**Legalwise Seminar**

**Retentions under the Construction Contracts Amendment Act 2015**

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## *I. Introduction*

The issue of retentions and the changes introduced by the Construction Contracts Amendment Act 2015 (**Amendment Act**) have been the subject of considerable controversy and debate within legal, industry and Government factions. Some of that debate has triggered further amendments which are introduced by the Regulatory Systems (Commercial Matters) Amendment Bill (183-2) (**Bill**). What led to the amendments and will they truly protect those they were intended to or will they cripple an already stretched industry?

This paper will examine the history of retentions, what led to the amendments and the amendments themselves. It will then examine the key issues arising.

## *II. What are retentions and what is their purpose?*

Before addressing the amendments themselves, it is important to put retentions into context – what are they? And what is their purpose? At a basic level, a retention is an amount of money which is withheld by a head contractor or client from a contractor or subcontractor as 'performance security' to ensure that party meets its obligations under the contract, in particular to provide defect-free building work and complete its work on time. Retentions have been part of the construction industry since the 1840s[1] and are now the most commonly used performance security.[2] The reason for their popularity is because despite a subcontractor being obliged to either fix or pay damages in respect of defects in their work, this can be challenging to enforce once the subcontractor has completed its work and left the site. Further, where there is no long-term relationship between the parties, there is no incentive for the subcontractor to fix defects (or even stay onsite to complete a project in some cases) in order to maintain a good relationship with the head contractor.

Most standard form contracts calculate the retention on a basis of a percentage of the contract price.[3] The retention is deducted from each payment to the subcontractor and paid out in two stages – 50% at the date of practical completion (i.e. when the works are substantially complete and reasonably capable of being used for their intended purpose) and the remaining 50% once the defect liability period has come to an end[4] and all defects have been rectified.

Bonds and guarantees remain a common form of security used in the industry however, while it is relatively standard practice in New Zealand for head contractors to provide a client with both a bond and retentions, subcontractors usually only provide retentions as security. This is because subcontractors typically find it financially difficult to provide a performance guarantee from a third party or provide the security to a bank to obtain a bank bond.

## *III. Reasons for the new regime*

Before the Amendment Act came into force, many industry players had been questioning the fairness of the way in which the retention system operated. It was (and is) commonplace for developers and contractors to use retentions as working capital, effectively treating the retention money as if it was an unsecured interest free loan which often ends up being for an unfixed term.[5] Commentators have noted that it was also common for head contractors to withhold or delay the payment of retention funds.[6] This creates pressure on a subcontractor's cash flow while the head contractor benefits from the use of the retention money. At the same time, however, others in the industry argued that so long as the party

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[1] House of Commons, Trade and Industry Committee *The Use of Retentions in the UK Construction Industry* (4 December 2002) at [5].
[2] John Green "We Can't Fix the Past – Can We Fix the Future?" (paper presented to RANZ Conference, Auckland, June 2013) at 4.
[3] See, for example, cl 12.3.1 and 12.3.2 of the Special Conditions of Contract of New Zealand Standard 3916:2013 (Conditions of contract for building and civil engineering – Design and construct). This is usually between 5 per cent and 10 per cent, depending on the value of the contract.
[4] The defect liability period is usually 12 months after practical completion but can range from anywhere between 3 to 24 months.
[5] Cabinet Paper "Legislative solutions to issues relating to the use of retentions in the construction market" (11 August 2014).
[6] P Raina and J Tookey "The Perceptions of Retentions as held by Clients, Contractors and Subcontractors" (2013) Proceedings of the 38th International AUBEA Conference 95.

'holding' the retentions can meet their obligations when they are due to be released, the use of retentions as working cashflow is a sensible use of those funds.

The collapse of Mainzeal in 2013 brought to the fore the way in which retentions were being treated. It is commonly known that when they went into liquidation, Mainzeal owed an estimated $70 million to subcontractors, $18.3 million of which was in retentions.[7] Whether the subcontractors retrieved their retention funds or not depended on where they ranked in priority with the creditors of Mainzeal. However, many subcontractors missed out as their retentions were effectively treated as unsecured debts, leaving them with no recourse.[8] This prompted the Government to consider the use of retentions in the construction industry. As the Construction Contracts Act 2002 (**CCA**) regulates how payments are made under a construction contract and was already under review by the Government, it was timely to consider whether a statutorily imposed change in the use of retentions was required.

