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Dear Melanie

STRATA BUILDING BOND & INSPECTIONS SCHEME

The Owners Corporation Network welcomes the opportunity to make a submission on the Strata Schemes Management Amendment (Building Defects Scheme) Bill 2018 and proposed amendments to the Strata Schemes Management Regulation 2016.

As the peak body for the rapidly growing number of residential strata owners in this State, OCN is keenly interested in seeing this 2012 initiative achieve its aim to reduce building defects and the lengthy and expensive litigation currently involved in owners attempting to have them rectified.

With this in mind, it is worth noting that the original intent – unanimously agreed to by stakeholders in early consultation - was for an expert to be independently appointed to inspect and report any defects. A scope of works in the interim report would ensure effective repairs. A costed scope of works in the final report would allow efficient allocation of any monies owed to the owners corporation should defects remain. The inspection was to be paid for by the developer, but co-owned by the owners corporation so the expert had an obligation to the owners.

What has evolved is an "inspector" appointed from industry panels with no set minimum qualifications, performing an inspection to a scope and fee agreed between the developer and inspector. The owners are required to provide access to the builder to rectify defects found by the interim inspection, yet the builder responsible for those defective works and is unlikely to be an expert remedial builder is not given a scope of works, and no check points are mandated. To compound this, Fair Trading's intention is to not require a costed scope of works in the final report.

The result of the continual watering down of the original intent will in many cases be a costly exercise that finds developers and owners still needing to engage experts to cost the defects and/or unfinished works listed in the final report. The current proposals will not deliver good public policy.

Sincerely
Karen Stiles
Executive Officer

OCN Submission
Strata Building Bond & Inspections Scheme
Prepared by Daniel Russell and Banjo Stanton

The existing law

The existing law of NSW provides owners corporations various protections in respect of defective residential building works. Chiefly this protection is in the form of the "statutory warranties", which an owners corporation generally has the benefit of against builders and developers.[1]

The statutory warranties are in the form of promises that the residential building work done would comply with the plans and specifications, be done with due care and skill, comply with applicable laws, and (so far as it involves the construction of a dwelling) be fit for use as a dwelling.[2]

If any of these promises are breached, the owners corporation can sue for damages in the form of the cost to repair the resulting defects.[3] Its time limit to do so is generally two years from completion of the work for defects that are not "major defects", and six years for defects that are "major defects".[4] An owners corporation will also usually have obligations to seek to mitigate their loss and damage, and that may (but need not) involve allowing the builder an opportunity to seek to rectify any defects.[5]

The *Home Building Act 1989* also requires certain insurance, or similar indemnity arrangements, to be in place in respect of residential building work relating to construction of a building of less than four storeys, but generally only provides cover in the event of the death, disappearance or insolvency of the builder.[6]

Owners of lots and owners corporations also may have protection in respect of residential building defects under Commonwealth or nationally-adopted consumer protection law, such as the *Competition and Consumer Act 2010 (Cth)* and the *Australian Consumer Law* ("**the Commonwealth Law**").[7] The law of New South Wales is invalid to the extent that it is inconsistent with this law, under and to the extent provided for by section 109 of the *Commonwealth of Australia Constitution Act*.

To the extent that it applies, the Commonwealth Law provides varying different forms of redress, including by means of an action for damages for non-compliance with a consumer guarantee under the *Australian Consumer Law,* generally available for 3 years.[8]

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[1] Section 3, 18B, 18C *Home Building Act 1989*

[2] Section 18B *Home Building Act 1989*

[3] *Allianz v Waterbrook* [2009] NSWCA 224 at [12]

[4] Section 1E *Home Building Act 1989*

[5] Section 18BA *Home Building Act 1989*

[6] Section 92, 96 *Home Building Act 1989*

[7] *Tranquility Pools & Spas Pty Limited v Huntsman Chemical Company Australia Pty Limited* [2011] NSWSC 75 at [535], [537]

[8] Section 273 *Australian Consumer Law*

Part 11

Against these existing arrangements, the *Strata Schemes Management Act 2015* ("**SSMA**") introduced its own Part 11, dealing with building defects in residential building work relating to new strata-titled buildings of four or more storeys.[9]

The Part 11 defects regime has the following essential features:

1. The developer must pay a bond in an amount derived from the contract price for the work.
2. The developer must appoint an inspector approved by the owners corporation.
3. The inspector must conduct inspections and provide both an interim and final report on defects in the strata scheme.
4. The builder can undertake repairs.
5. The bond can be called upon, chiefly to cover the cost of repair of defective work as identified in the final report.
6. The defects regime under Part 11 is not intended to impact on any other rights or remedies available to an owners corporation, however a court or tribunal may take matters done under Part 11 into account in determining matters relating to the subject work.[10]

