

Submission to the
Commerce Select Committee
On the
Construction Contracts Amendment Bill 97-1

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The Submitter

Personal details not published

Organisations and background

I am making this submission in my position as Executive Director of a national industry body whose members are principally engaged in subcontracting to the construction industry.

I am also on the Executive of the Specialist Trade Contractors Federation which represents the wider subcontracting industry in NZ.

I was 50% shareholder and manager of major subcontracting company, with 40 years of direct experience in subcontracting to the construction industry in NZ.

I was a subcontractor representative on the committee responsible for developing SA-2009, the first Master Builders subcontract agreement with input from the subcontracting industry. I have delivered two series of seminars on subcontract conditions with a third series scheduled for August.

I am on the NZ Standards Committee currently reviewing NZS3910 Conditions of Contract for Building and Civil Engineering.

Authority and consultation

I submitted an earlier draft of this to the industry bodies and received support from both for that draft.

I have not specifically consulted for this submission, but I believe my wide involvement in the subcontracting industry and various subcontracting organisations places me in a position to be familiar with the views of the wider subcontracting industry. I have also received considerable feedback when presenting seminars when the abuse of retentions by head contractors inevitably becomes the hottest topic.

My involvement in NZS3910 gives me an insight into the Client/Head Contractor relationship as well as the Head Contractors position regarding subcontractors.

Appearing before the committee

I would like to appear before the committee to speak to my submission and answer any questions.

My view on the bill

My submission is not to support or object to content of the bill.

My submission is to address a major omission.

- **Protection of retentions from misuse by payers and liquidators.**

And to suggest a worthwhile addition

- **Preventing liquidators clawing back properly made progress payments as voidable transactions.**

The recent Mainzeal collapse has shown many subcontractors have suffered potentially crippling losses which have been made worse by the unfair contractual provisions relating to retentions being imposed on subcontractors.

Their situation may be substantially worsened by payments which have been properly made for work completed being clawed back by the liquidator as voidable transactions.

While it may be unacceptable to introduce security of payment provisions specifically for the construction industry, the imbalance of power has led to a situation where misuse of retentions has reached a stage where our construction industry is fragile and subject to a significantly higher rate of failure than any other sector, in both good times and bad. It enables and encourages construction companies to operate while undercapitalised by utilising funds they have received to pay for subcontractors work to fund their own operations. This not only makes failure of construction companies through insolvency more likely, but it also increases the damage done to the wider construction industry and our communities by the flow on effects.

The construction industry is a major contributor to our GDP and its health is important to New Zealand's economy.

I believe there are some simple measures that will lead to significant improvement by removing the incentive for head contractors to abuse the use of retentions held against subcontractors and a similar although to a much lesser extent retentions held by developers against head contractors.

Retentions

Retentions are held by the principal on payments made to the head contractor and in turn are held on payments made by the head contractor to subcontractors.

In both cases the current system is open to abuse. The main problems are in the head contractor/sub contractor relationship, but correction measures should apply to all retentions in any construction contract, both head contracts and sub contracts.

The whole issue has been the subject of much debate by parties inclined to favour one side or the other.

The market is not ready to dispense with retentions, but it is essential for the long term health of the construction sector to change the current practices and eliminate abuse.

In appendix A I have discussed the issue in greater detail and addressed most of the arguments that have been raised. This is mainly from the contractor – sub contractor relationship where the major problems have arisen in the past, but much of the same applies to a lesser extent to the relationship between the principal and the head contractor.

The abuse of retentions against subcontractors

The default provisions of NZS3910 (the common head contract conditions) have retentions for head contractors held on a sliding scale starting at 10% of the first \$200,000 of contract value, then 5% of the next \$800,000 and then 1.75% with a maximum total retention of \$200,000. Many head contractors try to hold a blanket 10% retention on all their subcontractors. On a \$10,000,000 contract with say 85% subcontract content there is potentially \$850,000 being held in retentions by the head contractor while \$200,000 is held against the head contractor.

That potentially provides the head contractor with \$650,000 unsecured interest free long term finance.

This illustrates the issue although the figures quoted are unlikely to be that extreme because of the ability of some subcontractors to negotiate different terms.

