10 point plan for 'Building Stronger Foundations'

Submission by Banjo Stanton of Stanton Legal 24 July 2019

1. The most significant systemic factor behind the steep increase in residential unit block defects is that the persons profiting most from the construction control the quality of the construction and are generally well aware that there will be no consequence for them if the work is done defectively. That is due to loopholes in the law and the ability since late 2003 to build and develop residential buildings higher than 3 storeys (**multi-storey buildings**) via $2 companies;

2. Under the current regime which has been acknowledged as essentially *"self regulation"*, the builder and developer of a multi-storey building control the construction process. When using $2 companies, the persons behind the builder and developer of a multi-storey building know that even if their $2 companies can still be held liable by the time defects become known to the future owners corporation, they can simply walk away from dealing with the defect issues without any consequence to them (ie: the persons behind the companies).

3. Without any accountability or consequence for 'cutting corners', the temptation to increase profit by 'cutting corners' has left a trail of destruction for many thousands of new unit purchasers . That has caused the now overwhelming crisis in consumer confidence that is threatening the viability of the state's economy.

4. This crisis is not new. It has simply grown greater as the causes have become more entrenched. My submission[1] to the government on 21 August 2012 in respect of the Home Building Act Issues Paper included the following comment on the approach then being pursued of seeking to reduce building defect litigation by reducing consumer rights:

> [It] *"is clearly not a fair approach. Nor will it do anything to assist consumer confidence or the quality of construction in NSW. If anything, it is having, and will have the opposite effect. It will only encourage 'cowboy' behavior and increase shonky construction further increasing the already prevalent dialogue within the consumer sector along the lines of never buy a new unit, only buy a unit that has stood the test of time."*

Reform needed 1 – Closing the loopholes

5. The legal loopholes are known and easily addressed by simple amendments to the *Home Building Act 1989 (NSW)* (**HBA**) and implementing a strong statutory duty of care that is not 'watered down' during a consultation process.

6. The HBA loopholes are noted in the Owners Corporation Network's (**OCN's**) submission lodged today and annexure 'A' to the OCN's submission details the required amendments to the HBA.

7. Annexure 'B' to the OCN's submission of today provides the drafting for an appropriate duty of care provision.

[1] On behalf of Bannermans Lawyers where I then worked.

8. Closing the HBA loopholes and providing a statutory duty of care should be done retrospectively. The statutory duty of care is simply about making people accountable for their own incompetence/recklessness. Victims of professional incompetence/recklessness should not be left with no redress simply because the relevant wrongdoers thought that they would not be held responsible for their incompetence/recklessness at the time of their incompetence/recklessness.

Reform needed 2 – a single warranty period under the HBA

9. Returning to a single warranty period for all defect issues is another clearly desirable reform that can be immediately implemented.

10. The HBA warranty period was reduced in October 2011 from 7 years for all defects to 2 years for some defects and 6 years for others. Where a defect first becomes known or reasonably discoverable by an owner in the last 6 months of the relevant warranty period, the warranty period for that defect is extended by 6 months. Thus, consumers seeking redress for defects now need to understand and litigate 4 warranty periods as follows:

    (a) 2 years for non-*"major defects"* that first become known or reasonably discoverable by an owner in the first 1.5 years after completion;

    (b) 2.5 years for non-*"major defects"* that first become known or reasonably discoverable by an owner in the first 1.5 years to 2 years after completion;

    (c) 6 years for *"major defects"* that first become known or reasonably discoverable by an owner in the first 5.5 years after completion; and

    (d) 6.5 years for *"major defects"* that first become known or reasonably discoverable by an owner in the first 5.5 years to 6 years after completion.

11. Consumer rights were further reduced in 2015 by definition changes that reduced the types of defects issues that would have a 6 year warranty period.

