

Office of the Minister for Building and Housing

Cabinet Economic Growth and Infrastructure Committee

Regulating the use of retentions in the construction market - final policy decisions

Proposal

- 1 I seek confirmation of previous Cabinet “in principle” agreement to amend the Construction Contracts Act 2002 to regulate the use of retentions in the construction market.

Executive summary

- 2 On 11 August 2014, Cabinet:

agreed in principle, to amend the Construction Contracts Act 2002 (the Act),
subject to the report ... below, 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 judgement, 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;*

invited the Minister for Building and Construction (the Minister) to issue drafting instructions to the Parliamentary Counsel Office to include the amendments ... above in a Supplementary Order Paper (SOP) to the [Construction Contracts Amendment] Bill;

invited the Minister, before submitting the SOP to the Cabinet Legislation Committee, to report to the Cabinet Economic Growth and Infrastructure Committee with:

- *a Regulatory Impact Statement;*
- *details of any transitional arrangements that may be needed to avoid any negative impacts for construction companies;*
- *details of the implementation, enforcement and monitoring of the changes to retentions reflected ... above;*
- *the results of further consultation with the construction sector, banks and government entities that enter into substantial construction contracts.*

[CAB Min (14) 27/9, paragraphs 2, 4 and 6 refer]

- 3 This paper meets the report-back requirement. The Regulatory Impact Statement (RIS) is attached in the appendix to this paper. Consultation with the sector, banks and government departments confirmed general support for the proposed amendments. Concerns raised, or suggestions made, during the consultation have informed the recommendations in this paper for the final policy details of the amendments, including the transitional arrangements.
- 4 I recommend Cabinet confirms the “in principle” policy decisions made on 11 August 2014 and agrees to the following details of the amendments to the Construction Contracts Act 2002:
 - The amendments will only apply to new commercial construction contracts that are entered into after 31 March 2016.
 - The term “retentions” be defined as: *“money retained by a payer out of money payable by the payer to a payee under a commercial construction contract, as security for the performance of obligations of the payee under the contract to the standard specified in the contract.”*
 - Some details of the “in trust” requirement be prescribed in regulations, but the statute specifies:
 - the trust applies to cash retained by the payer and if the payer is using debt to fund the construction work, the payer is not obliged to draw down funds for retentions and separately hold them “in trust”
 - the trust obligation ends when either:
 - the retentions are paid in full to the payee; or
 - the retentions are used for the purpose, specified in the construction contract, for which they were retained, e.g: to fix defective work
 - the payer can keep any interest earned on the trust money, but the payer cannot charge any costs of administration against the trust money
 - small amounts of retentions (“de minimis” amounts) will not be subject to the trust requirement, with the minimum amount of retentions to be prescribed in regulations.

Background

- 5 On 11 August 2014, I sought Cabinet agreement to amend the Construction Contracts Act 2002 (the Act) to regulate the use of retentions in the construction market. Retentions are part of the contract price, specified under the contract as being 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.
 - 6 Regulation of retentions is necessary to address 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.
 - 7 Security of payment for retentions, to minimise the risk of loss in an insolvency, is the key concern of subcontractors.
 - 8 The use of retentions as working capital is the key concern for the Government and the key reason regulatory intervention is needed. 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.
 - 9 Cabinet agreed, in principle, to amend the Act 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 judgement, 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.
- [CAB Min (14) 27/9, paragraph 2 refers]
- 10 Cabinet also invited me to issue drafting instructions for the amendments, but, before submitting the amendments to the Cabinet Legislation Committee, to report to the Cabinet Economic Growth and Infrastructure Committee with:
 - a Regulatory Impact Statement;

- details of any transitional arrangements that may be needed to avoid any negative impacts for construction companies;
- details of the implementation, enforcement and monitoring of the changes to retentions;
- the results of further consultation with the construction sector, banks and government entities that enter into substantial construction contracts.

