FAQ: Retentions Regime 2023 changes

The Construction Contracts (Retention Money) Amendment Act 2023 (the **Act**) came into force on 5 October 2023, impacting the way retentions must be held. This FAQ answers the main queries we have been receiving from clients about complying with the new regime.

This FAQ does not provide legal advice. If you would like advice about anything referred to below, please contact a member of the Greenwood Roche construction law team directly.

Overview

The changes will apply to new contracts entered into, or existing contracts amended, from 5 October 2023. The key changes are as follows:

- **Trusts:** A trust is automatically created over retention money. This creates fiduciary obligations on you as a trustee.
- **Separation of funds:** Retention money must be held in a separate NZ bank account and cannot be comingled with other (non-retention) money. If a single account is used for multiple parties' retention funds, separate legers within the trust account have to be kept for each party and each construction contract.
- **Informing the bank:** The account holder must be informed that the account is to be used for holding retentions money on trust under the Act.
- **Reporting:** You must maintain and provide records about retentions to the other party when money is first withheld and at least once every 3 months after. The information must include:
    - each amount retained, the contract under which it has been retained, and the date of its retention;
    - the total retentions held under each contract;
    - the account details for any bank account (or instrument details) under which retention money is held; and
    - confirmation that the other party is entitled to inspect your accounts and records.
- **Use of retentions:** Retention money cannot be used for any purpose other than to remedy defects in the performance of the other party's obligations under the contract. If you intend to use retention money to remedy defects, you must give 10 working days' prior notice to allow the other party to remedy the defect or dispute your claim.

However, where the party holding retentions is the Crown, the obligations under the Act which deal with how bank accounts should be kept do not apply. Instead, retention money must be held with in accordance with Part 7 of the Public Finance Act (*PFA*). We note that the obligations under Part 7 of the PFA are not dissimilar to those under the Act, the main difference being the concept of Trust Bank Accounts.

Application

When do I need to start complying?

The new laws will apply to any construction contract entered into after 5 October 2023 or any construction contract *renewed* after that date.

Retentions held under contracts which were in place before this date will not need to comply with the new laws.

When is a construction contract 'renewed' for the purpose of the Act?

Despite it being one of the triggers for operation, the term 'renewed' is not defined in the Act.

The concept of 'renewing' contracts is uncommon in construction contracts which relate to the delivery of works and is more common in maintenance agreements (which are treated as construction contracts under the Construction Contracts Act 2002 (*CCA*)) which relate to carrying out maintenance works or services over a defined period of time. These contracts often contain renewal rights for further terms.

We expect in practice the main question here will be whether contract extensions are considered 'renewals' for the purpose of the Act. As with the variation question considered below, we expect this will be a matter of degree. We consider it unlikely that a maintenance agreement with a pre-determined extension mechanism which extends the operation of the agreement for longer period would be considered a renewal. However, if the extension is introduced as a variation to the original contract or the operation of the extension mechanism effectively replaces the existing contract with a new one, then we consider it more likely that a court would treat the extension as a 'renewal' for the purpose of the Act.

Is a variation agreement a new construction contract for the Act?

Certain variation agreements could be treated as new contracts requiring compliance, as variations are captured under the definition of "construction contracts" under section 5 of the CCA.

We would expect that it will be a question of degree as to whether the variation agreement triggers the new retention requirements. If the variation does not impact on the payment profile of the existing contract or is a scope variation to the existing project, then we consider it unlikely that it will trigger the new retention requirements. If, however, the variation introduced work and a payment profile that is separate from the original contract (e.g. a separate project or a new scope of works entirely unrelated to the original scope and not contemplated by the original contract terms), then we would expect a variation of this nature could be treated as a new construction contract under the CCA.

Is there a retention amount over which the obligations kick in?

No. Section 18B(4)(b) of the CCA allows for regulations to be made which prescribe a de minimis (minimum) amount, however, as at the date of this FAQ, no de minimis amount has been prescribed.

Bank Account

Can I ask a third party to hold retentions on my behalf?

