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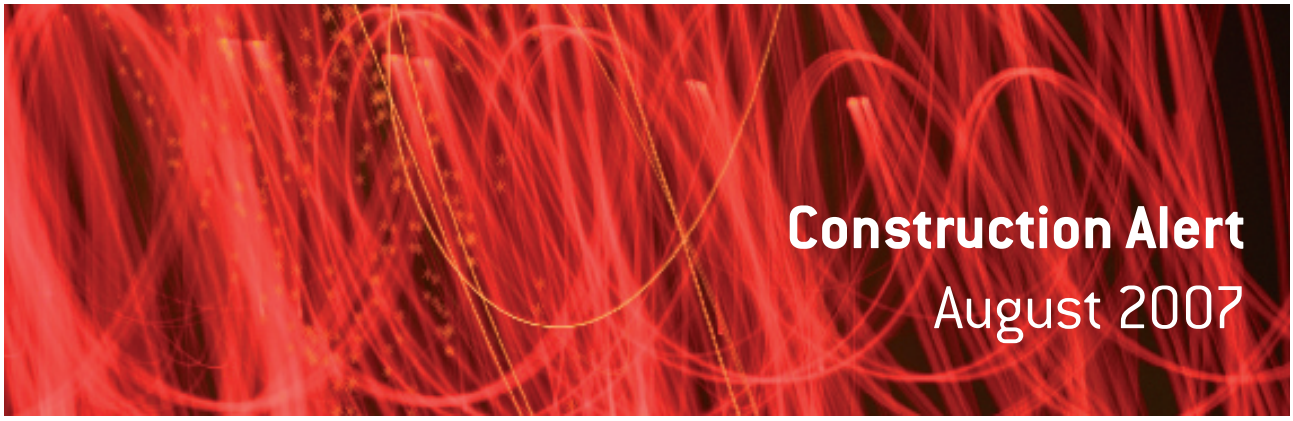


Residential Developers Liable for Builders' Sins

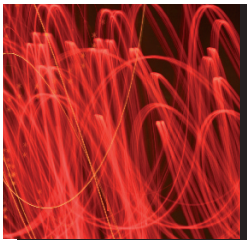
"Developers need to be aware that they may be held liable for defective work performed by the builders they have contracted."

It may come as a shock to many, but in NSW a "Developer" of residential property may be liable (for a period of 7 years from practical completion) to both the subsequent purchasers of that property and the Home Owners Warranty (**HOW**) Insurer, should the builder with whom the Developer contracted be found to have performed defective work in breach of the *Home Building Act 1989* (**HB Act**).

Under the HB Act a "Developer" is defined as any individual, partnership or corporation that is the registered proprietor of a site on which 4 or more residential lots (including strata lots) are constructed. Once a developer falls within this definition, then by the operation of other sections of the HB Act the Developer is liable for the defects of its builder even though:

- the builder was an independent third party;
- the building contract was a bona fide arms length transaction;
- the Developer took no part in the performance or supervision of the construction work.

If the builder is still solvent when a claim is made against the Developer, then the Developer may be able to cross-claim or seek an indemnity from the builder for its defective work. However, it is often the case that by the time the complaint is made the builder has become insolvent - leaving the Developer the sitting duck in the cross hairs of the disgruntled owners and HOW Insurer's sights.



Section 18C of the HB Act is the primary creator of the Developer's liability in that it states that:

"*A person who is the immediate successor in title to ….a developer who has done residential building work on land is entitled to the benefit of the statutory warranties as if the ….developer were required to hold a licence and had done the work under a contract with that successor in title to do the work.*"

As a result of Section 18C, the Developer is effectively placed into the shoes of the builder as far as liability to subsequent owners is concerned for building defects. This is despite the Developer entering into an arms length contract with a builder and the Developer having neither the expertise, the power nor the opportunity to ensure that the building work is properly performed. If such logic was applied across all aspects of life, then a father would be liable for the negligence of a doctor who operated on his son.