[CAB Min (14) 27/9, paragraphs 4 and 6 refer]

Details of transitional arrangements and the changes to retentions

- 11 The transitional arrangements are the key factor to mitigate the significant impact the “in trust” requirement will have on the construction sector. I propose a reasonable transitional period before the amendments apply. I recommend the amendments relating to the “in trust” requirement only apply to new commercial construction contracts that are entered into after 31 March 2016. This will give construction businesses a complete tax year to make any necessary adjustments to their financial and accounting practices.
- 12 The changes to retentions have been developed in more detail in light of comments and suggestions received during the consultation with the sector, banks and government departments.
- 13 The amendment to provide for a default rate of interest for late payments is straightforward and minor, no further detail is required.
- 14 The amendment to clarify the ban on “pay when paid” contract terms is also relatively straightforward, though comments received in the consultation on the proposed changes note certain matters that needed to be clear in the drafting. I recommend the drafting of the amendment to the ban on “pay when paid” contract terms ensures:
 - retentions can lawfully be withheld (not paid) until the payee has fully performed its obligations under the construction contract, such as fixing any defects;
 - any provisions in construction contracts that make payment conditional on the performance of obligations under a different contract are banned, e.g: payment to subcontractor A from head contractor B cannot be conditional on the performance of subcontractor C’s obligations under its contract with head contractor B.
- 15 The provisions requiring retention funds to be held “in trust” need a certain amount of detail to be in the Act to ensure it is clear what money is subject to the trust requirement and what the key terms of the trust obligation are. I recommend the following amendments to the Act be made:
 - A new section to define the term “retentions” as: *“money retained by a payer out of money payable by the payer to a payee under a commercial construction contract, as security for the performance of obligations of the payee under the contract to the standard specified in the contract”*. This definition ensures only retentions (and no other contract payments) are covered by the new requirements.
 - A new section to require any payer of retentions to hold the retentions “in trust” for the benefit of the payee (the terms “payer” and “payee” are already defined in the Act). The section will impose the fiduciary duty on the payer to only use the retentions for the purpose (specified in the construction contract) for which they are retained, and states:
 - The trust applies to cash retained by the payer and, if the payer is using debt to fund the construction work, the payer is not obliged to draw down funds for retentions and separately hold them “in trust.” (Private clients do

not usually draw down funds from banks until retentions are due to be paid, if a payer does draw down retention funds before they are due to be paid, they will need to hold them in “in trust” until they are paid for the purpose specified in the construction contract.)

- The retentions held in trust can be used for the purposes, specified in the construction contract, for which they are retained.
- The trust obligation ends when either:
 - the retentions are paid in full to the payee; or
 - the retentions are used for the purpose, specified in the construction contract, for which they were retained, i.e: to fix defective work.
- The payer can keep any interest earned on the trust money, but the payer cannot charge any costs of administration against the trust money.
- Small amounts of retentions (“de minimis” amounts) will not be subject to the trust requirement, with the minimum amount of retentions to be prescribed in regulations.
- A new regulation-making power to enable other details about how the trust requirement will operate in practice to be prescribed, such as:
 - Events that may result in ending the trust obligation in addition to those specified in the Act.
 - The minimum (“de minimis”) amount of retentions retained that will trigger the “in trust” requirement.
 - Methods for accounting for the money held in trust that will be acceptable (but not mandatory) for complying with the “in trust” requirement, e.g: if the money is held in a separate bank account, that is acceptable.

Monitoring of amendments

16 The amendments will be monitored on an exceptions basis – that is, if there are indications of issues. The Ministry of Business, Innovation and Employment will liaise with the sector to monitor the effect of the amendments on the holding of retentions, non-payment of retentions and transaction costs created by the amendments. This monitoring will help decide (in the first instance) what ongoing advice and information the Government needs to provide.

Results of further consultation with the sector, banks and government departments

Sector

- 17 The Ministry of Business, Innovation and Employment sought comments from a wide range of representatives of the construction sector on the proposed amendments to the Act. Comments received expressed general support for the proposed amendments, but noted some concerns. The key concerns raised are:
- In clarifying the application of the ban on “pay when paid” conditions, the amendment must not restrict legitimate contract terms that require subcontractors to fix defects or complete their work before retentions are paid. Further, the legislation should not incentivise inappropriately long defect liability periods being specified in contracts or a move to “pay when certified” conditions.
 - The new requirement for retentions to be held “in trust” is lacking in important details that cannot be left to the sector to experiment with or “figure it out.” In

particular, whether any separate accounting of the retentions held in trust is required (noting that it will be impossible to prove compliance with the trust requirement unless funds are held in a separate account). The precise terms of the trust requirement were also a matter of concern – the legislation needs to clearly state what the retention money can be used for (i.e: to fix defects) and when the trust obligation ends (i.e: when the subcontractor has performed all its contractual obligations).