12. The aim should be to have an efficient dispute resolution system focused on getting repairs done. Such an objective is undermined by needing to assess how a complex and convoluted definition of *"major defect"* applies to every separate defect issue. Nor should there ever be a need for evidence and arguments on when an owner should have seen the first sign of trouble for a certain (or every) defect issue with competing expert reports debating what the first symptoms of a defect issue probably looked like at particular points in time and at what time there was probably something visible that an owner should have noticed and should have been alarmed by.

13. The 4 separate warranty periods and the issues that they turn upon are a recipe for a 'lawyers' picnic'. They often makes disputes about what the builder and developer can 'get out of' instead of being about what repairs should be done.

14. If the warranty periods stay as they are, it will take 10-20 years of test cases to get to the point where lawyers can confidently advise upon which defects are and are not *"major defects"*. For each one of those test cases, there will be a party who pays a

very very expensive price for the privilege of developing the law and reducing the current uncertainties in how it applies. Even then, there would still be a number defects, and sometimes entire disputes, turning upon evidence of when an owner should have seen the first sign of trouble in respect of a certain issue with competing expert reports debating what the first symptoms of a defect issue probably looked like at particular points in time and at what time there was something visible that an owner should have noticed and have been alarmed by.

15. Reducing the complexity and cost of litigation for consumers, builders and developers while also truly aiming to make the focus of defect disputes about fixing the defects demands that there be only one warranty period for all defect issues under the HBA with no extensions to that period to apply in any circumstances. That will also assist the state's resourcing of NCAT and the Courts and their workloads.

16. Having one warranty period under the HBA is a 'no-brainer'. The only real discussion should concern how long such a warranty period should be.

Reform needed 3 – $2 building companies and regulating building licences for multi-storey buildings

17. The the urgently needed reform proposed below for $2 building companies and regulating building licences for multi-storey buildings can be immediately implemented. It does not need to wait upon the consideration and finetuning of other reforms. That first stage will be a good start towards addressing builders (but not developers) building multi-storey buildings through $2 companies.

18. There has been no attempt to regulate which builders should be allowed to build multi-storey buildings. Until late 2003, the effect of that lack of regulation was controlled by the underwriting requirements of private home warranty insurers. If no insurer could be persuaded that a particular builder was experienced or competent or solvent enough to build a development, the developer would have to find another builder. Where the issue was solvency, and particularly where the builder and/or developer were small or $2 companies, the insurers would generally deal with that by requiring a bank guarantee or directors' indemnity against any insurance payouts for defects. That provided a strong commercial incentive for those builders and developers to work towards providing a defect free building. It tempered their incentive to increase profit by 'cutting corners'.

19. That private 'policing' of this regulatory failure was removed for residential strata construction of more than 3 storeys in late 2003 when such construction was exempted from the need for home warranty insurance. Due to that, the absurd position is that the building licence regime in NSW works like this:

Builders without a licence	Restricted to work worth less than $5,000
Builders with a licence but not authorised by the government home warranty insurer to contract with a consumer for work worth $20,000 or more	These building licence holders can: (a) Contract with consumers to do work worth less than $20,000; **and**

	(b) Contract with anyone to build a high rise or anything else of any value that is over 3 storeys high; **and** (c) Subcontract (without the need for anything in writing) to build anything that the head contractor is licenced to do.
Builders with a licence that are authorised by the government home warranty insurer to insure for work worth $20,000 or more	These building licence holders can: (a) Contract with consumers to do work worth less than $20,000; **and** (b) Contract with consumers to build anything under 4 storeys that the government home warranty insurer will insure them for; **and** (c) Contract with anyone to build a high rise or anything else of any value that is over 3 storeys high; **and** (d) Subcontract (without the need for anything in writing) to build anything that the head contractor is licenced to do.

20. Under the current regime, the construction of multi-storey buildings, which is the most complicated and risky construction, is the least regulated construction. If a builder meets the requirements to be licenced to contract with a consumer to do work worth $5,000 to $19,999, the builder does not need to satisfy any other licence requirements to build a high-rise. Nor is there a home warranty insurer involved to say no if the builder is unsuitable for such work. As one would expect under such a regime, the large majority of people who build multi-storey buildings now do so via $2 companies.