Retentions represent money that actually belongs to the subcontractor. It has been certified as part of a valid claim representing value that has previously been supplied to the contractor, and for which the contractor has received payment from the principal. The payment the contractor has received has also been subject to retentions, but at a much lower average rate than the contractor is holding against the subcontractor.

The reality is that subcontractor retentions are used as a source of long term, unsecured, interest free, funding by head contractors.

Contractors deny this is their intent, but nevertheless that is the result of the present system.

Retentions are further abused because many head contractors will not pay retentions unless they receive a specific claim from the subcontractor for the retentions when they become due. Normally they become due in two stages which may be several months apart. Subcontractors have no way of knowing when the payments become due. They may periodically make enquiries of the head contractor, but the due dates are determined by actions of the head contractor and the first release of retentions may be a couple of years after the subcontractor has completed his work, left the site, and moved on to other jobs. During that time the subcontractor may have been forced out of business, may have relocated, may have lost track or just given up hope.

Retentions that are not paid because they were not claimed at the due date are eventually absorbed into the head contractors profits.

Although every head contractor experiences a positive cash position as a result of the present retentions regime, the extent to which it is abused varies with different contractors, and also varies within the one contracting company.

My personal experiences as a subcontractor

In my many years of subcontracting, I have never experienced retentions being used to rectify unidentified defects in my work, or to rectify defects that I would not otherwise have corrected as part of my normal business practices, regardless of whether retentions were being held and regardless of when the defects were identified. Retentions have never been used as the financial incentive to oblige me to meet my contractual obligations.

The two situations where retention money owing to me has not been paid are;

1. When construction companies fail and receivers are appointed, all retentions are taken by the receivers and used to pay secured creditors. Over 3 decades of trading and experiencing several dozen construction company failures, I have only experienced one case of receivers making any payment to subcontractors, and in that case it was more than 5 years after the failure and the amount paid out was less than 5 cents in the dollar. Construction company failures inevitably lead to subcontractors losing all money owed for progress payments not made as well as retentions held on work completed and for which the owner has made payment to the head contractor.
2. At the time when retentions are finally due and I have been trying to obtain their release, some less ethical contractors suddenly present a previously unidentified and un notified claim against me and refuse to release any of the retention money unless I agree to accept some reduction. This has always been a manufactured excuse to squeeze more money out of the contract for the head contractor. It has always been a carefully judged amount that is not sufficient to justify formal dispute proceedings and is an undisguised abuse of economic power. Some head contractors have a practice of continuing to withhold all retentions unless the sub contractor agrees to accept a reduced amount as full and final settlement for immediate payment. I have been offered immediate payment of 50% of the value of retentions as full and final settlement, or be forced to wait for an indeterminate period. Some smaller subcontractors have little option but to accept such practices.

Neither of these uses of my retentions are ever given as justification for current practices, but there are seldom any other situations where retentions are forfeited.

The consequences of current retention practices by contractors

Use of subcontractors retentions as long term unsecured interest free finance by contractors is unhealthy for the industry and our economy.

It encourages contractors to rely on these funds to operate their business when they would otherwise be undercapitalised.

It also enables contractors to continue operating while technically insolvent.

This increases the risk of failure which may contribute to construction failures always being at a higher rate than other sectors.

It increases the extent of damage caused when construction companies do fail, which is unfortunately too common.

This has wide effects because of the size of the failures, the large number of small subcontractors affected, the destruction of wealth, and the harm to the wider society.

The use of retentions to obtain IRD funding

One contractor who would always delay releasing retentions to well past due date was using the system to obtain additional funding from the IRD. It was only by persistent follow up by my staff that the retentions were ever paid. The contractor was using the “buyer created tax invoice” system which is common in the construction industry. When I finally received payment, the buyer created tax invoice was always dated 6 – 12 months prior. This enabled the contractor to claim GST and have the use of that tax money for an extended period without having paid for the associated goods and without the supplier having made the corresponding GST payment. The system required that I pay GST, but without having received a tax invoice nor the payment, I was unaware of my obligation. I would of course include that payment in my next GST return following receipt of the tax invoice, but by then the contractor had several months free use of taxpayer funds. This was not an isolated incident.

