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For: Raymond Horan, Manager Sector
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BY EMAIL

Dear Raymond

Changes to the Construction Contracts Act regarding retention money

1. NZ Society of Local Government Managers (**SOLGM**) would like to understand the impending changes to the Construction Contracts Act 2002 (**Act**) regarding retention money held under construction contracts and how these changes are likely to affect local government construction contracting practices.
2. We set out below a summary of the retention money amendments introduced by the Construction Contracts Amendment Act 2015 (**Amendment Act**), the implications for local government, and recommended actions to ensure that local governments comply with the new retention provisions.

Executive Summary

3. The retention money amendments introduced by the Amendment Act (in sections 18A – I of Subpart 2A) will apply to all commercial construction contracts entered into on or after **31 March 2017** where retention money is greater than the "de minimus" amount.
4. A summary of the retention money amendments is set out in paragraphs 7 to 22 below.
5. The main implications of the amendments for local council construction contracts are:
 - (a) Trust obligations will be imposed on councils who will hold the retention money 'on trust' for the benefit of contractors (s 18C);
 - (b) Councils will be required to keep detailed and proper accounting records relating to the retention money (s18D);
 - (c) Any provisions in council construction contracts that are inconsistent with the retention money amendments, i.e. 'prohibited provisions' under section 18I will be void; and
 - (d) There is likely to be a shift in the construction industry toward the use of retention bonds or other means of security in place of cash retentions due to restricted cash flows created by the amendments.
6. Ahead of the amendments at the end of March 2017, we recommend that councils take the following steps:

- (a) Review their current accounting processes and implement changes as necessary to comply with the requirement for keeping proper records of all retention money. This may include considering opening separate accounts for retentions at least for larger construction projects;
- (b) Ensure that processes are put in place to manage requests from contractors to inspect accounting records;
- (c) Review their standard form construction contracts to ensure that they do not contain 'prohibited provisions' in respect of the retention money and make amendments as necessary; and
- (d) Consider whether to accept alternative means of security (e.g. retention bonds) for remedying of defects instead of cash retentions.

Summary of the Retention Money Amendments

7. A key purpose of the retention money amendments introduced by the Amendment Act is to ensure better certainty of payment to 'payees' (e.g. head contractors, subcontractor, suppliers etc) of retention money which is held under commercial construction contracts for remedying of defective work.
8. The amendments are contained in sections 18A-1 and will be inserted into the Act as Subpart 2A.
9. Section 18A defines retention money as follows:¹

...**retention money** means an amount withheld by a party to a construction contract (**party A**) from an amount payable to another party to the contract (**party B**) as security for the performance of party B's obligations under the contract.
10. The amendments are not retrospective and will therefore only apply to commercial construction contracts entered into on or after 31 March 2017.²
11. Section 18B states that the amendments apply to construction contracts where the retention money is more than the "de minimis" amount. This amount has not yet been specified and will likely be prescribed by regulations prior to 31 March 2017.
12. However, the available commentary suggests that the amount will be relatively low compared to other jurisdictions where retention money is required to be held on trust (e.g. various Australian states) in order to bring smaller contractors into the statutory retention scheme.
13. Section 18C provides that the retention money must be held "on trust" by party A (the 'payer') as trustee, for the benefit of part B (the 'payee').
14. A payer's obligations under the trust come to an end in three circumstances:
 - (a) Retention money is paid;
 - (b) A payee agrees to give up their claim; or