21. As there is no home warranty insurer to satisfy any solvency risk issues or requiring any bank guarantees or director indemnities from builders or developers when considered needed, developers now carry out the large majority of residential developments via $2 companies without any threat of losing a bank guarantee or directors being liable for any defect issues. Thus, all a $2 company developer needs to achieve commercially is a building that is presentable for several months after completion. By that time, the developer has typically completed the sales for all units and the profits from the sales will have left the $2 company. Any defects that are discovered after that are of no consequence to the people behind the developer as liability for those defects is left with the $2 company which has no more assets or income to lose.

22. Such a system creates a commercial incentive for developers to proceed with reckless design decisions to reduce costs. It also creates a commercial incentive for developers to retain the building contractor that provides the cheapest quotation even if the building contractor is clearly insufficiently experienced for the work and/or has had to allow for ‘cutting corners’ in its contract price to win the work.

23. A number of commentators have referred to these dynamics as a ‘race to the bottom’ as without any consequence for defects, the cheaper the construction, the greater the profit.

24. I propose that the government introduce additional building licence requirements for a builder to be permitted to construct multi-storey buildings.

25. There is already a government agency that is the home warranty insurer for residential work up to 3 storeys. That government agency already has underwriting criteria for, and 9 years of practice in, assessing whether a builder is experienced, competent and solvent enough to be trusted enough to insure to build a strata development of up to 3 storeys (**3 storey insurance eligibility**). Even if the government does not immediately restore the requirement for insurance for building more than 3 storeys buildings, the government can immediately, amend its licencing of builders to restrict builders from building above 3 storeys if they do not have at least 3 storey insurance eligibility.

26. That would see builders that the government insurer does not consider an acceptable risk for building a 3 storey unit block not being able to simply build a high-rise instead.

27. That one change will go a long way towards stopping ‘cowboy’ builders and $2 building companies building multi-storey buildings. It does not address ‘cowboy’ $2 company developers. However, it should stop ‘cowboy’ developers being able to use obviously ‘cowboy’ builders. It should also stop obviously ‘cowboy’ and $2 company builders from undercutting reputable builders competing for multi-storey building construction contracts. It will hopefully also result in contractor pushback against dubious design decisions.

28. With time, the licencing requirements for building above 3 storeys can evolve so that there are appropriately tiered levels of eligibility requirements for building above 3 stories. For example, there could eventually be a set of licence eligibility requirements for building 4-6 levels, an increased set of licence eligibility requirements for building 7-12 levels and so on.

<u>Reform needed 4 –$2 company developers</u>

29. Addressing $2 companies for multi-storey buildings, and in particular, $2 company developers, is to restore the home warranty insurance safety net for multi-storey buildings.

30. As both the building licence regulator and home warranty insurance underwriter, the government can do this while controlling the insurance risk that it takes on. The government just needs the political willpower to impose appropriately strict underwriting criteria and realistic premiums. That would restore consumer confidence for the purchasing of new units.

31. Complaints by developers concerning cashflow and the payment of premiums could be addressed by not requiring the payment of the home warranty insurance premium until immediately before the registration of a strata plan. That would see developers

only having to fund the premium payments for the short period from then until the completion of unit sales. It is also reasonable to expect that the higher sale prices that the market will pay when consumer confidence is restored in this way will be more than the insurance premiums payable. That would see developers actually making a profit from restoring home warranty insurance notwithstanding the need to pay realistic premiums.

Reform needed 5 – further building licencing changes in practice needed

32. I propose that the government only issue residential building licences to individuals and that each person only be allowed one licence number for life. The eligibility of a licence holder from time to time, or at the same time, to contract to do work personally, or to be the licenced nominated supervisor for a company, and to be licenced at different times to do different categories of work, can all be easily administered via one licence number issued to the individual.