Why is legislation required

There have been complaints about misuse of retentions since I have been in business. The industry has been unable to resolve the issue principally because the larger players who have the most resources to lobby (the construction companies) have a huge advantage by continuation of the present system.

As the industry has acknowledged that there is a major issue, but has shown it is unable to deal with it, the only option is for legislation.

As with the original Construction Contracts Act, there is a need to address a problem brought about by abuse of the imbalance of power.

The construction sector is of significant size and its health is of importance to our economy.

The present system encourages unsound business practices.

No single contractor can afford to voluntarily discontinue this current practice of using subcontractor retentions to fund their operations as they are always competing against others who do, and this affects their funding costs.

Pay when paid

One of the major issues addressed by the Construction Contracts Act was to outlaw pay when paid, and pay if paid conditions.

This intent of the act is being circumvented by the retentions practices.

Head contractors impose conditions on release of retentions to subcontractors that while not stating they are subject to receipt of money by the head contractor, nevertheless are subject to issue of certificates that trigger payment to the head contractor. They become de facto pay when paid conditions. Subcontractors have no control over this timing. Release of final retentions subject to issue of the defects liability certificate and the timing of this is totally under control of the contractor. It is almost never related to subcontractor performance, and where it is, it would generally only be one subcontractor, yet retentions are being held against all subcontractors.

Final completion of a project

Since retentions provide a source of funds to the head contractor, it is not in their interests to have the final defects completed.

Some contractors delay attending to the final few minor defects because completion means they are due to release retentions to subcontractors that far exceed retentions being held on them, which depletes their working capital. The longer they can delay final completion and release of final retentions, the less likely that every subcontractor will claim at the appropriate time. In the meantime they have the use of the funds, and decrease the amount they will eventually pay out as fewer subcontractors will lodge the correct claim at the appropriate time.

Continuity agreements

Banks and building owners are trying to insist on subcontractors entering into "Continuity Agreements". These are to safeguard the banks in the event of the head contract being terminated (mostly because of insolvency of the contractor) the banks can expect the subcontractors to keep working on the project to complete it with minimal disruption.

This is a perfectly reasonable requirement and reduces the destruction of wealth associated with construction company failures, but it is another source of problems because the banks/owners have paid the contractor but the contractor has not passed on those payments to the subcontractors.

The subcontractors do not want to continue without receiving payment for the work they have done despite the owner having made payment for that work to the contractor.

Securing of the subcontractor's retentions would go some way to reducing the size of the problem.

The remedy

The remedy is to remove the ability of payers, whether principals or head contractors, to use retentions to fund their own operations.

If there is no ability to divert or use retentions to fund the payer's cash flow, the incentive to abuse the system is removed and fairer use of retentions will result in time.

This would also prevent the tax rort referred to above.

Possible legislative measures – 1 Trust accounts (my preference)

Require retentions on any construction contract under the CCA be held in a separate trust account.

That would apply to all contracts, including those between the principal and the contractor, as well as between the contractor and subcontractors.

The trust account needs to be held by a separate third party. I would suggest a government administered body.

Retentions required by the principal against the head contractor would be paid into a trust as would the full amount of retentions required by the head contractor against subcontractors.

Neither the party who made the payments from which the retentions have been deducted nor liquidators of that party should have access to funds from the trust account without an adjudication or court judgement in their favour.

It is important that retentions are not available to liquidators unless there is a default. In the normal course of events, subcontractors claims for work during the month are paid at the end of the following month. Liquidators seldom find payments to creditors of failed companies are up to date, and in most cases subcontractors are left with 2 to 3 months claims unpaid. It is unjust that in addition to their unpaid claims they also lose retentions which is money they have earned for work completed and paid for by the principal but diverted by the head contractor. The same applies between developers and contractors.

Retentions would be released to payees following application by the payee and confirmation by the payer that they are due. Since the money would not be available for use by the payer, there would be no incentive for them to abuse the system. This would not only secure retentions, but in time, it would bring about acceptance of a more realistic retention regime.