- A clear definition of the term “retentions” is also necessary to ensure the new requirements do not apply to all contract payments and are clear about how debt-funded projects will be covered. In addition, the legislation should not have the effect of “sterilising” contract funds by requiring multiple parties to hold the same amount (e.g: 2 x \$1000) in trust when only a single payment (e.g: \$1000) will be due on completion of the contract.
- A transition period before the new requirements come into force is critical because significant changes to capital funding and accounting practices will be required. Two years was suggested by the large construction companies and the Construction Strategy Group sought further discussions with the Crown about the implementation timeframe for the changes. The Specialist Trade Contractors Federation said a one year period was appropriate.
- Criminal penalties are necessary to provide the appropriate incentive to comply with the new requirements. Penalties should apply to both individuals and entities who breach the requirement and include fines up to the value of the retentions held.

18 The comments on the “in trust” requirement reflect a lack of understanding in the sector about the existing rules of trust law – this can be addressed through advice and education provided by the Government. The other comments have informed the recommendations for the detail of the legislation described in paragraphs 11, 14 and 15 above.

Banks

19 Westpac, BNZ and ANZ were consulted and given a draft of the RIS to comment on. Information from the banks has informed the final recommended details of the legislation in paragraphs 11, 14 and 15 above and the analysis in the RIS. All the banks confirmed there is no current likely source of additional equity funding for the construction sector and they are unlikely to provide debt funding to replace retentions that are being used as working capital (though noting they would consider existing clients on a case-by-case basis). The banks also suggested the sector would need about two years to adjust financial arrangements to meet the “in trust” requirement.

Government Departments

20 The Department of Corrections, Accident Compensation Corporation, Department of Conservation, Ministry for Primary Industries, Police, Ministry of Social Development, NZ Fire Service, Ministry of Justice, Office of the Privacy Commissioner, Reserve Bank, Inland Revenue Department (IRD) and The Treasury were consulted on the proposed amendments.

21 The Department of Corrections noted the requirements in section 66 of the Public Finance Act 1989 would apply to retentions withheld by government departments. Section 66 requires any money held in trust by the Crown to be accounted for separately from public money and the trust money is the responsibility of The Treasury on behalf of the Crown.

- 22 The Ministry of Justice provided advice on an appropriate approach for the enforcement of the amendments. I agree with the advice from the Ministry of Justice that existing offences (breach of trust and theft by a person with a special relationship, sections 229 and 220 Crimes Act 1961) will provide appropriate deterrence and punishment if the retention funds are used for any purpose other than that for which they are withheld. The existing offences carry penalties of imprisonment of up to seven years and can be prosecuted against both individuals and companies. Accordingly, I am recommending no new offences are created in relation to the requirement for retentions to be held in trust.
- 23 IRD provided advice on the tax implications of the proposal, noting that retentions held in trust would take priority over IRD claims in the event of an insolvency and that ordinary tax rules would apply to the funds held in trust.
- 24 All other comments received from the departments and agencies have informed the final recommended details of the legislation in paragraphs 14 and 15 above.
- 25 The Department of the Prime Minister and Cabinet was informed of this paper.

Financial implications

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

Human rights

- 27 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

- 28 The amendments will be drafted in a Supplementary Order Paper to the Construction Contracts Amendment Bill ("the Bill"). The Bill is awaiting its Committee of the Whole stage in the House. I intend to seek a category 3 priority (to be passed in 2015, if possible) for the Bill in the 2015 Legislation Programme.

Regulatory impact analysis

- 29 A 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.
- 30 A RIS for the proposal to impose a trust on cash retentions is attached at Appendix 1. The trust proposal would force the sector to change its financing and business practices from using retentions as working capital.
- 31 The RIS concludes the benefits of the proposal are likely to outweigh the costs:

Benefits

- payers would be holding retentions in trust rather than using them for working capital, which is appropriate because retentions are security payees have allowed the payer to withhold to protect against non-performance by the payees

- less retentions likely to be held (improving payees' cashflow) because there is less incentive for payers to hold retentions
- less risk that payers cannot pay retentions – estimated savings to subcontractors of between \$7 million and \$16 million per year
- less risk to the project as a whole (a positive knock-on effect of less retentions being held and more certain payment of retentions to payees) – these savings have not been quantified, but as a feasible scenario, if the lower risk resulted in 0.25 per cent savings across all projects involving retentions, the savings would amount to \$10 million per year

Costs

- additional capital will be required in order to hold retentions in trust (this comes at a cost because the trust money would earn less interest than the project's cost of capital – estimated at between \$15 and \$20 million per year to payers who currently use retentions as working capital)
- transaction costs in performing trustee responsibilities (not expected to be significant over and above good accounting practice).

