Have Home Owners Warranty Insurers won a battle, but lost the war?

The Court of Appeal's decision in Owners Strata Plan 66375 v King is critically important for all members of the residential building industry, including those who are on risk for Home Owners Warranty insurance policies. The decision effectively means that a builder engaged under a "construct only" contract is potentially liable for design defects. This will greatly expand the exposure of the insurers who have written policies to cover breaches of the implied warranties under s.18B of the Home Building Act 1989 (NSW).

On 3 August 2018, the NSW Court of Appeal handed down judgment with respect to the obligations of developers and builders under s18B and s18C of the *Home Building Act 1989* (NSW) (the **HB Act**) in *The Owners Strata Plan No 66375 v King* [2018] NSWCA 170 (***SP66375 v King***).

The appeal concerned a decision a first instance of Ball J ([2017] NSWSC 739) and addressed, *inter alia*:

1. The factual findings that ought to be made upon the available evidence, and in particular whether and what inferences should be drawn to determine whether the Defendants (the Respondents on appeal) had executed a contract for the performance of residential building works by Beach Constructions Pty Ltd in their personal capacity;

2. Whether the liability of a developer to an immediate successor in title pursuant to the notional contract under s18C is co-extensive or co-terminus with the liability of the builder under the actual contract between developer and builder for the residential building work;

3. The liability of developer and builder pursuant to the statutory warranties under s18B – in particular whether the warranty under s18B(a) to undertake the work *"with due care and skill and in accordance with the plans and specifications set out in the contract"* limited or excluded liability in respect of:

    a. the warranty that all materials supplied will be good and suitable for the purpose (s18B(b)); and / or

    b. the warranty that the work will be done in accordance with, and will comply with, this or any other law (s18B(c)).

As to points 2 and 3, the residential building work as completed by the builder was in accordance with the plans and specifications set out in the contract. However, the work did not conform to the requirements of the *Building Code of Australia* (the **BCA**), which had force of law by operation of the *Environmental Planning & Assessment Act 1979* (NSW), cognate regulations and the stipulated conditions of approval for the development (the **DA**). The non-conformances were the result of inadequate design or *"design defects"*.

In considering the following, it should be noted that the proceedings concerned a building contract (or notional contract) made prior to the *Home Building Amendment Act 2014* (NSW). As such, the defence under s18F(1)(b) of *"reasonable reliance"* on instructions given by a relevant professional acting for the person for whom the work was contracted to be done and who is independent of the builder - being instructions given in writing before the work is done or confirmed in writing after the work is done - was not available (per 125(2) of Schedule 4 to the HB Act). However, there are many projects in NSW that were undertaken under the HB Act before the amendments and many insurance

policies that will continue to respond to claims arising from those projects for a number of years to come.

Ward JA and White JA allowed the appeal, as did Leeming JA in part.

The notional contract under s18C

Under the s18C of the HB Act a person who is the immediate successor in title to an owner-builder, a holder of a contractor licence, a former holder or a developer who has done residential building work on land is entitled to the benefit of the statutory warranties as if the owner-builder, holder, former holder or developer were required to hold a contractor licence and had done the work under a contract with that successor in title to do the work. For the purposes of this section, residential building work done on behalf of a developer is taken to have been done by the developer.

In *The Owners – Strata Plan No 64757 v MJA Group Pty Ltd* (2011) 81 NSWLR 426 (***MJA Group***), the NSW Court of Appeal (per Young JA, with Allsop P and Macfarlan JA agreeing) held, in the context of finding whether a claim upon a developer under s18C was out of time pursuant to s18E, that the structure of ss18B-18E of the HB Act was to establish a notional contractual relationship between the developer and the immediate successor in title (often an owners corporation) *"and the contract made by the developer with the builder is what is being looked at as to the content of that notional contract"* at [36].

In *SP66375 v King*, Ward JA held that the liability under the notional contract created by s18C was not limited by the content of the actual contract with the builder (see paragraphs [303] – [318]). Provided the work done by or on behalf of the developer is residential building work then, even if it is beyond the scope of the actual contract between developer and builder, it can nonetheless fall within the scope of the notional contract for the purposes of s18C (at [317]). The observations of Young JA in *MJA Group* in this regard were distinguished as *obiter* (at [318]).