I am not a tax expert, but I expect each transaction into and out from the trust account would be subject to normal GST payments.

I expect a separate account would need to be established for each contract and each subcontract, with the payee having access to view the transactions relevant to his contract to be able to verify that the amounts being held in retentions are indeed being held securely. This would be similar to accessing your bank accounts on line to view transactions.

Although my wording often refers to the contractor/subcontractor relationship, the same applies to the principal/contractor relationship.

Possible legislative measures – 2 Bonds

Provide the right to provide conditional bonds in lieu of retentions.

This requires careful consideration as use of bonds can still be abused.

Contractors are very reluctant to ever permit subcontractors to supply bonds in lieu of retentions as that harms their cash flow, but where they do, they require “On Demand Bonds”. This means the bond can be called up simply by requesting payment without the need to show default by the subcontractor.

Banks and other bond providers also try to insist on “On Demand Bonds” as they do not want to be in the position of determining if a justifiable default has occurred and face possible legal challenge if they get it wrong.

“Conditional Bonds” which can only be called up in the event of evidence of a default are not so open to abuse but with the imbalance of power inherent in the industry, these are not generally accepted by payers.

The problem with “On Demand Bonds” is they could be called up unjustifiably and it would be beyond the resources of smaller subcontractors to challenge this in court. In the event of a liquidator being appointed to a head contractor, there would be a very real risk of “On Demand Bonds” being called up without due justification. Indeed they may see it as their duty to get hold of all possible funds as a first step.

It is perhaps worth noting the double standard that head contractors have adopted by insisting the default head contract conditions in NZS3910 Conditions of Contract provide them with a right to supply a conditional bond in lieu of retentions whereas no subcontract agreements offered by any head contractor offer subcontractors the same option.

The majority of subcontractors are small operators who do not have the resources to critically review the multitude of contractual documents they are presented with and are unlikely to be aware of the subtleties of different types of bond particularly when drafted by lawyers working for banks and contractors who are keen to obscure such dangers from their subcontractors.

The other drawback, is that security often needs to be provided for the full amount and the full period which has negative effects on working capital.

The consequences

Contractors will resist any measure to deprive them of unsecured interest free finance from subcontractors’ retentions.

Contractor's complaint will be about the need to fund the subcontractors retentions, but in reality all they are being required to fund are the retentions being held against the head contractor. The principal is paying the contractor the full amount of subcontractors progress claims, and only deducting the retentions to be held against the head contractor.

Head contractors will need to fund their own retentions, just as subcontractors do, but to a much lesser total value than being funded by subcontractors.

Head contractors will not be able to continue operating if they are relying on use of subcontractors' money to fund their operations. There will inevitably be some construction company failures if legislation is introduced to secure retentions, but only of those with inadequate resources which are not operating on a sound basis and which were at a high risk of failure anyway.

The long term benefits will well outweigh the short term pain.

Examples of wrongful use of retentions

The liquidators report on the Mainzeal collapse showed Mainzeal was withholding \$18.6 million in retentions from subcontractors while Mainzeal was owed \$11m in retentions. \$7.6 million of money Mainzeal had received to pay for work completed by subcontractors was being used to fund Mainzeal's own operations and has been totally lost to the subcontractors.

When Alliance Construction failed retentions owing to it were \$600,000 yet it was holding \$1,532,500 in retentions from subcontractors. 2 ½ times as much.

Any major construction company failure will show similar abuses.

Construction companies also complain of retentions held against them by principals also being abused.

Voidable transactions

Recent Court of Appeal decisions (CA773/2012 CA783/2012 and CA864/2012) has held that payments made are voidable unless they were made at the time that value was given. Payments made after value was given are voidable.

Construction contracts are subject to a payment process that means payment is never received sooner than 3 weeks and often 8 weeks or more after the work has been performed and will therefore always be voidable.

The Court of Appeal decisions introduces a much higher level of risk and uncertainty to an industry that is already acknowledged as experiencing the highest rate of company failures.

Flow of funds is a prime requirement for commerce and is one of the issues addressed by the CCA.

I request the Select Committee includes a provision in the Bill for payments properly made under the CCA to be exempt from the voidable transactions provisions of the Companies Act.