32 Treasury's Regulatory Impact Analysis Team has provided the following statement:

"The Regulatory Impact Analysis requirements apply to the proposal in this paper and a RIS has been prepared and is attached.

The Regulatory Impact Analysis Team has reviewed the RIS prepared by the Ministry of Business, Innovation and Employment and associated supporting material, and considers that the information and analysis summarised in the RIS **partially meets** the quality assurance criteria.

The RIS clearly identifies a problem, and provides a logical set of weighted objectives to evaluate the proposed options to address the problem. However, it is not clear that all the impacts on construction firms currently relying on working capital have been identified and considered, or how the options will impact projects with different debt configurations.

It is also not clear from the RIS how the relative net benefits of the preferred option compare in magnitude with the status quo (and the alternative options). The proposal could therefore benefit from more consultation with affected stakeholders to determine, inter alia, the necessary implementation details."

33 Some of the implementation details, proposed to be specified in regulations (see paragraph 15 above), will be the subject of further consultation with affected stakeholders.

Publicity

34 I publicly announced Cabinet's in principle decisions on 9 September 2014. Cabinet's final decisions will be communicated directly to the sector representatives who were consulted on the proposed legislation and a copy of this paper, and the corresponding Cabinet minute will be published on the Ministry of Business, Innovation and Employment's website.

Recommendations

35 I recommend the Committee:

- 1 **note** that on 11 August 2014 Cabinet agreed, in principle, to amend the Construction Contracts Act 2002 to regulate the use of retentions in the construction market [CAB Min (14) 27/9 refers];
- 2 **agree** to amend the Construction Contracts Act 2002 to:
 - 2.1. clarify the ban on “pay when paid” includes any term in a construction contract that makes a payment conditional on anything other than the performance of the obligations stated in the construction contract, but does not include a term that provides for retentions to be withheld when a payee has not fully performed its obligations under the contract;
 - 2.2. 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;
 - 2.3. define “retentions” as *“money retained by a payer out of money payable by the payer to a payee under a commercial construction contract, as security for the performance of obligations of the payee under the contract to the standard specified in the contract”*;
 - 2.4. impose a trust on cash retentions and a fiduciary duty on the payer of the retentions to ensure the funds are spent for the purpose for which they are held (as specified in the construction contract);
 - 2.5. specify the following matters in respect of the trust requirement:
 - 2.5.1. the trust applies to cash retained by the payer and if the payer is using debt to fund the construction work, the payer is not obliged to draw down funds for retentions and separately hold them “in trust”;
 - 2.5.2. the trust obligation ends when either:
 - 2.5.2.1. the retentions are paid in full to the payee; or
 - 2.5.2.2. the retentions are used for the purpose, specified in the construction contract, for which they were retained, e.g: to fix defective work;
 - 2.5.3. the payer can keep any interest earned on the trust money, but the payer cannot charge any costs of administration against the trust money;
 - 2.5.4. small amounts of retentions (“de minimis” amounts) will not be subject to the trust requirement, with the minimum amount of retentions to be prescribed in regulations;
 - 2.6. add a new regulation-making power to enable other details about how the trust requirement will operate in practice to be prescribed, such as:
 - 2.6.1. events that may result in ending the trust obligation, in addition to those specified in the Act;
 - 2.6.2. the minimum (“de minimis”) amount of retentions retained that will trigger the “in trust” requirement;
 - 2.6.3. methods for accounting for the money held in trust that will be acceptable (but not mandatory) for complying with the “in trust”

requirement, e.g: if the money is held in a separate bank account, that is acceptable;

- 3 **agree** the amendments requiring retentions to be held “in trust” will only apply to new commercial construction contracts entered into after 31 March 2016;
- 4 **note** that no new offences are proposed to be prescribed in relation to the requirement for retentions to be held “in trust” because existing offences in the Crimes Act 1961, for breach of trust and theft by a person with a special relationship, will provide sufficient deterrence and punishment for any breach of the trust requirement;
- 5 **invite** the Minister for Building and Housing 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;
- 6 **authorise** the Minister for Building and Housing to approve any further amendments required to give effect to the decisions in recommendation 2 above and include other minor or technical amendments to the Construction Contracts Amendment Bill (including any consequential amendments to the Act) in the Supplementary Order Paper;
- 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.

[signed]
Hon Dr Nick Smith
Minister for Building and Housing

26 / 11 / 2014