The time limits applying under Part 11 are:

1. Within 12 months of completion of the building, the developer must appoint a building inspector.[11]
2. The interim report must be provided between 15 and 18 months from completion of the building.[12]
3. The final report must be provided between 21 months and 2 years from completion of the building.[13]
4. The bond must be claimed or realised within 2 years of completion of the building work, or 60 days after the final report is given to the Secretary of the Department, whichever is the latter.[14]
5. Under the present regime the bond must be capable of being claimed upon for at least 2 years, and not more than 3 years, from completion of the building.[15]

[9] Section 191 *Strata Schemes Management Act 2015* ("**SSMA**")

[10] Section 215 SSMA; presumably, it is envisaged that the court or tribunal would not order compensation for a loss to the extent that compensation had already been paid for out of a building bond.

[11] Section 194 SSMA

[12] Section 199 SSMA

[13] Section 201 SSMA

[14] Section 209 SSMA

[15] Clause 51 of the Strata Schemes Management Regulation 2016

Existing complications

For owners corporations, and other participants in the existing legal process, there are numerous frustrations, including:

1. The inspection of apartment buildings for defects, particularly large apartment buildings (such as those of four storeys or more) is often a long and drawn out process. This process is complicated by factors including the following:

    a. Obtaining access to lots, and scheduling inspections with occupiers can be a lengthy and laborious process.

    b. There is often a need to have the building inspected by numerous different disciplines, such as experts in general building defects, fire and life safety defects, hydraulic defects, mechanical ventilation defects, façade defects and structural defects.

    c. The diagnosis of the origin or cause of defects, or even the discovery of whether an item is a defect, often requires more than a mere visual inspection, involving the need for various forms of testing, including destructive exploration in some cases.

2. The participation of other parties, such as builders and developers, can sometimes be difficult to procure. Even if there is willing participation on all sides, the process still necessitates that the parties form their own views and discuss their competing positions in an attempt to reach agreement.

3. This can be a lengthy and fraught process where the "list" of defects has many thousands of items, many of which may still be in the process of discovery and investigation when negotiations are occurring.

4. Many defects may still be in the process of becoming apparent during the first few years of a building's existence and may not even be capable of discovery until the process is part-way or almost complete, or even after it is complete.

5. The lack of a supporting insurance regime, combined with the ubiquity of the use of special purpose vehicles in the development industry, and anecdotally high levels of "phoenix" activity in certain sectors of the building industry, meaning that there may not be a liable person left standing to answer a claim.

The role of law

The truth is that most of these difficulties are not a result of any existing law.

The *Home Building Act 1989* does not contain a section requiring that it take a long time to have several disciplines of expert from each side (and there are often more than two) gain access to and inspect hundreds of units.

It is not mandated under that legislation that further investigations and exploratory works be necessary to discover the existence or cause of a defect.

It is not a requirement of any existing law that defects become apparent gradually throughout the life of a building, that it take time for reports to be prepared and considered by parties, nor that it may take parties some time to work through negotiations over thousands of separate items of claim.

These things are all matters of fact which attend upon the very nature of residential construction.

The law, prior to the introduction of Part 11, did not wholly ignore these realities. It is true that the 2 year time limit to take proceedings for breach of the statutory warranties cuts across the practical realities to a significant degree, but the regime has—to its credit—allowed flexibility and optionality to commercial parties as to how they seek to resolve disputes.

Additionally, the present lack of a controlled and prescriptive legislative regime has allowed the free market to innovate and create solutions, including (in some instances) the entry into agreements which render the 2 year period null, or alternatively sophisticated structured settlement regimes which provide for processes and means of determination suited to the particular need of the economic stakeholders, including owners corporations.

The role of Part 11

In that context, Part 11, and the proposed amendments to it, can broadly be characterised as follows:

1. A prescriptive regime which ignores the fundamental realities which it confronts concerning the inspection and reporting on defects in strata schemes.

2. A scheme which seeks to impose an unworkable "one size fits all" approach on participants.

3. A statutory straight-jacket preventing the development of innovative solutions by market participants.

4. An unwieldly *Big Government*, bureaucratic approach to the resolution of commercial disputes between private citizens, and an arrogation of power and control to the Department on a massive scale.

5. A failure to grasp the genuine opportunity that may have come by introducing a form of financial surety to underwrite the existing (and abundantly clear) legal obligations of builders and developers, and in that context a policy disaster that could so easily have been a true solution to the problem of the use of $2 companies and Phoenix activity in the building and development industry.