APPENDIX A – Discussion of retentions and the arguments

RETENTIONS APPLIED TO HEAD CONTRACTORS

The basis for holding retentions is thought to be to act as an incentive for the contractor to complete any remedial work that may be required after substantial completion of the project and handing over to the client. If the contractor is unable or unwilling to complete remedial works in a timely manner, the client is in possession of funds to enable that work to be carried out by others.

These are generally calculated on a sliding scale and are held until a specified time after the Head Contractor has completed the work and handed it over to the client. To this extent, the party on whom retentions are being held has some control over the length of time that they are held.

Unfortunately undercapitalized developers are inclined to push for a much higher level of retentions against head contractors to ease their funding requirements.

Head contractors can delay attending to the final few minor defects which would release retentions to the contractor, but would make them liable to release a larger amount to their subcontractors. This provides a funding benefit for both the developer and the head contractor.

RETENTIONS APPLIED TO SUBCONTRACTORS

Head contractors will provide forceful arguments for the need to hold retentions. In my view they have little real validity and the concerns they express can be appropriately address by other means.

The real reason that head contractors fight for their current position on subcontract retentions is that it provides a significant source of long term interest free unsecured finance to many organisations which often would not qualify for finance from mainstream providers. This reality is always denied, but there has been considerable anecdotal evidence of this, and it also becomes apparent when looking at construction company accounts following failures.

The main justifications advanced by head contractors are to ensure subcontractor performance and to cover the cost of defective work. While these sound reasonable, closer examination shows their significance is overstated. Proper management by head contractors will eliminate the need for retentions in many cases, and where they are justified, there are suitable ways of securing them.

Head contractors point out that retentions are held on them and it is unreasonable that they should have the burden of funding them. By passing

the burden on to subcontractors they are not only passing their own problems on to the weakest parties, but exacerbating it by magnifying the problem in the process. The issue of retentions held against head contractors can be dealt with, but the reality is that contractors do not want this solved as it is a justification for an exploitative retentions regime against subcontractors.

If head contractors are unable to fund their own operations from normal sources, why should they be able to misappropriate subcontractors money for that purpose.

A competent head contractor will only select subcontractors who have proven ability to carry out the work. Defects that become apparent during the performance of the contract are covered by deductions from the normal progress claims. Contractors have a tendency to over estimate deductions from progress payments as these deductions add to the head contractors cash flow if they have not been subject to the same level of deduction from the principal.

JUSTIFICATIONS FOR SUB CONTRACTOR RETENTIONS

- A financial incentive to ensure the subcontractor's performance of their contractual obligations
- A financial incentive to ensure the subcontractor completes remedial work in a timely manner
- A source of funds for the head contractor to complete remedial work if the subcontractor is unwilling or unable to.
- To ease the financial pressure on head contractors on whom retentions are being held.

THE RISKS TO THE HEAD CONTRACTOR

The subcontractor not commencing the work – retentions are of no help

The subcontractor's work being defective – normal credit terms are for payments to be made to the subcontractor no sooner than three weeks following the end of the month during which the work is carried out. That is normally sufficient time for the head contractor to become aware of the work being defective and to be able to withhold payment if appropriate. At that time the subcontractor will normally have carried out a full months work, plus at least a further three weeks work before payment is due so in most cases the contractor will be holding payment for at least 7 weeks of work which provides a significant level of protection for the head contractor and in the early stages is much more than is available through retentions.

The subcontractor falling behind program – retentions provide little help to the head contractor in this situation. Problems with meeting program are normally identified well before completion of the subcontract, and the normal progress payment credit delays referred to above provide the legitimate ability to

withhold much greater sums providing much more protection and greater incentive. The level of risk for the head contractor from application of liquidated damages will normally be much higher than can be covered by retentions held on the subcontractor and this sort of issue must be managed quite independently from retentions.

The subcontractor failing to carry out remedial work in a timely manner – defective work is normally identified during the subcontract period and deductions are made from progress payments to cover likely costs. The only times when this will not apply are with defects that can not be detected until more than a month following the subcontractors completion, or if the contractor is not performing his supervision duties.