Some subcontractors called for provisions that required the subcontractor to automatically have the option of providing the head contractor with a bond in lieu of retention payments, while others advocated to do away with the retention system altogether. However, an approach similar to that enacted in New South Wales was ultimately adopted which required all retention amounts to be held "on trust" for the benefit of those contractors from whom they were being withheld.[9]

The idea behind a "trust" regime was that retention money held "on trust" would not be beneficially owned by the head contractor. Rather, it would be beneficially owned by the subcontractor from whom it is deducted. This means that if the company holding the retention money on trust went into liquidation, the retention money would not form part of the company's assets so the company's creditors would not be able to claim that they were entitled to it. Only the subcontractor from whom it was originally deducted would have a right to it as legally, the property is beneficially owned by them.

## *IV. Key features of the regime*

This "trust" solution was introduced as an amendment to the Construction Contracts Amendment Bill 2013 (97-2) by way of Supplementary Order Paper in March 2015. The regime is now set to come into force on 31 March 2017. The key features are:

(a) "Retention money" is defined as "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]

(b) All retention money "must be held on trust by party A, as trustee, for the benefit of party B";[11]

(c) A trust over retention money ends when:[12]

(i) the money is paid to party B; or

(ii) party B agrees in writing to give up claim to the money; or

(iii) the money ceases to be payable to party B under the contract or otherwise by law;

(d) The provisions will apply to commercial construction contracts where the amount of retention money is "more than the de minimus amount";[13]

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[7] *Receivers' First Report on the State of Affairs of Mainzeal Property and Construction Limited (In Receivership & In Liquidation) Mainzeal Living Limited (In Receivership & In Liquidation)* PricewaterhouseCoopers, 8 April 2013) at 9.
[8] Cabinet Paper "Legislative solutions to issues relating to the use of retentions in the construction market" (11 August 2014).
[9] See the Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015 (NSW). The "trust" approach was first proposed by the Government in August 2014 (see Cabinet Paper, above n 8).
[10] Amendment Act, s 18A.
[11] Amendment Act, s 18C(1).
[12] Amendment Act, s 18C(3).
[13] Amendment Act, s 18FC.

(e) Party A must make accounting records of retention money available for inspection by party B at all reasonable times and without charge.[14]

(f) The retention money "does not need to be paid into a separate trust account" and "may be commingled with other moneys";[15]

(g) The retention money can be invested by party A in accordance with the Trustee Act 1956 and may retain the benefit of any interest earned on retention money on or before the date on which it is payable under the contract;[16]

(h) The retention money must not be appropriated "to use other than to remedy defects in the performance of party B's obligations under the contract";[17]

(i) Interest on retention money is payable to party B from the date on which it is payable under the contract until the date on which it is paid;[18]

(j) The retention money is "not available for the payment of debts of any creditor of party A (other than party B)";[19]

(k) Parties cannot contract out of these provisions to avoid compliance.[20]

Further, any contractual provision which makes the payment of retention money conditional upon anything other than the performance of obligations under the contract or at any date after the completion of a party's contractual obligations will be void.[21] While this may not make any practical difference in how or when retentions are paid, it may require contracts to be amended to make it clear that money is being retained until contractual obligations are complete, rather than until the performance of other non-contractual obligations such as the issue of a practical completion certificate upstream (as between the holder of retentions and the principal, for example) or a specified date

## *V. What you need to know*

### *A. When and what retention amounts are to be held on trust?*

Previously, it was ambiguous as to whether the regime would apply to retention amounts that were already being withheld under contracts existing at the time of 31 March 2017 or whether only those retention amounts withheld after that date would be caught by the regime.

On 12 October 2016, Parliament introduced a new part of the Bill proposing to amend section 11A of the Amendment Act to hold that the retention money provisions will only apply to construction contracts entered into or renewed on or after 31 March 2017.[22] Accordingly, holders of retention money under construction contracts currently on foot, and those that are executed prior to 31 March 2017, would not be required to hold retention money "on trust" (provided the contract is not renewed on or after this date).[23]

This is a welcome development for all parties in the industry. The application of the regime to amounts that were already being withheld under contracts existing as at 31 March would have had significant financial implications for parties operating under these contracts as on that date, they would have needed to suddenly rearrange their financial affairs to ensure compliance with the Amendment Act, many of which

[14] Amendment Act, s 18D.
[15] Amendment Act, 18E(2).
[16] Amendment Act, s 18F.
[17] Amendment Act, s 18E.
[18] Amendment Act, s 18G.
[19] Amendment Act, s 18H(a).
[20] Amendment Act, s 18I(2).
[21] Amendment Act, s 18I(1). For parties using the Standard Form Subcontract Agreement 2009, the due date for final retention release in the Specific Conditions may need to be reviewed to ensure that it does not extend beyond the issue of the defects liability certificate.
[22] Part 4 of the Bill.
[23] The Select Committee agreed with this proposed change in its report: see Commerce Committee *Regulatory Systems (Commercial Matters) Amendment Bill* (3 March 2017) at 4.

would be holding multiple retention amounts for multiple parties in respect of multiple projects.[24] The proposed change will allow parties time to assess the implications of the Amendment Act and arrange their future affairs accordingly.

