

ECANZ

**(Electrical Contractors Association
Of New Zealand)**

Submission

to the

**Commerce
Select Committee**

on the

Construction Contracts Act Amendment Bill

Introduction

ECANZ is part of the construction sector and represents the largest portion of electrical contractors in the sector. ECANZ is also part of the New Zealand Specialist Trades Contractors Federation.

The Construction Contracts Amendment Bill calls for amendments to the original 2002 Act.

- ECANZ is happy to support the amendments
- ECANZ wishes to propose an additional amendment

Amendment

ECANZ requests the select committee to very seriously consider adding to the proposed amendment what the majority of the specialist trades contractors consider an omission regarding **the protection of retention payment monies**.

ECANZ, as part of the NZSTCF, have placed before Minister Williamson a proposal to support the introduction to Part 2 Payments, Subpart 2 Progress Payments, and add in a second clause under 14 which would be 14.2

Suggested wording is as follows:

[section XX] The right to provide a bond in lieu of retentions

- (1) *Where a contract provides for the withholding of retention monies by a payer against a payee then the payee shall be entitled to provide a bond in lieu of retentions.*
- (2) *Where the payee provides a bond in lieu of retentions-*
 - (a) *It shall be in the form set out in [Schedule Y/approved by Regulation] and executed by the payee and its surety in favour of the payer.*
 - (b) *The surety must be a New Zealand registered bank or as otherwise consented to by the payer and payee.*
 - (c) *The payer shall release to the payee the retention held in the same amount as the bond within 5 working days of receipt of the bond.*

1. The solution outlined in our proposal to the retention problem already exists, but is not often implemented because it requires the payer's consent.
2. The solution is to allow the payee to provide a bond to the payer in lieu of the payer holding retention monies.

Forms of bond already exist. The fifth schedule to the New Zealand Standard NZS3910:2003 is one example. The Master Builders standard form of subcontract, SA-2009 includes a clause allowing for the provision of a bond in lieu of retentions, but the problem is that it is only enforceable with the consent of the payer. The guidance note published with that contract states:

"Although reference is made to performance bonds and bonds in lieu of retentions, and example forms are provided for these, it is not intended to promote the use of bonds, but rather to provide a basis for their use if agreed to by the parties."

3. Recent communications between ECANZ and its bankers indicates that commercial banks are willing to issue these sorts of bonds. In the UK standard form wording for bonds has been agreed between the Joint Contracts Tribunal (which publishes the well-known JCT forms of contract and subcontract) and the British Banking Association¹.
4. The bond has to be appropriate to the situation. It must allow the payer to call on the bond in the event of the default of the payee.
5. The payee has to have the option of providing the bond so that it can obtain the release of its funds to then deal with those as it sees fit.
6. The reason that this is not used often is because it makes commercial sense for main contractors acting from a position of privilege, to hold retentions. Further, it is commercially difficult for subcontractors to require the implementation of such a clause when there are other subcontractors who will take on that risk. This is not an everyday business risk, but is more akin to the oppressive sort of pay-when-paid clauses that were made illegal by the Construction Contracts Act 2002.
7. The solution is to introduce a clause into the Construction Contracts Amendment Bill (currently before the House) to provide the payee with the option of providing a bond in lieu of retentions.

Why Bonds?

8. By making the payee the decision maker on whether to provide such a bond, behaviour will be driven from the bottom up, rather than being imposed from the top down. Those higher up in the contractual chain will also have the opportunity of requiring that they provide a bond to their payer.

¹See <http://www.jctltd.co.uk/docs/Retention%20Bonds%202011.pdf>.

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9. The use of such a tool would be entirely at the discretion of the payee – so that there would be no mandatory requirement to use it, but there would be no excuses accepted if a payee failed to use it. The tool would work equally between main contractor and principal just as between subcontractor and main contractor.
10. The wording of the bond requires careful consideration and consultation with stakeholders. It is important to include the wording of the bond, probably within regulations, otherwise payers will include overly onerous bond provisions that will make the scheme unworkable.
11. However, these bonds are currently available, so this should not be problematic. Matters that would need to be covered include:
 - (a) When and how the bond may be called – for the cost of rectifying defective work in accordance with the contract provisions following appropriate notice to the payee.
 - (b) That the bond would not be enforceable until the retention monies which it secures have been paid over to the payee.
 - (c) Assignment provisions.
 - (d) Release of the bond when contract provisions otherwise provide for the final release of retention monies.
 - (e) That any money retained equals the value of the work in dispute and that the balance be released.
12. Consideration also needs to be given to enforcement. There would need to be a right to suspend work and/or apply for summary judgment in the event that the retention monies were not paid over. These consequential amendments would be straightforward.