Yes, if: the third party is either (from section 18E(3) CCA):

- a legal practitioner;

- the Public Trust (will only be applicable to Government clients);
- a trustee company[1];
- a chartered accountant;
- a registered audit firm; or
- where the client is a council-controlled organisation, a local authority that holds shares in, controls, or has a right to appoint directors of the client,

and the bank account is one ordinarily used to hold trust money and you have informed the third party that the money to be held in the account is retention money held on trust under the CCA.

Note that this does not affect any of your responsibilities in respect of reporting and recording. You should agree clear procedures for this with the account holder.

If a third party holds the retention monies, do we need any additional agreements or obligations put in place?

Parties should take legal advice on this but considerations may include:

- the need to create a direct relationship between the third party and the payee / the payer (if one does not already exist);
- the obligations of the third party in the event of the payer's insolvency;
- the need for pre-conditions to the third party paying out;
- the third party's liability where required to act on instructions;
- what happens when the retention money is subject to a dispute; and
- determining who can instruct a payment.

Can I retain any interest earned on retention money?

Yes, unless the contract states otherwise.

What if the party holding retentions is the Crown?

If the party holding retentions is the Crown, the money must be held and dealt with in accordance with Part 7 of the Public Finance Act 1989 (which deals with trust money). The sections in the Act which deal with the form of bank account do not apply (18D, 18E and 18FB). For the avoidance of doubt, the remainder of the Act applies to the Crown (including the new accounting and recording and (parts of) the penalty provisions (sections 18FC and 18DA)).

Recording and Reporting

Do I need to keep ledger records?

[1] Trustees Executors Limited, AMP Perpetual Trustee Company N.Z. Limited, PGG Trust Limited, New Zealand Permanent Trustees Limited, or The New Zealand Guardian Trust Company Limited

Yes, if:

- the bank account is used for multiple construction contracts;
- the bank account is used for multiple parties' retentions; or
- the bank account is held by a third party.

If your retentions account is only being used for holding retentions for one party under a single construction contract then you do not need to keep ledger records.

What kind of records do I need to keep about the retentions and the bank account?

In respect of each contractor, records must:

- include details of all bank accounts in which retentions are held for the contractor;
- identify these bank accounts as retentions accounts;
- identify the construction contracts under which the retentions are retained;
- include details of all payments into and out of the bank account(s); and
- if the bank account(s) hold retentions for any party other than the contractor, record that fact.

The contractor can request the above information at all reasonable times and without charge.

When do I need to report to the contractor?

In addition to the above obligation, you must provide a report to the contractor after retaining any retention money or otherwise every 3 months until the retention is returned/used.

We suggest providing a report alongside every payment schedule (on the assumption that the contract mandates the issue of payment schedules in response to all payment claims). In the defects notification period, you should set reminders or come up with a system which provides for 3 monthly reporting. It may be worth asking your bank if they can assist with your reporting obligations.

What does the report need to contain?

The report must contain:

- each amount retained, the construction contract under which it was retained, and the date of its retention;
- the total amount of retentions held for that contractor under each construction contract;
- the account details for the bank account, noting:
    - if you <u>are</u> the account holder, this needs to include the name of bank and branch and the name of the account; or

    - if you <u>are not</u> the account holder, this needs to include the name of the account holder and the type of entity the account holder is (i.e. legal practitioner / chartered accountant);

- the balance held in the bank account for the contractor;

- if separate ledger records are required (see above), the name of each ledger record relating to the contractor and the balance in that ledger record; and

- a statement that the contractor may inspect the accounts and records.

Non-compliance

What are the fines?

For failures relating to recording and reporting, parties may be liable to a fine up to $50,000.

For failures to keep retention money in accordance with the Act, parties may be liable to a fine up to $200,000. Where the party is a body corporate, each director is also liable to a fine up to $50,000.

The Chief Executive of the Ministry of Business, Innovation, and Employment may require information from any person in relation to the Act. A person who fails to comply with, misleads or hinders this request may be liable to a fine up to $50,000 while a body corporate may be liable for up to $200,000.

The new regime's impact on contracting

Do I need to amend my construction contract to reflect the new requirements?