However, as the second reading of the Bill has not yet been scheduled, there is a possibility that it will not become law until after the regime comes into force, leaving parties "in limbo" as to which retention amounts they should be putting on trust. The Commerce Committee (**Select Committee**) in their report on the Bill raised this issue which hopefully suggests that the progress of the Bill may be fast-tracked to coincide with the regime coming into force.[25]

There was a possibility for regulations to prescribe a "de minimus" retention amount as a threshold for triggering the retention regime,[26] however, none have been put forward to date.[27] Indeed, MBIE has indicated that the regime will apply regardless of the amount of money involved to ensure that smaller subcontractors are protected.[28]

*B. What must you hold on trust: cash or liquid assets?*

Retention money may be held in the form of cash or other liquid assets that are "readily converted into cash".[29] Holders of retention money must therefore identify an asset, call it retention money and hold it on trust. It is unclear what a "liquid asset" could constitute and there are no definitions provided in the Amendment Act to assist. It could be interpreted to cover financial investments, accounts receivable, trading stock, retentions receivable or other financial instruments.

The Select Committee in its report on the Bill recommended a completely separate option for protecting retention money, other than holding cash or liquid assets "on trust". If this is enacted, the "default position" that retention money is held "on trust" would remain,[30] however, holders of retention money would also be able to opt for an "alternative arrangement" which would allow parties to comply with the Amendment Act by instead obtaining a "financial instrument", such as insurance or a payment bond, to provide third-party protection of retention money [31] On this recommendation, there would be strict requirements to be a complying instrument - the issuer of the instrument would have to be a licenced insurer or a registered bank[32] and the instrument itself would need to require the issuer to pay the retention money if the holder fails to pay when it is required to under the contract.[33]

It would also enable party B to directly claim the retention money from the issuer if the holder is unable to meet the retention amount owing.[34] The Committee also recommended record-keeping mechanisms in respect of these financial instruments that parties would need to comply with, including recording what amounts of money are protected by each instrument, any caps on the issuer's liability and all information regarding the holder's compliance with the terms of the instrument (including for example, payment of premiums).[35]

If implemented, this would give holders of retention money the flexibility to protect retention money in ways other than holding cash[36] in order to avoid the expense and difficulty associated with obtaining

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[24] MBIE has estimated that there is approximately $150 million to $250 million retentions held in the commercial construction sector (Regulatory Impact Statement, 21 November 2014 at [7]), based on an MBIE survey of the commercial construction sector conducted in October 2014.
[25] Commerce Committee *Regulatory Systems (Commercial Matters) Amendment Bill* (3 March 2017) at 4.
[26] Construction Contracts Amendment Act 2015, s 18B(2). This is different to the retentions regime recently introduced by the New South Wales Government where the regime only applies to projects valued at over $20 million.
[27] No amount was proposed by the Select Committee in its report.
[28] https://www.building.govt.nz/projects-and-consents/why-contracts-are-valuable/construction-contracts-act-2002
[29] Amendment Act, s 18C(2).
[30] The Select Committee has proposed changing the title of section 18C from "Trust over retention money" to "Default arrangement: trust".
[31] Commerce Committee *Regulatory Systems (Commercial Matters) Amendment Bill* (3 March 2017) at 46.
[32] Note that the proposed section also contemplates future regulations prescribing further complying "issuers" (refer s 18FB(2)(c) of the report, p 47).
[33] Commerce Committee *Regulatory Systems (Commercial Matters) Amendment Bill* (3 March 2017) at 47.
[34] Commerce Committee *Regulatory Systems (Commercial Matters) Amendment Bill* (3 March 2017) at 47.
[35] Commerce Committee *Regulatory Systems (Commercial Matters) Amendment Bill* (3 March 2017) at 48.
[36] Ministry of Business, Innovation and Employment *Regulatory Systems (Commercial Matters) Amendment Bill: Departmental Report to Commerce Committee* (14 December 2016) at 5.

enough cash to meet the "trust" requirements.[37] It would also ensure that subcontractors have an alternative recourse to their retention money if the holder is unable to pay or goes into liquidation.