33. That approach will make a builder's track record much more transparent for consumers and also for the government insurer at the underwriting stage. The 'bad apples' will also not be able to hide behind the apparently clean record of a new licence number after abandoning a previous licence.

34. There should also be a presumption for residential building licencing that each (individual) licencee may only carry out residential building work through one company. It is difficult to justify why one person would need to have a number of different companies for that person to do residential building work through. However, it is common in my experience of being involved in at least several hundred residential building defect disputes for the licenced nominated supervisor of a company to be the licenced nominated supervisor for two or more companies. They are often similarly named. For example (Two Dollar Construction Pty Ltd and Two Dollar Construction (NSW) Pty Ltd and/or TD Construction Pty Ltd). The current licencing practice of allowing builders to have multiple licenced companies facilities phoenix company approaches to construction.

35. Similarly, there should be a presumption against allowing an individual licencee to build through a company when that licencee has previously been building through another company that been put into administration or liquidation or deregistered. Again, that is common to see when one is acting for owners corporations with defect issues and carries out searches on the persons behind the company that built the strata plan. Again, the new companies often have very similar names to the companies that have folded. Incredibly, it is not rare to see a licence given for someone's new company to build shortly after the old similarly named company folds.

36. Again, that licencing practice is facilitating phoenix company behavior. The fact that an owner has not thrown a lot of 'good money after bad' pursuing a $2 company to a judgment despite knowing that nothing will be recovered from the $2 company (which is needed to trigger the HBA's current provisions supposedly stopping phoenix company practices) does not mean that the builder is not engaging in phoenix type behavior.

37. The same factors support individual licence holders only being allowed to build through companies that they are a director of. A building company should be under the control of the person that is able and required to supervise its building work

Reform needed 6 – the government insurer properly screening corporate applicants for insurance

38. The government insurer's underwriting requirements for companies has at least historically been horrendously lax at great expense NSW taxpayers with those losses then used as an excuse to further reduce insurance protection for consumers. That is highlighted by the following extract from the OCN's submission dated 29 February 2016 on the HBCF Discussion Paper and the examples noted within that submission of extremely poor underwriting and issuing of licences (copy **appended**):

> *"The 'elephant in the room' is the minority of builders who use companies to avoid responsibility for their shoddy work. Only 18% of home building contractor licence holders in NSW are companies. However, insolvencies within that 18% of the licenced contractor population somehow accounts for 85.6% of all accepted insurance claims[2].*
>
> *There cannot be an innocent explanation for such an extremely disproportionate statistic over the 12 year period to June 2014. The extremely disproportionate amount of accepted claims relating to company insolvencies shows that the government's regulation of the sector is tolerating phoenix company behaviour. That leaves it to taxpayers to pick up the tab via the HBCF for the minority of shoddy builders who work through companies to avoid responsibility for their defects.*
>
> *It is obvious that the government should be focussing on the causes of the noted statistic. That is the key to not just achieving substantial savings for the HBCF but also substantially reducing the prevalence of residential construction defects in NSW. That is the only good government solution. The discussion paper should have confronted that rather than focussing on seeking to justify further reductions to consumer protection."*

39. The history of the 18% of licence holders that are companies (as opposed to sole traders) accounting for 85.6% of the government insurer's payouts clearly shows the government home warranty insurer's losses have been mainly due to lax underwriting controls for companies.

40. Hopefully, progress has been made in addressing those historical underwriting failures highlighted by the appended 2016 OCN submission. However, that should be independently reviewed and any recommendations for changes to underwriting criteria for companies or how those criteria are followed must be properly implemented. That will also become of wider public importance if a licence category for multi-storey buildings relying upon 3 storey insurance eligibility is now introduced as proposed above.

[2] Page 33 of the Discussion Paper.

41. Another appropriate measure would be if the government insurer has had to pay out in relation to work carried out by a company, any other company that a former director of the failed insured company is involved with should be ineligible for insurance unless the amount paid out by the insurer has first been reimbursed to the insurer (NB: That would not restrict former directors from continuing to operate by contracting in their own name thereby taking personal responsibility for their ongoing work as per 82% of current contractor licence holders).

