CONSTRUCTION CONTRACTS ACT - NEW STATUTORY TRUST MODEL FOR RETENTIONS

Jesse Wilson

From 31 March next year, retention monies under new commercial construction contracts must be held on trust in the form of cash or liquid assets. This change to the Construction Contracts Act 2002 (CCA) represents a wider-reaching version of a similar regime recently introduced in New South Wales.[1] The change – which was enacted in the wake of the collapse of Mainzeal – is intended to protect subcontractors from the insolvency of the parties holding retention monies.

The new regime has met with a mixed reception as the industry grapples with the implications. Last month, the Government decided to further amend the legislation to provide that the regime will only apply to retentions under contracts entered into, or renewed, from 31 March 2017 (rather than existing retentions, which the reforms originally covered).[2] As the implementation date draws closer, this article considers the potential hooks in the regime for contracting parties, their funders, and insolvency practitioners.

Existing Law Regarding Retentions

Previously, the CCA did not regulate contracting parties' ability to negotiate for the retention of a portion of the contract price in order to secure a contractor's performance of its duties. Typically, parties agreed that a percentage of the contract price will be held back until after certain agreed events have occurred which provide comfort that the works have been completed and satisfy the stipulated quality standards – e.g., the contract may provide that retention monies are released after practical completion or after a defects notification period.

The agreement can also provide that the owner holds the retention monies on trust for the contractor. This has been uncommon in the New Zealand market, though more common in the United Kingdom

The New Retention Monies Regime

The new regime applies to commercial construction contracts[3] which provide for monies to be withheld by one party (A) from an amount payable to another (B) as security for B's performance of its contractual obligations. The New Zealand reforms therefore cast a broad net, subject only to a de minimis threshold which is still to be set by regulation.[4] This stands in contrast to the New South Wales regulation, which applies only to retention money held by a head contractor when the construction project has a value of at least AUD $20 million.

From March next year, retention monies under new contracts must be:

- held on trust by A for the benefit of B,
- held in the form of cash or other liquid assets that are readily converted to cash,[5] and
- properly accounted for.

However, retention monies may be commingled with A's personal funds, as opposed to being held in a separate trust account. The intention is to create a "deemed trust model" rather than requiring the segregation of retention monies into trust accounts (as required under the New South Wales regime).

The amendments provide that the retention monies are:

- not available for the payment of debts of any creditor of party A other than party B, and
- not liable to be attached or taken in execution under the order or process of any court at the instance of any creditor of party A (other than party B).

Implications for Owners and Head Contractors

Under the new regime, sufficient liquid funds will need to be held on trust to cover the full value of the retention monies.

The reforms will prohibit any contractual provisions:

- making the payment of retention money conditional on anything other than the performance of B's obligations under the contract,
- making the date for payment of retention money later than the date on which B has performed all of its obligations to the standard agreed under the contract,
- requiring B to pay any fees or costs for administering a trust, or
- having the purpose, among other things, of avoiding the application of any of the provisions of the new regime.

Implications for Funders and Borrowers

The new regime effectively creates a statutory super-priority for contractors in respect of retention monies over claims by secured and preferential creditors (e.g., investors, employees, and the Revenue). The new law therefore has potential impacts on project finance.

Implications for Insolvency Practitioners

The context in which the statutory trust regime is most important – and the policy concern to which it is primarily directed – is the insolvency of the party holding the retentions. Insolvency practitioners are therefore likely to be on the front line of the early test cases under the new regime.

Some potential scenarios include:

- An insolvent party holding retentions for multiple contractors in its bank account fails to account for the funds as retention monies. Who is entitled to the monies: the contractors or the company's secured creditors?
    - o In the context of contractual obligations to hold retentions on trust, the common law position is that no trust is created until the monies have been set aside. Once the funds are set aside, they are impressed with a trust and the contractor has beneficial ownership of the money. Otherwise, no trust arises and the contractor would be an unsecured creditor.[6]
    - o However, that outcome would be contrary to the evident purpose of the statutory regime – which is to protect subcontractors against the consequence of the head contractor's default – and arguably inconsistent with section 18H, which provides that retention monies are not available for the payment of debts of any other creditor.
    - o Furthermore, even if the owner or head contractor properly accounted for the retentions, the funds may nonetheless be commingled under the CCA; i.e., there may be no separation of the company's own monies (subject to security interests) and the monies held beneficially by each contractor (subject to statutory trusts). Equity can trace trust assets but the principles and their application are not straightforward.
- The receivers or liquidators of a company holding retentions obtain advice that the company has a good, arguable basis to withhold the retention money on account of defective workmanship, but that there would be litigation risk.

o If, acting on that advice, the receivers or liquidators treat the money as the company's and therefore distribute it to the secured and preferential creditors, they will have caused a breach of trust if an adjudicator, arbitrator, or court later concludes that the company was not entitled to withhold the retention.

o This risk may result in insolvency practitioners defensively setting aside retention monies notwithstanding that there are good grounds for the company to appropriate the monies under the construction contract. This would add uncertainty, time, and expense to the process of realising assets for secured creditors.

Our Views

We have reservations about the merits and practicality of the new regime. It is inconsistent with the established treatment of secured and preferential creditors under other legislation and may create uncertainty for insolvency practitioners and industry participants.

We are currently meeting with clients to discuss the amendments to the CCA that come into effect on 31 March next year. If you would like to talk with us further about retention monies or any other CCA issue that may affect your business, please contact us.

Disclaimer: This publication is necessarily brief and general in nature. You should seek professional advice before taking any action in relation to the matters dealt with in this publication.

Endnotes

1 Construction Contracts Amendment Act 2015; c.f., the Building and Construction Industry Security of Payment Amendment (Retention Money Trust Account) Regulation 2015 (NSW) promulgated under the Building and Construction Industry Security of Payment Act 1999 (NSW). See also Bell Gully's November 2015 update here.

2 The change was inserted into the Regulatory Systems (Commercial Matters) Amendment Bill.

3 This means any contract for carrying out construction work in which one of the owners is not a residential occupier of the premises at which the works are occurring.

4 MBIE has consulted on the appropriate threshold value to engage the regime – please see Bell Gully's submission here.

5 MBIE has consulted on the appropriate accounting rules for liquid funds. See Bell Gully's submission here. The legislation provides that the funds may be invested subject to the rules that apply to the investment of trust funds.

6 See, e.g., *MacJordan Construction Ltd v Brookmount Erostin Ltd* [1994] CLC 581 (CA).

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