White and Leeming JJA considered that the content of the notional contract under s18C was determined by the actual contract between builder and developer, following the observations of Young JA in *MJA Group* (Leeming JA at [366]-[370]; White JA at [390]). Further, Leeming JA considered that to expand the notional contract beyond the terms of the actual contract would be to create an "*even more* counter-factual result" (emphasis original) than was required by the terms of the stature (at [369]).

The statutory warranties under s18B

On the statutory construction of s18C of Ward JA, her Honour concluded that was not strictly necessary to determine the issue of the developer's liability for "design defects" under the notional contract as this issue, as argued, was predicated upon the liability of the developer under the notional contract as being co-terminus with the builder's liability under the actual contract (at [331]).

However, Ward JA stated that if her construction of s18C was incorrect and the liability of the developer under the notional contract was and is coterminous with the liability of builder under the actual contract, then the developer was liable for "design defects" pursuant to s18B(c) in any event for the reasons stated by White JA (at [332]).

White JA held (at [396]-[409] that the liability of a developer or a builder for breach of the statutory warranties in s18B(b) and s18B(c) was not limited, modified or excluded by compliance with the

warranty under s18B(a) – i.e. if the residential building works were completed in accordance with design (the plans and specifications) and, therefore and thereby:

- the materials supplied were not good and suitable for the purpose (s18B(b)); and / or
- the work was not in accordance with, or complied with, the HB Act or any other law (s18B(c)).

then the builder (or the party that was subject to the obligations stipulated by the statutory warranties) was liable.

This conclusion was reached by reference to the text and purpose of the legislation (at [403]). To permit compliance with *"plans and specifications set out in the contract"* to exclude these warranties would allow "contracting out" of the warranties, which is specifically prohibited by s18G of the HB Act.

White JA considered that the question was not whether it was "fair" that some burden was imposed on the builder, but simply whether it was imposed by s18B(b) and s18B(c). His Honour recognised the potential conflict that could arise in compliance with s18(a) and s18(c) where the design was defective but thought that the builder could, and perhaps should, negotiate some contractual protection in respect of the potential liability (at [406]).

At [408], White JA reconciled that conflict in this way:

> The statutory warranties can be read together. The builder warrants both that the work will be carried out in accordance with the plans and specifications and that it will comply with the law. Impliedly the builder warrants that the construction of the work in accordance with the plans and specifications will comply with the law. The order of precedence does not mean that s 18B(c) has no application if the non-compliance with the law is the result of design defects in the plans and specifications.

Furthermore, at [409], White JA noted that this conclusion was consistent with the authorities of *The Craftsman Restoration & Renovations v Boland* [2008] NSWSC 660 at [96]-[97], *The Owners Strata Plan 62930 v Kell & Rigby Holdings Pty Ltd* [2010] NSWSC 612 at [329]-[330] and *The Owners – Strata Plan No 68372 v Allianz Australia Insurance Ltd* [2014] NSWSC 1807 at [76].

Although Ward JA focused on the notional contract, at [325] her Honour referred to and relied on the reasons that White JA had set out in [402] to [409], where White JA resolved the conflict between s18B(a) and s18B(c) by the implication of an additional warranty by the builder - that the construction of the work in accordance with the plans and specifications will comply with the law.

It remains to be seen how a breach of the implied additional warranty arising from the construction of s18B may be answered by the *"reasonable reliance"* defence now afforded by s18F.

In dissent on this point, Leeming JA expressed reservations as to the reasons and conclusions of White JA by reference to various legal obligations for the performance of residential building works (at [378]). The submissions of the Respondents as to the consequences for a builder or developer were also noted (at [385]). However, his Honour ultimately disagreed because he had not reached a final conclusion on the questions of law involved having regard to the way in which the issues were addressed in argument (at [380], [385]-[387]).

Conclusion

In cases involving building contracts, or notional contracts, for residential building works, this decision of the NSWCA informs the nature and extent of the liability for breach of statutory warranties. The relevance of any distinction between "design defects" and "construction defects" has substantially diminished, if not dissolved, insofar as the residential building work ultimately completed does not conform to each and all of the statutory warranties.

Developments shall continue, with the additional implied warranty of the builder that the construction of the work in accordance with the plans and specifications will comply with the law likely to be tested against the *"reasonable reliance"* defence afforded by s18F pursuant to the 2014 amendments to the HB Act.