Reform needed 7 – more site supervision/inspections

42. Many stakeholders have recently commented upon the clear need for more independent inspections of work during construction.

43. Requiring the return of the 'clerk of works' role has been a suggested reform. If that can be achieved, it would be a very positive step. However, due to there generally not being a clerk of works for any residential projects In NSW over the last few decades, it may be difficult in the short to medium term to find enough sufficiently experienced and willing building practitioners to resource, or at least capably resource, a mandatory clerk of works requirement.

44. A viable alternative that would involve less cost would be to:

    (a) Require designers to nominate hold points in their declared designs which are to form part of the approved construction consent plans; and

    (b) For all those hold points to be inspected by independent government employed and specially trained hold point inspectors.

45. Such a system would allow for independent inspections of critical stages in the construction process (where the adequacy of work carried out can be visually checked before proceeding further makes that no longer possible) without having to resource a further full time presence on site.

46. That cost to government could be paid for or subsidised by charging inspection fees. There would also be scope for structuring those fees to reward good construction by charging less when the construction being inspected is passed.

Reform needed 8 - private certifiers

47. As it currently stands, at least for the foreseeable future, the NSW construction industry, and therefore the NSW economy, needs private certifiers to stay in business. However, the viability of the already small number of private certifiers continuing to operate is already under severe threat due to insurance premiums and now insurance exclusions.

48. There has been valid criticism of private certifiers being selected and retained by developers. That independence issue is an issue with the system. There have also been examples of particular private certifiers acting inappropriately. However, generally where there are defects, the private certifier has not been the main, or even a significant, culprit. The provider/s of the inadequate design and/or construction are

the main culprits. However, certifiers are often conveniently blamed for the wide prevalence of defects.

49. A further issue for private certifiers is the use of the word *"certifier"* to describe them. That does not accurately reflect their legislative role. However, it typically leads purchasers of units to the impression that a 'certifier' has checked and certified that all aspects of the building has been properly constructed. It would be impossible for anyone to do that for a strata building without having had a full time role on site, assistance from various specialist contractors and reasonable payment for such a role. None of those are provided to private certifiers.

50. My proposal in relation to private certifiers is that:

    (a) They now be referred to in a way that accurately represents what they do and does not create a false consumer perception. One possibility would be a 'private consent authority';

    (b) They be allowed the same protections from liability as a Local Council under the *Local Government Act* but only for the work that they carry out in the capacity of being a private consent authority;

    (c) The valid independence criticism of the current private certifier system be addressed along the lines of Local Councils having a list of approved private certifiers for their area who are allocated by random or rotation basis for any party seeking the appointment of a private certifying authority to progress a development (that would go a long way to addressing the independence issue while keeping the current practitioners in work. It would also allow the practitioners to provide all the other services that their skillsets allow them to provide to the construction industry on a normal consultation retainer basis subject to appropriate conflict of interest controls).

Reform needed 9 – Declarations of plans and registration schemes

51. The government's proposed declaration of plans registration scheme reforms are positive steps that will add to a 'wholistic' solution to the current issues. However, their effect on reducing the prevalence of defects in NSW will not be as strong as any of the Reforms Needed numbered 1-7 above. Care also needs to be taken so that the end result does not create a disproportionate amount of 'red tape'.

52. An important aspect of these reforms will be mandatory wordings to use for the declaration of plans and construction so that disclosure of any issues cannot be avoided by carefully worded 'certificates'.

53. Another important aspect will be ensuring that an owners corporation has full access to all the documents submitted on the relevant portal for its own building. Its seem trite to say that an owners corporation should be provided access to the documents for its own building. However, the current systems in place resist that. Developers generally do not provide the documents they are supposed to provide owners corporations prior to their first AGM. Also, the government has to date, despite requests made on behalf of the OCN, refused to allow owners corporations to access

the equivalent portals for their own buildings that are being created for the purposes of the defects bond scheme.