*C. How is retention money to be put on trust?*

The Amendment Act provides that "all retention money must be held on trust".[38] Strictly interpreted, this wording imposes a positive obligation on parties withholding retention money to actively put those funds "on trust". There is no suggestion that the retention amounts are automatically deemed trust property.[39] The High Court has made it clear that when Parliament uses the term "trust", in the absence of a specific definition, it must be taken that the law of trust applies.[40]

The regime expressly allows for the commingling of retentions with other money, including money held in relation to separate projects and for other parties, and does not require the money to be paid into a separate trust account.[41] This differs from the New South Wales regime which requires retention money to be held in a separate trust account.[42] However, under general trust law, holders of retentions will owe certain duties as a trustee to act honestly and in good faith for the benefit of the beneficiaries (i.e. the party from whom the retentions are taken) and these apply regardless of a separate trust account, so long as the amounts are on trust. There is a risk that if retentions remain in a general working account, holders may inadvertently use the retention money in breach of their trustee obligations (which may also attract liability to the directors of the company holding the retentions), for example by using the funds as working capital or to pay out other contractors. Further, a holder's obligation to make available its accounting records for inspection in respect of the withheld amount[43] may mean that the disclosure of other unrelated accounting information will be necessary if retentions are mixed together in the same account.

Ultimately, whether the administrative burden of creating separate trust accounts outweighs the risk of non-compliance with trustee duties is something for parties to consider and will largely depend on the nature of their business.

*D. What methods of enforcement are there when the retention money holder breaches its obligations?*

The Amendment Act is silent on what penalties parties will attract for non-compliance with the regime.[44] However, as discussed above, in the absence of statutory guidance, general trust law will apply. If the head contractor breaches its fiduciary duty by, for example, paying all or some of the trust money to a person not entitled to receive the money or using its trust powers for its own benefit, compensatory damages are available to beneficiaries to restore them to the position they would have been in had the breach not occurred.[45] Punitive exemplary damages may also be awarded in particularly serious circumstances where the contractor had exhibited a deliberate and conscious wrongdoing.[46]

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[37] Ministry of Business, Innovation and Employment *Regulatory Systems (Commercial Matters) Amendment Bill: Departmental Report to Commerce Committee* (14 December 2016) at 5.
[38] Amendment Act, s18C(1).
[39] This can be contrasted with the legislative position in Western Australia and Northern Territory where, under schedule 1, division 9, section 11 of the Construction Contracts Act 2004 (WA) and schedule 1, division 9, section 10 of the Construction Contracts (Security of Payments) Act (NT), retention money is deemed to be held on trust: *"If the principal retains from an amount payable by the principal to the contractor for the performance by the contractor of its obligations a portion of that amount… the principal holds the retention money on trust for the contractor…".*
[40] *Eaton v LDC Finance Ltd (in rec)* [2012] NZHC 1105 at [117].
[41] Construction Contracts Amendment Act 2015, s 18E(2).
[42] The Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015 (NSW), cl 6(2). Such an approach was considered but ultimately dismissed by Cabinet in New Zealand due to the high compliance costs.
[43] Construction Contracts Amendment Act 2015, s 18D.
[44] In New South Wales, there is a maximum penalty for breach of the regulations providing for the treatment of retentions at 200 "penalty units", currently set at $22,000.
[45] *Day v Mead* [1987] 2 NZLR 443 (CA); *Chirnside v Fay* [2006] NZSC 68, [2007] 1 NZLR 433; *Stevens v Premium Real Estate Ltd* [2009] NZSC 15, [2009] 2 NZLR 384.
[46] *Aquaculture Corp v New Zealand Green Mussel Co Ltd* [1990] 3 NZLR 299 (CA); *Cook v Evatt* (No 2) [1992] 1 NZLR 676 (HC).

Other possible penalties include:

(a) A dishonest breach of trust giving rise to criminal liability for criminal breach of trust[47] or theft by a person in a special relationship;[48]

(b) Claims against the directors of the construction company holding the retentions for knowing or dishonest assistance in the company's breach of trust. This will depend on the degree of knowledge of the director in the circumstances;

(c) Claims in knowing receipt where directors have personally received the proceeds of misapplied trust money; and

(d) A mandatory injunction may be available compelling a holder to put retention money on trust.[49]

If the penalties are too light, there is less incentive for head contractors to comply. And if it is expensive and time consuming to enforce the penalties, then subcontractors will have to weigh up whether it is worth pursuing the retentions, rendering the changes ineffective altogether. Ultimately, the enforcement of penalties will lie with those entitled to the retentions[50] and will depend on how easy it is for subcontractors to identify their retention moneys and trace their movements.