6. A "smoke and mirrors" affair that poses a genuine risk of distracting owners corporations from the pursuit of their real, tangible legal rights under the *Home Building Act 1989* by adding untold layers of unnecessary legal red tape and bureaucracy, none of which the (predominantly) volunteer members of strata committees are equipped to adequately navigate.

This policy scenario is such an abject disappointment, because the problems which this regime could have solved were so simple:

1. To provide a fund to mitigate against the unfair effects of the winding up of developers and builders that prevents owners corporations from obtaining fair compensation for breaches of existing obligations under the law.

2. Further, or alternatively, to provide a "fast track", "rough justice" route to a claim on that fund by instigating an independent inspection regime giving rise to a single dollar figure outcome which could later be subject to an adjustment.[16]

The reality is that the Part 11 regime has not come close to achieving either of these outcomes, as the proposed amendments make clear.

[16] Similar in concept to the *Building and Construction Industry (Security of Payment Act) 1999*

The amendments

Unworkable

The proposed amendments betray that the Government has at last realised that the entire fabric of the scheme is fundamentally unworkable, in the face of the simple (and unchangeable) realities discussed above.

The Government can no longer pretend that the building bond scheme is in any sense capable of achieving:

1. Anything approaching adequate levels of inspection of buildings within the time allowed, as to the extent of buildings to be inspected, the scope of the inspections, the expertise of the inspectors, or the adequate identification of items.

2. An adequate level of scoping or particularisation of proposed repairs.

3. A meaningful estimate of the actual costs involved in repair of affected strata schemes.

Although it remains to be seen what format the interim and final reports must take, this outcome is nonetheless clear because:

1. The scheme, in sections 209 and 209A, is reduced to nothing more than the "agreement" of the owners corporation and the developer to an amount to be released, or the obtaining yet another report (this time by the Secretary).

2. The exclusion of liability for building inspectors acting in good faith shows that the interim and final reports need be nothing more than a "fair go", with experts having no level of accountability or responsibility for ensuring the accuracy, scope, extent, quality or even timely delivery of their reports.

The Secretary's role

Firstly, it is submitted that section 209A(1)(a) is unjust in that it may require the production of experts reports that are protected by legal professional privilege, which privilege would dissipate upon that release (a similar issue applies in respect of the proposed enforcement powers in section 211E).

Secondly, given the likely shambolic state of the documents to be produced in the inspection and reporting process, the Secretary will have no choice but to deploy section 209A(1)(b) on almost every occasion.

This, in frank terms, reduces the scheme to one where either the parties agree to share the bond between them, or the Secretary of the Department obtains a report on the defects and the cost of repair.

That outcome in essence renders the entire process of interim and final inspection reports merely preliminary, with the real issues only resolved by the Secretary obtaining a report under section 209A(1)(b) or adjudicating the matter between the parties.

This fails to achieve any semblance of a "fast track" process. Dispute on the adequacy of this final report or the correctness of the Secretary's determination under section 209A will be common.

As the Secretary's task is to assess the cost of rectifying defects amounting to breaches of statutory warranty under the *Home Building Act 1989* identified in the final report, the scope of such disputes will be broad.

From that perspective, therefore, the scheme is one whereby a departmental officer serves functions which classically would be served by a judicial officer or Tribunal member. Significant rights and obligations—involving determinations concerning the distribution of very substantial sums of money—fall to be determined by New South Wales Government bureaucrats.

This extraordinary arrogation of judicial functions by the Government offends foundational principles of good government in the Westminster tradition – that is, the separation of powers, namely that between executive and judicial functions.

Constitutional invalidity

Furthermore, it should be a significant cause for concern for the Government that, in *Burns v Corbett,*[17] the High Court unequivocally held that Chapter III of the Constitution prevents New South Wales from conferring on an executive agency of the State (such as the Secretary) adjudicative authority in respect of any matter listed in section 75 or section 76 of the Constitution.

In particular, the direct application of the decision in *Burns v Corbett* in this context is that the Secretary cannot resolve a dispute concerning the release of the bond if one of the parties to the dispute is a resident of a state other than New South Wales.

As the entire regime ultimately rests on a decision of the Secretary, it is capable of circumvention by the mere expediency of having a share of the development owned under joint title by a resident of a state other than New South Wales.

Due to section 30 of the *Judiciary Act 1903* and section 76 of the Constitution, the Secretary additionally may not have jurisdiction to decide whether *Burns v Corbett* applies in a particular case, because to determine that question may involve a matter arising under the Constitution or involving its interpretation, which the Secretary could not determine in the face of *Corbett v Burns*.