Parties should consider whether the construction contract adequately provides for compliance with the CCA. Issues to look out for include:

- how retentions may be held;

- how retentions may be used (noting a common issue with construction contracts is that these do not include provisions expressly enabling the use of retention funds);

- when retention money ceases to be trust property; and

- the contractor's right to inspect records.

Contracting out of the CCA is prohibited (section 12). So, where a contract is inconsistent with the CCA, the CCA's meaning will be determinative.

What are my alternative options for holding security if I don't want to hold cash retentions?

- <u>Performance bond instead of retentions:</u>
  This is a preferred option for some clients as the full bond is typically available from the start of the project until practical completion and there is no need to comply with reporting requirements. Some contractors will not offer this as it ties up capital and others will offer it but price on the cost of providing it.

- Bond in lieu of retentions
  The NZS 391x contract suite has the concept of a 'bond in lieu of retentions'. Unlike a standard performance bond, this is released at final completion. The standard drafting provides the Contractor with the option of providing a bond in lieu of retentions, so those wishing to avoid holding retentions will need to amend the general conditions of contract to make this mandatory.

- Overarching bond
  Some clients who work with the same contractors and suppliers on a regular or framework basis have adopted overarching bonds which automatically applies to contracts entered between the parties. The benefit of this is it saves the hassle of having to procure and administer individual bonds. However, there are various legal and commercial considerations when adopting an overarching bond, including the duration of operation, the value of the overarching bond (which is typically tied to the expect value of contracts to be entered during the overarching bond period or defined intervals) and appropriate review points to consider the appropriateness for the bond amount (e.g. is it too high or too low given the value of the contracts awarded?).

- Milestone payments
  Payments for works tied to achievement of milestones, with the final milestone being payable once the defect rectification period obligations have been discharged. This will not be treated as a retention under the CCA and so payers will not need to hold money on trust or provide reports. However, if milestones are structured to put the contractor in a cash neutral or cash positive position, there may be less (or no) security during the delivery phase for payers. If milestones are structured to put the contractor in a cash negative position, it may increase the cost of the works as the contractor will pass on its financing costs (and this may prevent certain contractors being able to perform the works).

- Parent / holding company guarantee
  Guarantees are useful in that they ensure the holding company or company with greater covenant strength stands behind the contract. This should come at no cost to the contractor and may encourage good behaviour from the subsidiary. The downside of these guarantees is that they provide no security in a group insolvency event and a judgement from a court may be required to recover money from the guarantor, which may not be viable for minor defects (given the cost of dispute resolution and enforcement action).

- Increase the value of the contractor's performance bond (where the client usually requires bond and retentions as security)
  This is a simple alternative to holding retentions and is administratively straight-forward. As with bonds in lieu, contractors may resist this as it locks up cash flow. Contractors will also pass on the cost of providing this.

- Holding the retention in the form of a complying instrument
  The Act allows parties to hold 'complying instruments' in lieu of a cash retention. A complying instrument is a financial guarantee from an independent third party (such as an insurer) from which protected retentions will be available when they are due if the retention is not returned when due. The advantages of a financial instrument is that it negates the need for cash to be held on trust and can be used across multiple contracts. Parties seeking to use a complying instrument in lieu of a cash retention should be aware that the record-keeping and reporting obligations under the Act will still apply.

- Third party holds and administer retentions
  As noted above, certain third parties can hold retention money. This may be an option where a payer's bank account set up does not permit it to hold retentions which comply with the Act and none of the other alternatives are viable. If this approach is adopted, the third party is likely to seek to impose additional requirements on the payer which may include a deed of indemnity or agreement setting out the terms of holding the funds and additional conditions to satisfy any anti-money laundering and / or professional standards requirements.

- No retentions or retentions substitute
  This option will lessen or completely remove the payer's security over the contractor's performance. However, this should, in theory, deliver lower prices and lessen the financial stress on the contractor. The downside of this for payers is that they are more exposed if the contractor goes insolvent and may find it more challenging to compel a contractor to return to site to fix defects during the defects notification period.