Protection for Retention money

13. That any retention money is automatically deemed **money in trust**. That such identified money would be subject to the controlling party being held as the fiduciary trustee.
14. That the retention deemed **money in trust** would only be accessible by either party to the contract, under the terms of the contract and not available for the day to day use of either party.
15. That any dispute arising would be treated in the same way that a payment claim and or payment schedule dispute is similarly treated in the current version of the CCA.

Possible taxation loss for the government

16. The focus of sub contractors has been sharpened by the loss of millions of dollars in retentions and unpaid progress payments as the cost of the Mainzeal receivership is now becoming clearer.
17. This magnitude of failure has further impacted upon the country with the loss of taxation benefits that should have flowed through, but will now not be realised.
18. Whilst there are many variables in the payment system the facts can't be denied. The money being held by the main contractor as retentions is not protected, belongs to sub contractors and is held by the main contractor in an unsecured, informal basis that is open to for abuse.
19. Further to this the funds held in retentions are effectively "off the books", having no formal invoice attached to them on a GST basis. The figures are generally not included in company accounts and if shown are a contingent liability.
20. Such a positive change to the existing system, allowing the money to flow correctly, when due, based on work completion, will bring formal invoicing and profitability forward twelve months creating a significant tax wind fall for the country.
21. By freeing up these unseen funds they would incur GST, Company tax and potentially Dividend tax raising a prospective \$45-50 million per \$100 million of freed up retained value.
21. Using the Mainzeal example and the figures quoted earlier of \$18 million of retentions held on sub contractors and the Industry accepted value of 5% of turnover on average being held in unsecured retentions gives an indication of figures far in excess of the \$100 million example above.

Supporting comment

Notes to our proposed solution

Is a solution needed, does a problem exist? One only needs to look up retentions and security of payment on the internet to see a vast array of issues and solutions all around the world. Our closest neighbour Australia, in particular New South Wales, has just completed an inquiry, conducted by Bruce Collins QC, into security of payment and therefore retentions.

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The problem identified in our submission clearly exists in many countries and different solutions have been adopted. The solutions on offer reflect that a one glove fits all approach is not workable and that New Zealand needs to develop its own solution.

Much of the rhetoric around the need for retentions reflects the holding of retention money serving to act as a financial incentive to ensure the contract is completed by and against the subcontractor if they become insolvent.

The committee must also consider the protection of the sub contractor and protect them against the insolvency of the main contractor and always remember whose money is actually being held without security. Attached to our submission is a list of main contractors who have collapsed owing money to sub contractors in recent years. (Appendix One)

It is fundamental to establish at the outset that there is a distinction between work in progress for which an buyer created invoice can be raised in due course, and the retention monies.

Work in progress payments address a situation faced by many businesses, in many industries, where there is a risk that the payer may become insolvent before an invoice can be raised and paid. That is generally an accepted part of doing business.

Retention payments are sums of money that are withheld for work which the payee has already undertaken, and in that sense have been earned by the payee – it is just that they are held by the payer for a prolonged period on a “just in case” basis.

The reasoning for retention payments to be created was to secure the payee’s performance under the contract.

The holding of retention payments exposes the payee to the risk of the payer not being able to pay the payee’s money when it falls due, primarily due to insolvency. This has been highlighted recently by the Mainzeal collapse and others as per appendix one.

Often retentions are simply seen by the payer as working capital which incentivises the payer to hold as much as possible of a payee’s payment, and for as long as possible.

A concrete example that is known was the liquidation in 2012 of Alliance Construction Limited wherein the Liquidators first report filed at the Companies Office reveals that an estimated \$600,000 was being held in retentions against Alliance, but that it was holding over \$1.5 million in retentions against its subcontractors. More recently with the collapse of Mainzeal the figures outlined in the initial report by BDO to creditors and shareholders showed \$11.3 million being held on Mainzeal whilst they in turn held \$18.3 million on their sub contractors.