Commercial difficulties

Furthermore, the release of a bond on commercial terms is problematic. It is likely that most bonds will be provided by insurers, and the insurance arrangements (which will have a direct impact on negotiations) are unlikely to freely permit bonds to be called upon, and certainly not without penalty.

In most cases it is likely that a release of an insurance bond would result in an immediate call by the insurer on surety such as personal guarantees, which could have substantial flow-on effects for bond-givers, and therefore give them significant motivation to prevent such an occurrence.

In effect, it is likely that most bonds will be provided on the basis that they are 100% retained, it being anticipated that repair works will be done to prevent the bond having to be called upon.

However, the unavoidable realities of residential construction mean that repairs are highly unlikely to be completed, even in ideal circumstances, before the time the bond must be called upon.

[17] [2018] HCA 15 (18 April 2018)

There is a real risk that significant commercial pressures for builders and developers result in them beginning to demand the early release of the bond, or binding assurances of the release of the bond, before repair works are undertaken at all.

This outcome would of course render Part 11 entirely ineffective.

Failure to secure existing liabilities

The accumulated result of these difficulties means that the Part 11 scheme is wholly divorced from any role it might have played to secure the liabilities of builders and developers under the *Home Building Act 1989.*

In the face of the issues identified above, the Part 11 scheme is, overall, a threat to the effective, timely, and cost-effective enforcement of rights under the *Home Building Act 1989* and imposes significant detrimental burdens on owners corporations, including:

1. The need to obtain substantially more legal advice and assistance due to the significant multiplication of complexity and competing considerations in play.

2. The need to obtain more costly expert evidence, as owners corporations will not only need to obtain reports to prosecute their rights under the *Home Building Act 1989* but will need to obtain reports to protect their interests in the Part 11 process (for example, to ensure that they can form a view on the correctness of a report obtained by the Secretary under section 209A).

3. Additional significant commercial matters and complexity of process that must be dealt with in negotiations, involving added expense with both lawyers, experts and other assisting parties, such as strata managing agents and building managers.

4. The costs of having to facilitate multiple further rounds of inspections of lots, including for both interim and final reports, as well as ad-hoc repairs by builders.

Dilution of the value of the bond

The amendments propose to allow the use of the bond for additional purposes, including the paying of costs of experts (who, at the same time, have no level of accountability for their services), and imposes potential additional costs on owners corporations, some of which are itemised immediately above.

These factors in effect serve to substantially and unnecessarily erode the value of the bond to owners corporations.

Misguided reliance on enforcement powers

The proposed amendments involve a substantial shift in the legislation towards investigative and enforcement powers being placed in the hands of the Secretary.

Apart from re-iterating the point that it is offensive to fundamental notions of good government that investigative and enforcement powers be vested in the same body that has powers to quell and determine disputes of a judicial nature between parties, it is paradoxically unnecessary in a number of significant cases.

In particular, there is no conceivable reason why the Act could not simply provide that a bond must be lodged before an occupation certificate can be issued.

The change from requiring the bond to be lodged before the certificate is issued to requiring it to be lodged before an application for an occupation certificate is made is of no consequence—the fact remains that the section does not make the lodging of the bond a statutory pre-condition for the issuing of an occupation certificate.

An occupation certificate issued without the lodgement of the bond will be just as valid as it would have been under the un-amended section.

A penalty—even of the substantially increased size—is ineffectual, because:

1. The penalty must be issued and enforced.

2. If a developer was financially incapable of paying the bond before the penalty was issued, they will be (ironically) less capable of paying the bond after such a penalty is issued.

3. An insolvent party is not capable of paying a penalty any more than they are capable of lodging a bond.

Essentially the same issues render the debt recovery powers in section 211A inadequate—there is no merit in having a power to recover an unpaid or underpaid bond from a person who is financially incapable of paying it.

Lack of control over insurance products

In its practical operation, the Part 11 regime is likely to rely substantially on insurance bonds issued by insurers.

No provision in the legislation seeks to control any of the following factors:

1. How actuarial estimates are made of insurer's liabilities (such that they could be dramatically underestimated based on faulty assumptions—such as the false assumption that the majority of defects are likely to be repaired).

2. How premiums are determined by the insurers.

3. How insurers assess the risk of being unable to call on surety such as a deed of indemnity or guarantee, particularly in circumstances where the party in fact procuring the bond may not have substantial assets to satisfy a claim on an indemnity or guarantee.

4. The quality of the underwriting assessments made by insurers concerning their recovery avenues.

5. What occurs when an insurer is unable to meet its obligations, has substantially underestimated its liabilities, or has substantially overestimated the value of its surety?