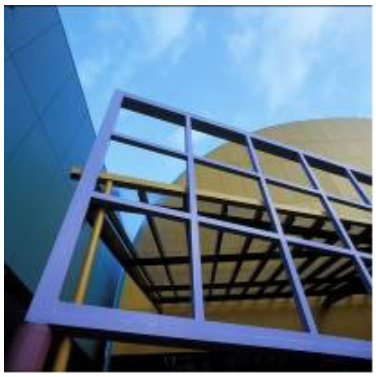
Further, as a result of Section 18C, a HOW insurer who pays out for defective building work and receives the subrogated rights of the insured, is then able to claim recovery of that payment from the builder or the Developer.

This subrogated right is also provided specifically to the Building Insurance Guarantee Corporation (**BIGCorp**) under Section 103M of the HB Act. BIGCorp was created on 30 June 2001 as a result of the liquidation of HIH Casualty and General Insurance (**HIH**). Through BIGCorp, the NSW Government agreed to indemnify beneficiaries of HIH and FAI HOW Policies with BIGCorp assessing such claims and paying out from the Building Insurer's Guarantee Fund which the NSW Government created with $20m as the start up grant.

With one eye to the future recovery of payouts made by BIGCorp, the NSW Government also amended the HB Act so as to bestow upon BIGCorp additional powers to recover from Developers the money it was likely to pay out. These powers include:

> Section 103M – under which beneficiaries of insurance payouts are deemed to assign their rights to BIGCorp thereby allowing BIGCorp to seek to recover the money paid out against the Developer;

> Section 103ZB - which empowers BIGCorp to stand in the shoes of HIH or FAI in relation to any indemnities or personal guarantees previously obtained by the now insolvent insurers against developers or even personal guarantors.



An insight into HOW insurer's recoveries can be gleaned from the 2006 BIGCorp Annual report. This report reveals some very dry but interesting information for Developers, namely that:

> for the financial year 2005-2006 BIGCorp paid 217 claims for a total of approx $16m with a further 528 claims still under assessment and 197 new claims received during that year.

> BIGCorp's financial statements show non–current assets (being debtors against whom BIGCorp can seek to recover payments made out) of $95m. However, it states that it has made a provision for doubtful debts (a euphemism for being unable to recover from builders and developers) at 98% ($93.12m) leaving only 2% ($1.9m) as the stated estimated recovery.

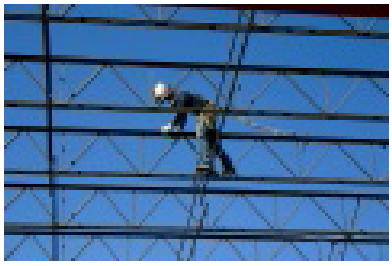
Given the extensive recovery powers awarded to BIGCorp under Sections 103M and 103ZB of the HB Act, the very low estimated recovery rate of 2% would appear to indicate that virtually all builders, developers or guarantors against whom BIGCorp have a right of recovery have already been wound-up, made bankrupt or have insufficient assets - to make recovery by BIGCorp commercially unviable.

Based on the above, it would appear that there is only a low theoretical probability of BIGCorp seeking to recover monies paid out under a HOW Policy against a Developer - however empirical reports appear to point to the contrary. This therefore leads to the question - *what should Developers do in the circumstances?*

Firstly, Developers may wish to structure their projects and the entities undertaking these projects in such a manner that may defeat any call on the assets of the company at some later time due to the failings of its builders.

Secondly, if faced with a demand by property owners or a HOW Insurer, the Developer should request detailed particulars of the alleged right to recovery, the defects, their rectification and

cost. If the claim is defended by the Developer, then the matter will proceed with all the problems associated with standard building litigation - not the least of which is the likelihood of incurring considerable legal costs.



However, as in nearly all manner of things, forewarned is forearmed.

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