

## **Legislative solutions to issues relating to the use of retentions in the construction market**

### **Proposal**

- 1 I seek agreement to amend the Construction Contracts Act 2002 to regulate the use of retentions in the construction market.

### **Executive summary**

- 2 Retentions are part of the contract price retained by the client or head contractor to ensure defective building work is fixed.
- 3 Policy work on the use of retentions in the construction market began soon after the collapse of Mainzeal in February 2013. The Mainzeal collapse highlighted possible issues with the use of retentions. The following key issues relating to the use of retentions in the construction market have been identified:
  - Subcontractors risk non-payment of retentions due to insolvency of clients or head contractors, and they are not the best party to manage this risk.
  - The high risk of insolvency in the construction market (relative to other markets), and therefore the higher risk of loss of retentions, detracts from the sector's growth and productivity.
  - The use of retentions as working capital, by clients and head contractors, supports poor practices such as low-price tendering.
- 4 I have considered a wide range of possible solutions. The market-driven solutions (such as education about better tendering practices) will have minimal effect. There are few incentives for the sector to change their existing practices and attempts to do so have all failed to date.
- 5 I consider legislative change is needed to force the sector to pay retentions in a timely manner and stop reliance on retention monies to fund other projects. The Construction Contracts Act 2002 already regulates how payments are made under construction contracts, so it is appropriate that provisions relating to payment of retentions be included in that Act.

- 6 I propose the Act be amended to:
  - clarify the ban on “pay when paid” includes any tactics that delay payment of retentions beyond the date specified in the construction contract (or under the default provisions in the Act)
  - provide for a default rate of interest (prescribed in regulations) to be applied to late payment of retentions in the absence of a rate of interest being specified in the construction contract
  - require retentions to be held “in trust” following the legislation model used in some states of the USA.
- 7 A Construction Contracts Amendment Bill is already in the House, awaiting its Committee of the Whole stage. I therefore propose a Supplementary Order Paper to the Bill be drafted to make the amendments.
- 8 I will publicly announce the decisions Cabinet makes.

## **Background**

- 9 Retentions are part of the contract price retained by the client or head contractor to ensure defective building work is fixed. The use of retentions is a common and long-standing practice in commercial construction projects. Following the collapse of Mainzeal in February 2013, issues relating to the use of retentions were highlighted.<sup>1</sup>
- 10 The key issues are:
  - Subcontractors risk non-payment of retentions due to insolvency of clients or head contractors, and they are not the best party to manage this risk.
  - The high risk of insolvency in the construction market (relative to other markets), and therefore the higher risk of loss of retentions, detracts from the sector’s growth and productivity.
  - The use of retentions as working capital, by clients and head contractors, supports poor practices such as low-price tendering.
- 11 Security of payment for retentions, to minimise the risk of loss in an insolvency, is the key concern of subcontractors.
- 12 The use of retentions as working capital is the key concern for the Government. Funding working capital from retentions can mask and reward poor performance and poor financial management practices. For example, undercapitalisation and low-price tendering are long standing features of the construction market that contribute to its low productivity and innovation. The use of retentions as working capital enables those features to remain with no incentive to change and no incentive for clients or head contractors to properly manage project risks.

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<sup>1</sup> When it was placed in receivership, Mainzeal held \$18 million in retention payments that were due to be paid to subcontractors, but the Mainzeal clients were only due to pay \$11 million in retentions to Mainzeal. The difference of \$7 million would have needed to be funded from other parts of the Mainzeal operations or from payments from new/future contracts.