*E. Does the regime protect retention money in the event of the retention holder's liquidation?*

The importance of whether the retention money is held "on trust" at all and is identifiable is highlighted if the party holding the retention money becomes insolvent. Expressly allowing head contractors to mix retention money in with other funds is problematic when considered in the context of general trust law and may pose difficulties to subcontractors in the event of a holders' liquidation. It is a fundamental and uncontroversial principle of trust law that trust property must be identifiable in order for a trust to exist.[51] Subcontractors may find it difficult to identify their retention money if such funds are mixed with other subcontractors' retention money and/or funds belonging to the head contractor. If the head contractor withdraws funds from that account for other purposes, it can be difficult at times to determine whose money was withdrawn from the account and at what time. This makes it difficult for the subcontractor to identify the money it is entitled to and can prevent subcontractors (as beneficiaries) from claiming their retention money back.

This is important because if retention moneys are held on trust and cannot be identified (and therefore traced) once mixed with other funds, then putting the retentions on trust does not get subcontractors anywhere in a liquidation of the head contractor. In this situation, the only recourse left to the subcontractor would be a damages claim and this would rank with the claim of all unsecured creditors.

Requiring head contractors to maintain "proper accounting records" of the retention money, showing among other things "all dealings and transactions" in relation to the money, will make the chances of a subcontractor being able to trace and identify its funds more likely in the event of liquidation. However, the burden will rest with the subcontractor to regularly inspect the accounting records, which may involve engaging a forensic accountant where the retention moneys are mixed with other funds.

Accordingly, if the retention money is actually put on trust and is identifiable as trust property, it belongs beneficially to the party from whom it was deducted and no longer forms part of the assets of the company in liquidation. If this occurs, subcontractors will not need to be concerned with where it ranks in priority with creditors as it will not fall into the general pool for distribution. However, if the client or head contractor has failed to follow the provisions of the Amendment Act and has instead used retentions as general cashflow, the subcontractor is still no better off because the trust property no longer exists.

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[47] Crimes Act 1961, s 229.
[48] Crimes Act 1961, s 220.
[49] See, for example, *Wates Construction (London) v Franthom Property* (1991) 53 BLR 23 (CA) holding that an injunction was available to enforce a contractual provision that money be held on trust. See also *Earthquake Commission v Insurance Council of New Zealand Inc* [2014] NZHC 3138 and *Far North District Council v Rightside Properties Ltd* [2012] NZHC 2 for their discussions of injunctions in relation to statutory obligations.
[50] Construction Contracts Amendment Act 2015, s 18D(2) requires the holder to make available accounting records of retention money for inspection by the "beneficiary" at all "reasonable times" and without charge.
[51] *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669 (HL) at 705.

## *VI. Conclusion*

Whether the Amendment Act retention provisions will provide security of payment for subcontractors will ultimately depend on whether or not the retention money is readily identifiable and traceable and, most of all, the integrity of the industry. The Select Committee's "alternative arrangement" proposal, if enacted, may see many parties opting for these alternative methods of compliance to avoid the burden of attempting to comply with the trust requirements and attracting liability as a trustee. Subcontractors may also insist on holders of their retentions going down this route in light of the continued risk of non-recovery of retentions in the event of the holder's liquidation because of some of the apparent deficiencies in the regime.

Indeed, this latest proposal is a step towards a more pragmatic approach and appears to go some way in circumventing initial concerns that requiring retentions to be set aside would have a serious effect on cashflow in the industry. It allows holders more options in terms of securing payment for their contractors, without this being at the cost of placing immense restrictions on their ability to finance their projects.

Alternatively, the uncertainty associated with the regime may see some parties doing away with retentions altogether and agree on a bond or guarantee instead. New Zealand Standard 3916:2013, a widely used standard form contract, already provides for a bond in lieu of retentions.[52] Certainly there will be an increasing focus on the role that the parties themselves (or their representatives) play in preparing terms governing security in construction contracts – despite the increasing governance through legislation.

[52] See New Zealand Standard Form Contract 3916:2013, cl 12.3.3 of the General Conditions and sch 5.