¹Construction Contracts Amendment Act 2015, s 18A

²Regulatory Systems (Commercial Matters) Amendment Bill

- (c) The money ceases to be payable by law (i.e. money ceases to be payable under the relevant construction contract).
15. Where payment of the retention money is late contrary to the terms of the construction contract, default interest will apply in accordance with section 18G.
16. Section 18E(1) prohibits the use of retention money for any purpose other than to remedy defects in the performance of party B's obligations under the contract – e.g. remedying defective work.
17. However, section 18E(2) confirms that retention money does not need to be held in a separate trust account and can be mixed or 'comingled' with other money. It may be held in the form of cash or other 'liquid assets' (e.g. potentially as accounts receivable or bank guarantee) and can be invested provided the investment is in accordance with the Trustee Act 1956 (section 18F).
18. While the money does not need to be held in a separate account, section 18D provides that party A must keep proper accounting records of all retention money held that:
- (a) Correctly record all dealings and transactions in relation to the retention money;
 - (b) Comply with generally accepted accounting principles; and
 - (c) Are readily and properly auditable.
19. Part A is required to make its accounting records available for inspection by a payer at all reasonable times.
20. Section 18I deals with prohibited provisions in construction contracts regarding retentions, namely provisions which:
- (a) Make the payment of retentions conditions on anything other than performance of party B's obligations under the contract;
 - (b) Make the date on which payment of the retention money is payable later than the date on which party B has performed all of its obligations under the contract; or
 - (c) Require party B to pay any fees or costs for administering the trust.
21. Any terms in the construction contract which fall afoul of these rules will be void.
22. Section 18H provides that the retention money will be protected in the event of a party A's insolvency as it will not be available to pay the debts of any creditors of party A or be taken by court order at the insistence of any creditor. This section simply restates the basic trust law principles that money held on trust is only to be used for the benefit of the beneficiaries.

Implications for local government construction contracts

23. The main implications of the retention money amendments on local governments are discussed below.

Obligation to hold retention money on trust

24. As noted above, party A is required to hold the retention money on trust for the benefit of party B³.
25. Councils as trustees will owe a fiduciary duty to their contractors in respect of the retention money and any use of this money other than to remedy defects in the contractor's performance will be a breach of the trust obligations. The Crimes Act 1961 and New Zealand trust law also create impetus to abide by the trust obligations.
26. General principles of trust law provide that assets of the trust must be clearly identifiable in order for the existence of a trust.⁴ Keeping proper records of the retention money will be a useful tool to maintaining identifiable trust money where no separate account has been created (see discussion at paragraphs 30 to 35).
27. Section 18C(2) states that "[a]ll retention money may be held in cash or liquid assets that are readily converted into cash". Some commentators have raised concerns about what exactly "liquid assets" will include. Liquid assets have been expressed as including short term investments which are able to be converted into cash quickly and in no more than 3 months. Whether accounts receivable will constitute liquid assets however remains open for debate.
28. Imposition of trust obligations on councils in respect of the retention money may not have a significant practical effect. The money is probably held in cash already and councils are unlikely to be appropriating retention money for uses other than remedying defects in the contractor's performance (i.e. in breach of the trust obligations).
29. However, the amendments are nonetheless likely to have a significant impact on the construction industry by highlighting the importance of ensuring that the retention money is available to payees on completion of their contractual obligations.

Obligation to keep proper records of retention money

30. The requirement for councils to keep proper accounting records of all the retention money, as required under section 18D, is likely to have a significant impact on local councils.
31. As noted in 18D(1) accounting records must correctly record all dealings and transactions in relation to the retention money, comply with generally accepted principles of accounting and be readily and properly auditable.
32. The obligation to make all such accounting records available for inspection by contractors at all reasonable times could potentially be problematic if the retention money is mixed in with other money. The risk of unrelated and confidential information being inadvertently exposed as a result of such inspections may be significant unless the retention money is diverted to a separate account.
33. In addition, comingling of monies may create issues of uncertainty as to what money can be considered the retention money (which is a trust asset) and which money can be used by councils for other spending.

³ Construction Contracts Amendment Act 2015, s 18C

⁴ *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669 (HL) at 705

34. Accordingly, while there is no obligation to hold retention money in a separate trust account⁵ in order to ensure compliance with generally accepted accounting principles and the payer's trust obligations this would likely be a safer option.
35. Councils may require some education and assistance from accounting specialists to ensure that their records will comply with generally accepted accounting principles in respect of the retentions and be capable of being made readily available for inspection and auditing.
36. Councils should also consider preparing formal processes to be followed in the event of requests by contractors to inspect the records.