## Comment

- 13 The issues are largely of the sector's own making and require a significant behavioural change in order to be addressed. However, attempts to achieve behavioural change have so far not succeeded or been shown to be ineffective. Clients and head contractors have low incentives to change their behaviour because of the potentially high financial impact on their working capital. The long history of low-price tendering in the sector also means any head contractor who "takes the lead" in tendering at more realistic prices runs a high risk of not getting work. I have considered a wide range of possible market-driven and legislative solutions. Further market-driven solutions (such as education about better tendering practices) will not be sufficient, on their own, to make the changes required. Legislation is necessary to regulate the use of retentions.
- 14 The Construction Contracts Act 2002 currently regulates how payments are made under construction contracts, including default payment timing provisions and processes for resolving payment disputes. The Act has been effective in ending the "pay when paid" approach to contract payments that it was designed to address. However, in relation to retentions, clients and head contractors have found other ways to delay payments that are not always obviously "pay when paid". These tactics need to be clearly banned under the Act. I also think the Act should provide for penalty interest to be paid on overdue amounts. I therefore propose two minor changes to the Act:
- Clarifying the ban on "pay when paid" includes any tactics that delay payment of retentions beyond the date specified in the construction contract (or under the default provisions in the Act).
  - Providing for a default rate of interest (prescribed in regulations) to be applied to late payment of retentions in the absence of a rate of interest being specified in the construction contract (the Act already allows interest to be claimed at the rate stated in the construction contract).
- 15 To provide security of payment and make it nearly impossible for clients and head contractors to use retentions as working capital, I propose the Construction Contracts Act be amended to require retention funds to be held "in trust". Many states of the USA and Canada regulate construction contract payments in this way, though they have different regulatory frameworks for their legislation. In Canada the legislation is highly prescriptive, whereas states in the USA take a more light-handed approach. I consider the light-handed approach is appropriate for New Zealand because it will be consistent with the performance-based approach we take to legislation in the construction sector. The legislation would therefore be modelled on provisions in USA statutes and include the following main features:
- impose a trust on the retention monies earned on a project for the benefit of the subcontractors on that project
  - make the contractor in receipt of the money the trustee of the funds and therefore owe a fiduciary duty to the beneficiaries (i.e. subcontractors) to exercise proper and honest judgment, the primary duty is to ensure that funds are spent on the particular project for which they were received
  - provide for penalties for an entity that fails in its fiduciary responsibilities to the trust beneficiaries and that uses the funds to pay off debts not related to the specific project.
- 16 Clients and head contractors would be free to determine how to meet the trust obligation in practice, but would not be required to, for example, set up costly trust account processes with third parties.

- 17 The trust requirement will force the sector to change its financing and business practices from using retentions as working capital. This has high risks in the current economic climate – the recovery from a recession and high demand for construction work in Canterbury and Auckland is placing significant pressure on the sector that will make it difficult to adjust to a requirement to hold retentions in trust.
- 18 The trust approach will have high costs in the short term, but benefits in the long term:

#### *Short term costs*

- The small businesses that make up the majority of the sector will have difficulties accessing alternative forms of financing.
- The fragility of the sector should not be underestimated – some businesses may not be able to survive the change and this will not necessarily be limited to the “bad” businesses.

#### *Long term benefits*

- Growth in the capital market may be stimulated by clients and head contractors sourcing their working capital from other funders.
- Construction businesses should be more financially stable and the insolvency rate could also be lowered.

### **Public consultation**

- 19 The Ministry of Business, Innovation and Employment (“the Ministry”) consulted with representatives of the construction sector to identify the key issues and determine viable possible solutions. The consultation included three face-to-face workshops in July 2013, August 2013 and April 2014. In total over 45 representatives from the sector attended the workshops, representing a wide range of clients, head contractors and subcontractors.
- 20 The consensus views of the sector support the proposal to clarify the ban on “pay when paid”. The sector also supports, in principle, the trust approach, but has concerns about how it will work in practice and how it could be enforced. In particular, to mitigate the expected high costs, the sector has asked for a reasonable lead-in time to be provided before the amendments come into force to enable the sector to manage the change. These concerns can be addressed during the drafting process for the amendments.

### **Departmental consultation**

- 21 The Treasury has been consulted on this paper. The Department of Prime Minister and Cabinet was informed about this paper.

### **Financial implications**

- 22 The proposals in this paper have no financial implications.

### **Human rights**

- 23 The proposals are not intended to be inconsistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993. A final view on consistency will be determined when the legislation has been drafted.