The risk of hidden defects not becoming apparent until more than a month after the subcontract is completed is specific to each subcontract and it is not appropriate to address it by applying a blanket one size fits all retention policy. The situation and risk from work carried out by the steel placer for instance is quite different from the electrical subcontractor. The adequacy of the steel placing is checked prior to placing the concrete and there is no real possibility of defects in this work being discovered after the subcontractor has finished. If that is not the case, the head contractor is not doing his job. The full range of electrical system functions may not be used and their adequacy confirmed until some months following occupancy. There will be a few trades where it is appropriate for retentions to be held following practical completion.

The subcontractor being incompetent or insufficiently resourced – head contractors hold themselves out to be competent experts in their field, and take on the responsibility of carrying out a construction project on behalf of their client. If they wish to employ subcontractors to carry out some of the work for them, they should be sufficiently expert to ensure they only award the work to competent subcontractors. It would seem irresponsible and unprofessional to blindly accept lowest price offerings and expect that holding retentions would somehow guard against their own lack of care.

A contractor will always withhold amounts from progress payments to cover any defects that have been identified. Therefore the only realistic justification for holding retentions in addition to any such amounts is to cover defects which can not be identified at the time of completion of the sub contract, but which may possibly be identified before the practical completion certificate is issued. In that case an appropriate amount and time period should be determined for those instances where it is required.

ARE RETENTIONS AN APPROPRIATE INCENTIVE

Retentions have little practical effect on the outcome from those risks listed above. The benefits to the head contractor are purely as a source of unsecured interest free credit. The justification previously used has been that retentions are held on the head contractor so why should they pay the subcontractor. The whole pay when paid, and pay if paid concept that was

widely abused was in part addressed by the Construction Contracts Act 2002 but is still in effect in the application of retentions.

Retentions on tradespeople and specialist contractors are pretty much confined to those subcontracting to head contractors. The specialist contractors whom the Head Contractor engages are seldom ever subject to retentions when carrying out any work other than when they are subcontracting to head contractors on construction projects. If retentions are ever held in other situations, they are for a relevant period which is much shorter.

Retentions are not normal where an electrical contractor is carrying out work directly for a building owner. Retentions are not used for other forms of trade such as work done on cars, nor to ensure goods purchased are as described and fit for purpose.

What is so special in the construction industry that subcontractors should have retentions held for extended periods that have no relationship to any risk associated with the performance of the subcontractor? The only possible justification is to finance the operations of the head contractor. The only way this has come about is by abuse of power.

Why do subcontractors accept the retention system – simply because there is a major imbalance of negotiating power. Retentions are applied differently to different subcontractors, depending solely on the relative power of the subcontractor.

There is a significant incentive for head contractors to use the retention system to the fullest against subcontractors simply as a form of free credit.

Although there has been some improvement since the introduction of the Construction Contracts Act 2002, the current system of holding subcontractor retentions is bad for all involved in the construction industry and the New Zealand economy as a whole.

IN SUMMARY

- Subcontractor retentions help to keep unsound and unethical contractors in business.
- Subcontractor retentions increase the financial fallout from failure of contractors.
- Subcontractor retentions are a real cost that must eventually find their way through to the clients and tenants, but they are a real cost that provides few real benefits, other than to unsound contractors.
- Subcontractor retentions cause more harm than good to the wider community. The harm outweighs any benefit to our economy.

- Subcontractor retentions are of particular concern because they are a hidden cost that is accepted only because that is the way things have been done, rather than because of a rational review of costs and benefits.
- Subcontractor retentions actually encourage some head contractors to delay attending to the final few minor problems, as that triggers the final release of retentions to the subcontractors which negatively impacts on the contractor's funds.

THE EFFECT OF ABOLISHING RETENTIONS

- Inadequately financed contractors would be forced out of business.
- Contractors would be more inclined to award subcontracts considering more than just the lowest cost
- Contractors would be obliged to take responsibility for engaging sound and competent subcontractors.
- In the long term a sounder construction industry.
- More professional subcontractors as head contractors became more selective.
- Less financial damage from construction company failures.
- One less opportunity to rot the GST system