Prohibited provisions in construction contracts

37. Section 18I states that:⁶

"Any term in a construction contract is void that purports to—

- (a) make the payment of retention money conditional on anything other than the performance of party B's obligations under the contract; or
 - b) make the date on which payment of retention money is payable later than the date on which party B has performed all of its obligations under the contract to the standard agreed under the contract..."
38. Cabinet outlined that a key reason the prohibition amendments were included was to "clarify the ban on "pay when paid".⁷
 39. If party A fails to pay retentions once the contractor has fulfilled all of its contractual obligations the amount of retention money owed to party B will accumulate interest every day until the date that it is paid as per section 18G of the Act.
 40. Given that the contractor's obligations will almost always include remedying any defects in the contract works, the retention money will typically not be required to be paid until the end of the defects liability period and completion of any outstanding defective work in accordance with the contract terms.
 41. However, any terms in council construction contracts that purport to make payment of the retention money contingent upon something else (e.g. payment by a third party funder) will be void and the retention money will accrue interest from the date that the contractor performed all of its obligations under the contract.

Increased use of retentions bonds

42. Currently in the construction industry main contractors typically rely on the retention money held against them by their clients (e.g. councils) to satisfy their retention obligations to their subcontractors and supply chain – i.e. contractors hold the "net" amount of retention money or the difference between the amount required to be held by them and retentions held against them.
43. The amendments do not expressly state whether party A must hold on trust the gross or net amount of retention money. However, the wording of section 18C(1) which

⁵ S 18E(2)(a)

⁶ 18I(1)

⁷ Regulatory Impact Statement 21 November 2014 "Retention in Construction Contracts"

states that "all retention money" must be held on trust suggests that the gross amount is intended to be held.

44. This conclusion is consistent with the overall objective of the retention money amendments which was to make sure the retentions provisions used by payers to get defects fixed do not unduly expose payees to risk. The Ministry of Business Innovation and Employment in a Regulatory Impact Statement ("RIS") specifically noted that the primary objective of the amendments was to address the "inefficient allocation of risks currently created by payers using retentions as working capital".
45. This primary objective seems only capable of being met by requiring the "gross" amount of retentions to be withheld by payers at all levels in the contracting chain (e.g. principles, contractors, subcontractors etc).
46. Moreover, the MBIE RIS assessed 4 options that might be used to solve the issue of payers unduly allocating the risk to payees of non-payment of the retention money. Option 3 of the 4 options proposed that the "amount equivalent to net retention must be held in trust". This option was ultimately not preferred and Cabinet agreed in principle with option 1 – i.e. that (gross) cash retained must be held in trust by each payer. This further supports the conclusion that Cabinet's intention underlying the amendments is to require gross cash retentions to be held by each payer rather than an amount equivalent to net retentions.
47. Lastly, our interpretation is consistent with limited legal commentary on the matter following the Amendment Act being enacted.
48. Assuming that cash retained must be held in trust by each payer (as seems most likely), this will inevitably place pressure on the contracting parties cash flows due to the cumulative total of money that is tied up in retentions. Head contractors, who have typically used the retentions as working capital are likely to be most affected and will need to obtain additional capital in order to hold retentions on trust.
49. The result of these cash flow pressures may be an increased trend to construction contracting parties using alternative security arrangements that are free from the constraints of trust obligations – e.g. retention bonds.

Conclusion and Recommendations

50. The new retention scheme introduced by the Amendment Act represents a considerable change to the industry's current treatment of retentions, in particular the requirement for all retentions to be held on trust for the benefit of the payee.
51. Further clarification, through regulations, is required for several issues including the "de minimis" amount to which the retention money amendments will apply. Regulations may also confirm whether the amount to be withheld is "gross" or "net", although the former seems more likely based on the current wording of the legislation.
52. Ahead of 31 March 2017, we recommend that councils take at least the following minimum steps to ensure they are ready for the changes in respect of retention money:
 - (a) Review current accounting processes and implement changes as necessary to comply with the requirement to have proper records of all retention money which can be produced for inspection and audit on request. This may require specialist accounting advice and consideration of whether a separate account for holding retentions, at least for larger projects, is feasible;

- (b) Ensure that processes are put in place to manage requests from contractors to inspect accounting records that will reduce the risk of inadvertent disclosure of unrelated or confidential information;
- (c) Review standard form construction contracts to ensure that they do not contain 'prohibited provisions' in respect of payment of the retention money, and make amendments where necessary; and
- (d) Consider whether to accept alternative means of security for remedying of defects in place of cash retentions, such as a retention bond. The requirements for such a bond may be that it is an unconditional on-demand bond, meaning that it may be called at any time by the council. Minimum requirements for the bond surety (e.g. must be a NZ registered bank) should also be considered.

Yours faithfully
SIMPSON GRIERSON

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