## **Legislative implications**

24 Amendments are required to the Construction Contracts Act 2002 to implement the proposals. A Construction Contracts Amendment Bill is currently before the House, awaiting Committee of the Whole stage. A Supplementary Order Paper to the Bill is proposed to be introduced, when Parliament resumes after the General Election, to make the required amendments. There are some drafting errors in the Bill (as reported back from Select Committee) that need to be corrected, so a Supplementary Order Paper will be required in any event.

## **Regulatory impact analysis**

25 A regulatory impact statement (RIS) is not required for the amendments to clarify the ban on “pay when paid” or the provision of a default interest rate because they will have only minor impacts on construction sector businesses.

26 A RIS is required for the proposal for retention funds to be held on trust. After consultation with the Treasury, it has become clear that it is better to prepare a well-considered RIS, rather than one prepared at short notice to accompany this Cabinet paper. Before I submit the draft Supplementary Order Paper to the Cabinet Legislation Committee, I will report to the Cabinet Economic Growth and Infrastructure Committee (EGI) with:

- a Regulatory Impact Statement analysing the problem and the expected effects of options for addressing the problem
- details of how the changes will be implemented and enforced, and how the effectiveness of the changes will be monitored
- results of further consultation with the construction sector and banks, as well as government entities that enter into substantial construction contracts.

## **Publicity**

27 I will make an announcement about the decisions and communicate the decisions directly to the sector representatives who have worked with the Ministry on the proposals. The announcement will be made before the General Election.

## **Recommendations**

28 I recommend the Committee:

- 1 **note** long standing practices relating to the use of retentions in the construction market have created the following issues:
  - Subcontractors risk non-payment of retentions due to insolvency of clients or head contractors, and they are not the best party to manage this risk.
  - The high risk of insolvency in the construction market (relative to other markets), and therefore the higher risk of loss of retentions, detracts from the sector's growth and productivity.
  - The use of retentions as working capital, by clients and head contractors, supports poor practices such as low-price tendering;

2 **agree** to amend the Construction Contracts Act 2002 to:

- clarify the ban on “pay when paid” includes any tactics that delay payment of retentions beyond the date specified in the construction contract (or under the default provisions in the Act)
- provide for a default rate of interest (prescribed in regulations) to be applied to late payment of retentions in the absence of a rate of interest being specified in the construction contract
- require retentions to be held “in trust” and the amendment will include the following features:
  - the statute imposes a trust on the retention monies earned on a project for the benefit of the subcontractors on that project
  - the contractor in receipt of the money becomes trustee of the funds and owes a fiduciary duty to the beneficiaries (i.e. subcontractors) to exercise proper and honest judgment, the primary duty is to ensure that funds are spent on the particular project for which they were received
  - penalties for an entity that fails in its fiduciary responsibilities to the trust beneficiaries and that uses the funds to pay off debts not related to the specific project;

3 **invite** the Minister for Building and Construction to issue drafting instructions to Parliamentary Counsel to include the amendments in recommendation 2 in a Supplementary Order Paper to the Construction Contracts Amendment Bill;

4 **authorise** the Minister for Building and Construction to include other minor or technical amendments to the Construction Contracts Amendment Bill in the Supplementary Order Paper;

5 **invite** the Minister for Building and Construction, before submitting the Supplementary Order Paper to the Cabinet Legislation Committee, to report to the Cabinet Economic Growth and Infrastructure Committee with a Regulatory Impact Statement, along with details of the implementation, enforcement and monitoring of the changes to retentions reflected in recommendation 2, and results of further consultation with the construction sector, banks and government entities who enter into substantial construction contracts;

6 **note** the Minister for Building and Construction will inform the sector about the decisions in this paper and publicly announce the decisions before the General Election;

7 **authorise** the Ministry of Business, Innovation and Employment to place a copy of this paper and the minute of the Cabinet decision on its website.



Hon Dr Nick Smith

Minister for Building and Construction

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