



## COVERSHEET

<b>Minister</b>	Hon Jenny Salesa	<b>Portfolio</b>	Building and Construction
<b>Title of Cabinet paper</b>	Proposed Amendments to the Construction Contracts Act 2002 (Retention Money Regime)	<b>Date to be published</b>	7 July 2020

### List of documents that have been proactively released

<b>Date</b>	<b>Title</b>	<b>Author</b>
25 May 2020	Proposed Amendments to the Construction Contracts Act 2002 (Retention Money Regime)	Office of Hon Jenny Salesa
25 May 2020	CAB-20-MIN-0239 Minute	Cabinet Office
18 May 2020	CAB-20-MIN-0231.02 Minute	Cabinet Office
13 May 2020	DEV-20-MIN-0076 Minute	Cabinet Office
12 March 2020	Impact Summary: Proposed Amendments to the Construction Contracts Act 2002 (retention money regime)	Ministry of Business, Innovation and Employment

### Information redacted

**NO**

Any information redacted in this document is redacted in accordance with MBIE's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

In Confidence

Office of the Minister for Building and Construction

Chair, Cabinet Economic Development Committee

## **Proposed Amendments to the Construction Contracts Act 2002 (Retention Money Regime)**

### **Proposal**

1. This paper seeks agreement to amend the retention money regime in the Construction Contracts Act 2002 (CCA) to clarify and strengthen existing requirements for the protection of retention money.

### **Relation to government priorities**

2. Government and the construction industry are working together to transform the sector through a Construction Sector Accord and a Transformation Plan. The Construction Sector Accord was signed and launched in April 2019. It includes high-level goals and the outcomes needed for a high performing construction sector [DEV-19-MIN-0335 and CAB-19-MIN-0652 refer].
3. As part of the Transformation Plan, Government and industry are looking at ways in which the retention money regime in the CCA operates in practice. My proposals are a step towards strengthening the retention money regime, and meeting our commitment to work in partnership with the construction sector.

### **Executive Summary**

**The retention money regime in the CCA came into effect in 2017 to help manage risk in the construction sector**

4. Retention money is an amount withheld by a party to a construction contract (party A, a 'payer' for example a contractor) from an amount payable to another party to the contract (party B, a 'payee' who may be a subcontractor) as security for the performance of party B's obligations under the contract.<sup>1</sup>
5. The holding back of retention money is a voluntary practice within the construction sector. Depending on the terms of the contract, retention money can be between 2 and 10 per cent of the contract price and is paid after 12 months, following the expiry of the defects liability period.
6. Not being paid retention money when due can significantly affect business risk and profitability for subcontractors. This risk increases when construction companies fail. Following the collapse of Mainzeal Property and Construction

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<sup>1</sup> The Construction Contracts Act 2002 section 19 defines a payee as: "the party to a construction contract who is entitled to a payment"; and a payer as: "the party to a construction contract who is liable for that payment."

Ltd in 2013, the retention money regime in the CCA came into effect on 31 March 2017. The intention of the regime was to change behaviour and ensure that construction companies withholding payment of retention money did not use the money as working capital, unduly transferring their business risks to subcontractors. The regime was also intended to protect retention money where a company becomes insolvent by requiring that it be put on trust.

7. The 2017 changes aimed to provide greater protection of payment for subcontractors and to ensure that retention money was responsibly managed by head contractors. The provisions require that retention money be held on trust in the form of cash or other liquid assets readily convertible into cash, unless a financial instrument has been purchased to cover this liability. Under the provisions, subcontractors are also able to inspect the records of head contractors to check that retention money is being properly held.
8. Since its introduction the retention money regime has protected money owed to subcontractors and some retention money has been returned to subcontractors where head contractors have become insolvent. However, there are still some issues with non-compliance, and more can be done to protect retention money owed to payees.
9. The Ministry of Business, Innovation and Employment (MBIE) has sought feedback from the building and construction sector on a package of proposals. I am proposing to strengthen and clarify the retention money regime by amending the CCA.
10. The proposed package of changes to the retention money regime in the CCA will:
  - 10.1. strengthen and clarify the existing “on trust” requirement for retention money held;
  - 10.2. improve the transparency of retention money held; and
  - 10.3. introduce new offences and penalties in the CCA to deter non-compliance.
11. I have sought a place on the 2020 legislative programme with a category 2 priority (must be passed in 2020) to progress these changes and expect a Bill to be introduced before Parliament rises in August 2020.