The problem is how to ensure that both the payer and payee have recourse to the same funds without prejudicing either party.

Background to ECANZ Submission

One of the original successes of the Construction Contracts Act was to outlaw the “paid if, paid when” behaviour that was prevalent in the construction industry. ECANZ believes strongly that the proposed changes outlined in our submission are the next step to making the construction sector stronger, more competitive balanced and financially transparent.

The issue of retentions has been around for many years however a string of recent collapses within the sector signal that if the industry wishes to be more productive then some changes have to be made.

Let us answer some basic questions with a guide to retentions 101. And list some of the ripple effects from a Mainzeal collapse

Over and above the taxation benefits to the country it is imperative we consider the knock on effects upon the subcontractors employed by or working under a main contractor. The potential loss of hundreds of jobs and the financial costs to the sub contractors are worth millions, particularly as the ripple effect begins.

Sub contractors account for the vast majority of work on a typical construction site. They are now exposed and may not be able to pay their staff or suppliers.

Sub contractors usually receive progress payments on jobs, these payments are typically made some 20 days after the end of the month worked. In addition retentions are also held against them to ensure they return if any issues arise from their work.

This is frequently defect period of up to 12 months after completion of the project and sometimes longer for which retentions are held.

Retentions also serve to protect the main contractor and client if a sub contractor goes into receivership and can't complete the job, the same should also apply to main contractors or clients who commercially fail and can't pay the sub contractor.

When we consider that the retentions held over the sub contractors are substantially more than those held over the main contractor we begin to see how the additional money is be used to prop up or increase the cash flow of the main contractor.

This really means that many main contractors are getting interest free loans from their subcontractors in return for work.

As this money is not protected it can be used by the main contractor for any purpose and if the worst happens and the main contractor goes into receivership then the money is lost.

We have already highlighted the lost jobs and closures of businesses effected by the loss of the money however we should also seriously consider other ripple effects. The

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sub contractor is unable to expand his business, nor increase staff numbers, maybe apprentices, nor improve his systems or training regimes. All of these can impact upon productivity, one of the key drives by the current government.

It also means many main contractors are running their businesses with other people's money, and if this money was removed into trust for example, many of these main contracting businesses would be forced to get money from elsewhere or would be unable to continue. This puts some main contractors who do separate retention monies at a disadvantage.

It could be argued that by having this interest free money available main contractors are able to operate too easily in such an important industry without adequate capital. This can mean that competition in the market is false, margins are very thin, quality is driven out and that if a problem occurs many of the participants are impacted upon sometimes fatally.

Increased productivity will not occur in an Industry where the balance of power is so askew. The time is right for some surety to be put into the construction Industry given the projected increase in rebuilding and new building required.

The Construction Contracts Act began a process leading up to its introduction in 2002 and the time is now to improve upon the CCA and introduce some protection for the retention monies.

What the Industry needs to address is the protection of this money which has been earned by the subcontractor and which the main contractor holds for a prolonged period of time.

Form a survey conducted amongst New Zealand Specialist Trades Contractor members we now have a snapshot of the current situation with regards to retentions and progress payments.

The money which belongs to the sub contractor should be protected and mechanisms put in place to enable settlement of disputes that arise from the contract

The construction industry is vital to New Zealand and needs strong commercial chains to hold it together and until industry changes from the top down construction will stumble on providing uncertain futures for those who venture in to it.

It is time for the Industry to step forward and engage with government to put in place a process in which security of payment is the norm and retention money is protected.

- **ECANZ would like to support its submission by appearing before the select committee**

ECANZ Endorsement

ECANZ fully endorse the submission of New Zealand Specialist Trade Contractors Federation

ECANZ

Electrical Contractors Association of New Zealand (ECANZ)

ECANZ has a membership of in excess of 1200 electrical contracting business who employ 7,000 people including some 1,300 apprentices. These businesses represent a combined sales turnover of \$900 million. ECANZ is the only organisation representing this sector. The demographics of membership are New Zealand wide with business entities from “one man bands” to companies employing 200 people. The average size business is three to four people, therefore we represent small business New Zealand and simply put small business is New Zealand’s largest employer.

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