The history of the law of residential building defects in New South Wales over the past two decades tells us that these are extremely significant factors which have, on numerous occasions, threatened the stability of the entire system, and contributed to the demise of significant market participants.

Moreover it is highly questionable why a bond regime, underwritten by insurance policies, is considered a preferable policy outcome to the existing (or a modified version of) the insurance regime under the *Home Building Act 1989.*

Additionally, it is questionable how, from an actuarial perspective, it is felt that insurers are more likely to be able to bear the burden of losses under the Part 11 regime than they were able to bear the burden of losses under the *Home Building Act* regime.

In that context it must be noted that insurer's surety under *Home Building Act* policies is likely to be in essentially the same form as insurer's surety under insurance bonds issued for the purpose of Part 11 (namely, personal guarantees).

Additionally, the Act does not control the relevant provisions of any insurance product. A complying product could contain numerous provisions detrimental to the regime from a policy perspective, including:

1. A clause prohibiting a builder or developer from agreeing to the release of the bond, making any admissions, or requiring the insurer's consent to the same (thus adding an additional party to the negotiation process).

2. A clause rendering payment on a bond to be a default by the bond giver for other purposes, thus giving rise to potential cascading breaches affecting the stability of the market.

3. An arrangement where each particular bond is drawn from a pooled facility, giving rise to a risk that the bond is not easily, or not properly, vetted for its full compliance upon lodgement, due to the interaction of numerous cascading policy documents.

4. A policy otherwise drafted with sufficient complexity to make it difficult or impossible to determine whether or to what extent it actually complies with the applicable bond requirements.

Recommendations

Preventing the sale of units without the bond in place

1. To prevent developers selling units without the bond being in place, Fair Trading should prevent strata plans being registered and/or occupation certificates issued without confirmation that the bond has been lodged. That confirmation could be easily and cheaply done via the SBBIS portal Fair Trading has developed. This would ensure no owners corporation is left without a bond. And avoid an extra burden on limited Fair Trading enforcement capacity.

Owners corporation to be party to inspector contract

2. The owners corporation must also be party to the contract with the building inspector (and the developer), with the inspector's fees paid by the developer, so that the inspector has contractual obligations to the owners corporation. OCN notes that Inspection Reports Part 3 – Recording defective building work prompts the inspector to notify "the client" of a present or serious safety hazard. Under current provisions the client is the developer.

Scope of works required in the interim report

3. If the scheme is going to provide a genuine positive force for change, a scope of works with key check points must also be included in the interim report, to ensure effective repair of defects.

Repair costs estimate required in the final report

4. To avoid unnecessary additional expert reports and litigation, it is essential that the final report provides a costed scope of works to rectify the defect.

   That amount should not be subject to any appeal or review process, and the owners corporation should be immediately entitled to call upon the bond for that amount. Where the building inspector does not feel able to do all or part of the costings, the building inspector should appoint and brief a suitable expert to cost the building inspector's scope.

   There will an element of 'rough justice' for the owners corporation or the developer, however, it is the simple, quick and cheap approach achieve the original intention to reduce litigation.

Independent strata inspector panel required

5. The Building Professionals Board is the obvious accreditation vehicle for inspectors, with an effective tiered accreditation model in place.

Inspectors to be liable

6. OCN strongly opposes the introduction of Clauses 213A and 213B. It is inconceivable that building inspectors should be exempt from any liability where they have acted "in good faith".

   Inspectors' motivation to identify defects will be adversely affected by knowing that it does not matter if they carry out an incompetent inspection. It would also in reality be impossible for an owners corporation to prove in Court that an inspector did not act in good faith.

   The justification provided is that is the same protection has recently been given to members of an owners corporation's strata committee. This ignores the fact that strata committee members are *lay volunteers, not specialists running a business for profit*.

   This would be less of an issue if inspectors were appointed by a completely independent body with a reasonable level of minimum qualifications. That is what was originally agreed by stakeholders. It is not what is being implemented.

Form of the interim report and the final report

7. In finalising the form of the interim and final reports FT must clarify crucial details such as what inspectors are required to inspect and the regime for requesting access to units. For example, will inspectors and builders be able to give 14 days' notice and then knock on the door at any time after that 14 days? Will they be able to say that they will require access at some time on a particular day and the occupant be expected to make arrangements to be at home the whole day waiting? Or will they be required to nominate a preferred date and time of access, with that being subject to change if the occupant has a holiday booked or cannot take that particular time off work? Not having a clear and fair access requesting process will leave another part of the scheme ripe for exploitation to the detriment of the owners corporations.