## **Background**

12. The CCA aims to facilitate regular and timely payments between the parties to a construction contract, provide for the speedy resolution of disputes arising under a construction contract, and provide remedies for the recovery of payments that arise under construction contracts.

## **Review of the retention money regime and targeted consultation document**

- 13.** In August 2019, KPMG prepared an implementation report for MBIE to help understand the effectiveness of the retention money regime in the CCA. The review considered overall compliance with the regime, and included a survey with 71 respondents across the construction sector.
- 14.** Findings indicated that parties to construction contracts are holding retention money on trust for the performance of contractual obligations. However, a number of substantive issues were identified such as retention money being co-mingled with working capital. In addition to findings from the KPMG report, results from the 2019 BDO Construction Survey Report indicated that a quarter of the survey respondents were not holding retention money in a separate account from other monies. While permitted under the CCA, these two factors significantly undermine the extent of protection provided to subcontractors on the insolvency of a head contractor.
- 15.** The findings from the KPMG report raised a number of concerns, including:
  - 15.1. retention money being co-mingled with working capital or not being held on trust in a separate bank account;
  - 15.2. information to subcontractors on the status of money held as retention money is being provided on a variable basis and quality;
  - 15.3. a lack of statutory mechanisms to deter the use of retention money as working capital or retention money not being set aside.
- 16.** In response to the KPMG report MBIE sought feedback on the package of proposals to strengthen and clarify the existing retention money regime in the following areas:
  - 16.1. clarifying the existing trust requirement for retention money;
  - 16.2. removing the ability for businesses to co-mingle retention money with other monies;
  - 16.3. creating a requirement for a confirmation receipt for retention money;
  - 16.4. providing adjudicators the ability to issue penalties for breaches of statutory requirements for retention money; and
  - 16.5. creating penalties for non-compliance with the retention money regime, and considering whether directors of companies should be liable for non-compliance.
- 17.** Targeted consultation was carried out with key stakeholder groups, including construction industry organisations most likely to be affected. The four week targeted consultation ran from 28 January to 21 February 2020 and attracted 22 responses from 33 stakeholder groups on the proposals, a 67 per cent response rate.
- 18.** There was majority support for the package of proposals. Respondents were broadly supportive of greater clarity on how the retention money is 'held on

trust'. Respondents also wanted greater transparency for subcontractors to know how their retention money is held, and the creation of new penalties for breaches of the retention money regime.

19. Some concerns were raised by stakeholders on the use of an adjudication process to issue penalties for breaches of the retention money requirements. Stakeholders also suggested there be greater transparency of retention money through an existing payment schedule process in the CCA rather than through a separate confirmation receipt. Feedback was used to inform the detail of the final proposed package.
20. In response to targeted consultation, the following policy proposals were amended:
  - 20.1. the mechanism for issuing offences and penalties from adjudication to the court system; and
  - 20.2. enhancing transparency of retention money held from a confirmation receipt to a statement within the existing provisions in the CCA for a payment schedule.

### **Details of the proposed package of changes to strengthen and clarify the retention money regime in the CCA**

#### **Strengthening and clarifying the existing trust requirement under the CCA for retention money held**

21. I have heard a number of concerns from the construction sector regarding the nature of the trust created by the retention money regime. This follows a High Court decision in *Bennett v Ebert Construction Limited (In rec & liq)*<sup>2</sup>, where the High Court noted that the CCA had policy gaps and the trust requirement was imprecise.
22. In the High Court case, liquidators sought to claim retention money for subcontractors. The case was the first judgment on the disbursement of retention money held in a retention account by a company in liquidation since the retention regime came into effect in 2017. Importantly, not all retention money was paid out to subcontractors because of how the trust requirement was interpreted in the case.
23. The CCA does not require retention money to be paid into a separate trust account and allows retention money to be co-mingled with other money. This reduces the administrative cost of creating separate accounts for holding retention money. The co-mingling provision is interrelated with the trust requirement, as it affects the nature of the trust created. Co-mingling increases the risk that retention money cannot be easily identifiable if a company goes into liquidation or that money intended for retention money is used as capital and forms part of the companies' assets. Subcontractors may therefore miss out retention money owed to them.
24. I propose to:

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2 *Bennett & Ors v Ebert Construction Limited (in receivership and liquidation)* [2018] NZHC 2934

- 24.1. remove the ability to co-mingle retention money with other payer monies; and
  - 24.2. clarify the requirement that retention money is to be held on trust in a separate bank account from other payer monies.<sup>3</sup>
- 25.** I propose that the retention money be held on trust in a separate account:
- 25.1. for the retention money held in respect of a particular subcontractor; or
  - 25.2. for all retention money held in connection with a particular construction project of the head contractor.
- 26.** Under the CCA, contractors have the ability to hold retention money through a complying financial instrument, an alternative arrangement to holding money in a separate account on trust. Contractors will still have the ability to utilise complying financial instruments, and the proposed changes will not affect the existing provision.

#### **Improving the transparency of retention money held**

- 27.** Under retention money regime, payees, often subcontractors, have the ability to inspect records when retention monies are being held. The law requires that accounting and other records be made available within reasonable times without charge. This allows subcontractors to know information about how retention money owed to them is kept. However, it provides an onus on payers to inspect records. Financial capability in the construction sector is variable, and the ability of subcontractors to inspect records may be limited.
- 28.** There is more that can be done to increase the transparency of retention money being held. Subcontractors may not necessarily be receiving the information they require about the money held.
- 29.** An existing requirement under the CCA covers payment schedules (which acts as a response to a form of invoice for construction contracts). This is required where a payment claim has been made by subcontractors, which includes the amount owed. The contractor may then respond to that claim by serving the payment schedule. If the amount in the payment schedule is less than the amount claimed, the payment schedule needs to provide the reasons for withholding payment.
- 30.** I have heard from stakeholders through targeted consultation that they would like greater transparency of retention money held to be provided through the payment schedule. A statement in the payment schedule by the company, if retention money is being held, would enhance transparency.
- 31.** I propose to amend the CCA to require that where retention money is held, a payment schedule by the contractor must include the amount of retention

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<sup>3</sup> Complying financial instruments are defined under section 18FB of the CCA and may include, for example, a complying form of insurance, a bond, or a guarantee.

money held and the form in which the retention money is being held (complying financial instrument or on trust in a separate bank account).

### **Introducing an offence and penalty to increase deterrence and improve compliance**

- 32.** A failure of contractors to comply with the retention money regime impacts on the CCA achieving its aims, and can create significant financial harm for subcontractors and flow on effects for the sector. It also undermines the aims and objectives of the Construction Sector Accord Transformation Plan.
- 33.** The majority of respondents in targeted consultation agreed with the introduction of new offences and penalties for the retention regime, and felt that the status quo (for example the lack of offences and penalties) was not sufficient to deter poor behaviour. Additionally, there was a preference for determinations to be made public through the court system, forming a further deterrent in the form of a loss of reputation.
- 34.** In developing the proposals below, I have also considered similar offences, including those in the Building Act 2004, the Companies Act 1993, the Fair Trading Act 1986 and the Financial Markets Conduct Act 2013.
- 35.** To provide appropriate incentives for compliance, I propose to amend the CCA to make it a strict liability offence for a payer to fail to hold retention money on trust in a separate bank account or complying financial instrument. I propose that the penalty for failing to comply with this requirement be a maximum fine of \$200,000.
- 36.** Introducing personal liability of directors will cover instances where a breach is discovered at the point of company insolvency. As with the Health and Safety at Work Act 2015, personal liability imposes accountability on directors to exercise due diligence in holding management strictly and continuously to account for meeting the obligations of the retention money regime.
- 37.** There are also statutory restrictions on indemnities and insurance against criminal liability. For example, section 162 of the Companies Act 1993 prohibits a company from indemnifying or effecting insurance for a director or employee of the company for criminal liability. Additional liability may affect insurance cover for some directors.
- 38.** I propose to include personal liability for directors when a company, as a payer, is in breach of its obligations to hold retention money on trust in a separate bank account or complying financial instrument with a maximum fine of \$50,000.
- 39.** I also propose that statutory defences be included as part of the amendment to recognise that in some cases there may be extenuating circumstances that may impact on a payer's failure to comply with the requirements in paragraphs 35 and 38 above. I propose that these defences include:
  - 39.1.** where all reasonable and proper steps have been taken to ensure that the payer complied with the requirements of the CCA;

- 39.2. where the person took all reasonable steps to ensure that the payer complied with requirements;
- 39.3. in the circumstances the person could not reasonably have been expected to take steps to ensure they complied with requirements.

