

## More Reasons to Avoid Retentions

Retentions aren't a common feature of the residential construction industry. The standard form contracts put out by the two big trade associations – Certified Builders and Master Builders – don't make any allowance for them, and nor do the contracts used by the volume building companies and franchises. And that is understandable. The small-medium builders who do most of the residential construction work can't afford to have 5-15% of their income withheld from them for weeks if not months at an end, especially when they have paid out the bulk of their income to suppliers and subcontractors and they don't have much left to pay their own bills.

They don't have high volumes of cash flowing in and out of their coffers from multiple building projects, like the big construction companies do. If they are going to be deprived of their money temporarily then they need to cover the shortfall from a bank overdraft. That isn't easy to come by for a small business without substantial assets. And if they can get an overdraft, it is not easy in a competitive market to add the borrowing cost into their contract price, in which case it erodes their margin.

There's a moral argument against retentions, too. A construction project is one of mutual exchange. The builder provides labour, materials and project management, and the owner pays him in money. There is no logical reason that why one party should perform his side of the bargain first, and the other later. As it is, the builder does tend to go first, and then he invoices periodically in the hope that he gets paid. It is just as logical to ask the owner to pay first, in the hope that the builder then does the job. One party has to assume the risk, but it could be either.

Retentions are in fact used as leverage to get the builder to finish the job, and to be fair, there is a reason for that. To be able to survive in the building industry you have to be continually picking up new projects as you complete old ones, otherwise you could be out of work for a long time. When the old one approaches the end, it is a natural tendency to channel your resources into the exciting new project and neglect the boring old one, especially when you have been paid in full on practical completion. So retentions create a powerful incentive to get the final finishing touches done, and more particularly, to rectify the defects identified during the defects notification period.

Retentions are commonplace in commercial and infrastructure projects, where the standard form contracts most commonly used are the New Zealand Standards and New Zealand Institute of Architects forms, and less frequently, overseas models like the FIDIC and NEC contracts. All of those allow for retentions, and often they are used in the more up-market residential projects as well, especially if an architect or engineer is administering the contract for the owner. If you as a builder are invited to sign a contract that provides for retentions out of your payments, then chances are you are going to want to withhold retentions out of the money you will owe your subcontractors as well. And as of 31 March 2017, there is a good reason why you might think twice about that.

On 31 March 2017 the amendments to the Construction Contracts Act that relate to retentions, come into play. All retentions (above a certain level) that are held on or after that date, must be held in trust for the party that the money is owed to. And present indications

are, that means all retentions that you happen to be holding at midnight on 30 March. In other words, it will apply to contracts you are entering into right now, that will still be going when April 2017 rolls around.

The new rules only apply to commercial construction contracts, not residential. But don't be fooled by that. A commercial construction contract means a contract for carrying out construction work in which none of the parties is an individual who is occupying, or intends to occupy, the premises wholly or mainly as a dwellinghouse. That means that some residential contracts will be caught by the new rules. For example, where the dwellinghouse is an investment property, or it is owned by a company (as long as it is not a trustee for the occupants). Or, where the builder is working for a franchise or group home building company, or the builder is a subcontractor. In those cases, the builder's client is not an individual who is going to live in the premises. And obviously the builder isn't going to either, so all subcontracts will be commercial construction contracts.

What does that mean for you as a head contractor? It means your homeowner client won't have to hold retentions in trust for you, but if you are withholding retentions from your subcontractors, you will have to hold those retentions in trust for them. You must hold them in the form of cash or other liquid assets that are readily converted into cash, so you can get them back quickly. Therefore come 31 March, you will actually have to hold the money, although it does not need to be paid into a separate trust account, and it can be mixed up with other moneys. You will have to keep proper accounting records showing where that retention money is being held, and your subcontractors can insist on inspecting those accounting records at all reasonable times and without charge.

There are some other strict rules. You must not use any retention money for the payment of debts owed to any of your creditors other than the subcontractor you are holding it for. If you don't end up paying the retention money out, you must not use it for anything other than to remedy defects in the performance of the subcontractor's obligations under the contract. And if there are no defects, then retention money is payable on the date on which the subcontractor has performed all of its obligations under the contract to the standard agreed under the contract. So for the many subcontractors who do their work at the beginning of the project, you will have to pay out their retentions long before practical completion, unless you have expressly required them to come back and rectify defects in their work that are notified during the defects liability period.

Like me, you must be asking yourself: Are retentions actually worth the trouble?

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