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Get to Know the New Rules about Retentions

On 31 March 2017 the new rules about retentions will come into force. The main rule simply says “All retention money must be held on trust by party A, as trustee, for the benefit of party B”. Whether this law change will be good news or bad news for you, depends on whether you are party A or party B. If you are withholding retentions from a contractor below you, then you will be party A, and you will have strict obligations to comply with. If you are having retentions withheld from you by a client or head contractor above you, you will be party B, and your money should be a lot safer and should be paid out a lot quicker than it is at the moment.

The new rules only apply to commercial construction contracts, not residential. 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 you are working for a franchise or group home building company, or you are a subcontractor. In those cases, your client is not an individual who is going to live in the premises. And obviously you aren’t either, so any subcontract you enter into will be a commercial construction contract.

The Government is still deciding what the minimum amount of retentions will be before these new rules apply. Assuming your retentions exceed that amount, these are the rules that will apply from 31 March 2017:

- You must hold retention money in the form of cash or other liquid assets that are readily converted into cash.
- You must keep proper accounting records and make them available for inspection.
- You must not use any retention money for anything other than to remedy defects in the performance of party B’s obligations under the contract.
- You must pay interest on retention money to party B from the date on which it is payable under the contract until the date on which it is paid.
- You must not use any retention money for the payment of debts owed to any of your creditors (other than party B).
- You must not make the payment of retention money conditional on anything other than the performance of party B’s obligations under the contract.
- You must not make the date on which retention money is payable any later than the date on which party B has performed all of its obligations under the contract to the standard agreed under the contract.
- You must not require party B to pay any fees or costs for administering the trust.
- You must not attempt to rely on any provision in a construction contract if the purpose, or one of the purposes, of the provision is to avoid the application of any of the new rules.
- You can rely on the provisions of the Trustee Act 1956 especially insofar as they relate to the investment of trust funds.

The trust accounting records can be inspected and audited, which means there is at least the potential for some degree of supervision. But these requirements are unlikely to be enforced anywhere nearly as strictly as the rules applying to lawyers’ trust accounts. And these requirements are being imposed, out of the blue, on developers and contractors who were not schooled in trust accounting like lawyers are. Consequently, the temptation to dip into the trust fund to carry the business through some troubled financial times, is likely to prove irresistible for many. After all, the day of reckoning generally won't arrive until the end of the project. Many contractors will gamble that somehow, they will be able to fulfil their obligation when the time comes.

Apart from the above rules, there is considerable flexibility allowed. In particular, retention money held in trust by party A does not need to be paid into a separate trust account, and may be mixed up with other moneys.

As with most of the reforms in building industry law this century, the new retentions regime proceeds on the mistaken assumption that all contractors are as well-resourced, well-informed and as diligent as the major construction companies. Those majors are already setting up their trust accounts, procedures, accounting systems and alternative financing arrangements in anticipation of the new rules coming into effect. It is the small-medium construction contractors who will fall foul of this legislation. Not only will many of them not have the resources or the expertise to comply, but many of them will not have even heard of these rules by the time they come into force.

Will that worry them unduly? After all, party A to a construction contract is invariably a limited liability company. If that company becomes insolvent, the fact that some of its assets legally belonged to someone else (in this case the subcontractors who had earned the money) and cannot be touched by the company's creditors, is of little consequence to the failed company. It is really only the directors who have anything to fear, and if they have worked hard to salvage the company and they have blown the whistle when the company was approaching the point of no return, they should escape being held accountable for breach of directors' duties.

However it is not quite that simple. Section 220 of the Crimes Act 1961 (theft by a person in a special relationship) and section 229 of the same Act (criminal breach of trust) would apply to directors and senior managers of companies who have knowingly and intentionally broken the rules. And the maximum penalty for committing those crimes? Up to seven years' imprisonment. So I can see some serious attention being paid to these new rules in the period leading up to 31 March 2017.

This article is not intended to be relied upon as legal advice.