#### **Aligning with existing insolvency practices**

40. In the process of targeted consultation on the retention money regime, I have heard from key stakeholder groups in the construction sector on how retention money held on trust in a separate bank account may be administered in the event of insolvency.
41. I propose that the receiver, or liquidator appointed to a construction company administer the retention money account, in the event that the business becomes insolvent, and that they can charge reasonable fees to administer the account. The intention is to allow subcontractors to access retention money without a Court order in the event of insolvency. This retention money will not be available to meet debts to third parties. This aligns with existing practices in the wider economy, and ensures that the party with effective control of the company's assets and records is able to distribute funds appropriately.
42. A number of issues are out of scope of the current set of reforms being proposed in this paper. I am aware of concerns raised regarding the ability of subcontractors to enter a site and recover their tools when a business has been placed into receivership. These issues are important. The appointment of receivers does not affect the subcontractors' rights in relation to their property.

#### **Transitional arrangements**

43. To manage the impacts on the sector of the additional requirements, following feedback MBIE received as part of targeted consultation with the sector, I propose that the new requirements come into force six months after Royal Assent. The new requirements will apply to new construction contracts signed six months after Royal Assent. This will include renewed contracts, and new contracts entered into for an existing project.

#### **Estimated financial impacts of the package**

44. There are no direct financial implications to the Crown. MBIE estimates that under this package, initial private administrative costs (bank fees, book keeping, trust establishment and audit costs) will be approximately \$55 million, however once trusts are established private administration costs will be approximately \$16 million per annum across nearly 62,000 building and construction businesses.
45. The benefits are expected to be significant (this is based on avoided financing costs and avoided insolvency costs and feedback from stakeholders) and in the order of \$50-\$100 million per annum. Benefits have been analysed by small, medium and large organisations, as organisations can be both contractors and subcontractors for projects.



46. Smaller building and construction organisations (with less than 20 employees) are expected to be approximately \$718 per annum better off (on average), while those larger organisations (with over 100 employees) are expected to be approximately \$9,000 worse off (noting that this is likely to be a small proportion of their turnover). Medium to large organisations (between 20 to 99 employees) are expected to be \$788 worse off. Overall, 98 per cent of all building and construction businesses will be better off from the proposed package of changes to the retention money regime.

### **Next Steps**

47. I expect the package to be introduced into Parliament before the House rises in August 2020. Proposed changes will come into force following a six month transition period after amending legislation receives Royal Assent. I have a sought place on the 2020 legislation programme for a Bill with a category 2 priority (must be passed in 2020) to amend the CCA.

### **Financial Implications**

48. As noted in paragraph 41, there are no direct financial implications for the Crown. MBIE estimates that under this package, initial administrative costs in the construction sector will be approximately \$55 million, however once established administration costs will diminish to approximately \$16 million per annum across the construction sector.

### **Legislative Implications**

49. In order to strengthen and clarify the retention money regime, the CCA will need to be amended. Part 2 of the CCA outlines provisions for holding retention money.
50. The CCA binds the Crown. The proposed amendments will also bind the Crown.
51. I have a sought place on the 2020 legislation programme for a Bill with a category 2 priority (must be passed in 2020) to amend the Construction Contracts Act 2002.

### **Impact Analysis**

#### **Regulatory Impact Statement**

52. MBIE's Regulatory Impact Analysis Review Panel has reviewed the attached Impact Summary prepared by MBIE. The Panel considers that the information and analysis summarised in the Impact Summary **meets** the criteria necessary for Ministers to make informed decisions on the proposals in this paper.

