of any sum of money to be satisfied or paid in terms of this Guarantee Bond. Where the Contractor becomes Insolvent (as defined in the Schedule), it shall be sufficient for the Employer to serve on the Guarantor a certificate stating the extent of the losses and others suffered by the Employer as a result of the said insolvency.
2. The maximum aggregate liability of the Guarantor and the Contractor under this Guarantee Bond shall not exceed the sum set out the Schedule (the "Bond Amount") but subject to such

limitation and to clause 3 the liability of the Guarantor shall be co-extensive with the liability of the Contractor under the Contract.

3. The Guarantor shall not be discharged or released by any alteration of any of the terms, conditions and provisions of the Contract or in the extent or nature of the Works and no allowance of time by the Employer under or in respect of the Contract or the Works shall in any way release, reduce or affect the liability of the Guarantor under this Guarantee Bond.
4. Whether or not this Guarantee Bond shall be returned to the Guarantor the obligations of the Guarantor under this Guarantee Bond shall be released and discharged absolutely upon Expiry (as defined in the Schedule) save in respect of any breach of the Contract which has occurred and in respect of which a claim in writing containing particulars of such breach has been made upon the Guarantor before Expiry.
5. The Contractor having requested the execution of this Guarantee Bond by the Guarantor undertakes to the Guarantor (without limitation of any other rights and remedies of the Employer or the Guarantor against the Contractor) to perform and discharge the obligations on its part set out in the Contract.
6. This Guarantee Bond and the benefits thereof shall not be assigned without the prior written consent of the Guarantor and the Contractor.
7. Save where expressly stated otherwise in this Guarantee Bond, nothing in this Guarantee Bond shall confer or purport to confer on any third party any benefit or right to enforce any term of this Guarantee Bond.
8. This Guarantee Bond shall be governed by and construed in accordance with the laws of Scotland and only the courts of Scotland shall have jurisdiction hereunder, and the parties hereto consent to registration hereof for preservation and execution.

IN WITNESS WHEREOF these presents consisting of this and the preceding page together with the Schedule annexed hereto are executed as follows:

*[Insert signature block for Contractor, Employer and Guarantor]*

This is the Schedule referred to in the foregoing Guarantee Bond between [ ], [ ] and [ ].

**The Contractor:** [ ] whose [address] [registered office address] is [ ].

**The Guarantor:** [ ] whose registered office address is [ ].

**The Employer:** [ ] whose [address] [registered office address] is [ ].

**The Contract:** A contract [dated the [ ] day of [ ]] [*to be entered into*] between the Employer and the Contractor in the form known as [ ] for the construction of works comprising [ ] for the original contract sum of [ ] pounds (£[ ]).

**The Bond Amount:** The sum of £[ ] pounds sterling (£[ ]).

**Expiry:** [*Insert details of the event agreed between the parties*] which shall be conclusive for the purposes of this Guarantee Bond.

**Insolvent:** [*Insert a definition of "Insolvent" by reference to the contract provisions or by reference to the Companies Acts*]