#### **Climate implications of policy assessment**

53. The Ministry for the Environment has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met.

## **Population Implications**

54. The proposals in this paper are not expected to have significant implications for population groups.

## **Human Rights**

55. The proposals in this paper are not inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

## **Consultation**

56. The following agencies and crown entities were consulted on the proposals in this paper: Ministry of Housing and Urban Development, Treasury, Te Puni Kokiri, Kāinga Ora, Department of Internal Affairs, Ministry for the Environment, Ministry of Health; Ministry of Education, Department of Corrections, Ministry of Justice, New Zealand Transport Association, Department of the Prime Minister and Cabinet, Inland Revenue Department, Financial Markets Authority, Infrastructure Commission, WorkSafe, and Tertiary Education Commission.

## **Communications**

57. I intend to issue a media statement once Cabinet decisions have been made. This paper, and the Regulatory Impact Summary, will be made publicly available on MBIE's website.

## **Proactive Release**

58. This Cabinet paper and associated minute will be published on MBIE's website subject to any necessary redactions.

## Recommendations

The Minister for Building and Construction recommends that the Committee:

1. **note** that subpart 2A of the Construction Contracts Act 2002 contains provisions for holding retention money for construction contracts;
2. **note** that the proposed changes to strengthen and clarify the retention money regime align with the Construction Sector Accord Transformation Plan [DEV-19-MIN-0335 and CAB-19-MIN-0652 refer];

### Clarifying the trust requirement

3. **note** that there are concerns in the construction sector that the trust requirement in the Construction Contract Act 2002 does not sufficiently protect retention money held on trust for subcontractors in the event of company insolvency;
4. **agree** to amend the Construction Contracts Act 2002 to clarify the existing trust requirements to:
  - 4.1. remove the ability for retention money to be co-mingled with other payer money; and
  - 4.2. require that retention money must be held on trust in a separate bank account;

### Offences and penalties

5. **agree** to amend the Construction Contracts Act 2002 so that it will be a strict liability offence for a payer to fail to hold retention money on trust in a separate bank account or complying financial instrument with a maximum fine of \$200,000;
6. **agree** to include personal liability for directors when a company, as a payer, is in breach of its obligations to hold retention money on trust in a separate bank account or complying financial instrument with a maximum fine of \$50,000;
7. **agree** to include statutory defences for the offences outlined above to recognise that in some cases there may be extenuating circumstances that may impact on a payer's failure to comply, including;
  - 7.1. where all reasonable and proper steps have been taken to ensure that the payer complied with the requirements of the CCA;
  - 7.2. where the person took all reasonable steps to ensure that the payer complied with requirements;
  - 7.3. in the circumstances the person could not reasonably have been expected to take steps to ensure they complied with requirements.

### Enhanced transparency

8. **agree** to amend the Construction Contracts Act 2002 to require a payment schedule to stipulate the amount of retention money held (if any) and the how the retention money is being held;

#### **Aligning with insolvency practices**

9. **agree** that the receiver or liquidator appointed to a construction company be given the ability to administer the retention money account, in the event that the business becomes insolvent;
10. **agree** that retention money held on trust in a separate bank account:
  - 10.1. is not available to meet the debts owed to any other creditor of the construction company; and
  - 10.2. is not liable to be attached or taken in execution under the order or process of any court at the instance of another creditor of the construction company;
11. **agree** that the reasonable fees of a receiver or liquidator appointed to a construction company, to administer the retention money account, be able to be met from the retention money held on trust;

#### **Transitional arrangements**

12. **agree** that the new requirements will come into force 6 months after Royal Assent and will apply to new construction contracts, and renewed or new construction contracts entered into for an existing project;

#### **Drafting instructions**

13. **note** that the proposals will be given effect through the Construction Contracts Amendment Bill, which I have sought a category 2 priority on the 2020 Legislation Programme (must be passed in 2020);
14. **invite** the Minister for Building and Construction to issue drafting instructions to the Parliamentary Counsel Office to give effect to the proposals in this Cabinet paper;
15. **authorise** the Minister for Building and Construction to make decisions consistent with the proposals in this Cabinet paper, on any issues which arise during the drafting process;

#### **Communications**

16. **note** that I intend to issue a media statement once Cabinet decisions have been made.

Authorised for lodgement

Hon Jenny Salesa

Minister for Building and Construction