Reform needed 10 – subcontracts to be in writing

54. A regulatory hole in NSW not commented upon by recent studies is that in NSW it is not mandatory for any subcontracts in relation to the carrying out of residential building works to be in writing (see section 7(8) and section 7AAA(3) of the HBA).

55. I have always found it incredible that any residential construction work done under a subcontract in NSW, irrespective of how much of the work (which could be the entirety of the work and/or to a value of tens of millions) or its importance, can be done on a 'handshake' basis and without a record of who was contracted to do what.

56. I see this as a regulatory gap that should be closed to promote the objectives of good and accountability based construction. I suspect that the ATO would also support such a step.

I hope that the above is of assistance and would be happy to meet to discuss any aspect.

Banjo Stanton
Stanton Legal

24 July 2019

APPENDIX TO BANJO STANTON SUBMISSION

OCN SUBMISSION DATED 29 FEBRUARY 2016

ON THE HBCF DISCUSSION PAPER

29 February 2016

HBCF Reform

Fair Trading Policy & Legislation

PO Box 972

PARRAMATTA NSW 2124

Dear Sir/Madam

REFORM OF THE HOME BUILDING COMPENSATION FUND (HBCF)

Strata is the fastest growing form of residential property ownership in Australia. Over half the new dwellings to be built in our metropolitan areas over the next decades will be strata titled. The growth of this sector raises increasingly important questions over property ownership and governance.[1]

The Owners Corporation Network of Australia Limited (OCN) is the peak body representing residential strata and community title owners and occupiers. OCN is therefore the key consumer voice in this review.

OCN is concerned by the growing theme of issues being distorted, at the expense of consumers. The *Analysis of the Impact of the Proposed Strata Defects Bond, October 2015* released earlier this year based its findings on government figures. That is, claims by single dwellings and strata buildings of 3 storeys or less. The cost of rectification in those cases is much lower than with a complex high rise building. It also based the anticipated cost of inspections on the likes of Jim's Inspections. Might owners get a discount on lawn mowing if they engage such an unregulated 'expert'?

At the same time, the excellent Lambert Review has made a number of practical and cost-effective recommendations to better regulate the construction industry and reduce defects claims. IPART has referenced a number of these recommendations in its *Review of the Reporting & Compliance*

Burdens on Local Government, January 2016. But there is no attempt in this discussion paper to offer this as an option for reducing claims on the HBCF, rather than reducing consumer protections.

And OCN is concerned that no mention is made of the large savings already initiated – again at the expense of consumers – by the introduction in 2015 of the major defect definition which will prevent many owners corporations making claims after two years.

OCN urges the government to focus its attention on the causes of the cost of HBCF claims, being preventable defects and deliberate insolvencies, rather than continually reducing protections for consumers such as defects claims time limits, availability of insurance, and redistributed responsibilities.

OCN supports a fair and equitable 'safety net' system that supports reputable builders and protects vulnerable consumers, and is happy to engage with government on any aspect of this submission, and to work with government to develop solutions to the issues identified.

Sincerely

Karen Stiles

Executive Officer

[1] *City Futures Research Centre 'Strata Data' Issue 4, October 2011*

OCN SUBMISSION
REFORM OF THE HOME BUILDING COMPENSATION FUND (HBCF)

Prepared by Banjo Stanton

GENERAL COMMENTS

Are the 2013 and 2014 loss figures a valid basis for (further) reform (that further reduces consumer protection)?

The discussion paper argues that HBCF losses during the period 1 July 2012 to 30 June 2014 show that the HBCF in its current form is unsustainable and must therefore be reformed.

That premise for urgent reform overlooks the fact that the level of cover available from the HBCF has already been substantially reduced since June 2014. The *Home Building Amendment Act* 2014 commenced operation on 15 January 2015. Those reforms included:

(a) The retrospective reduction of the period of cover for many defects from 6 years to 2 years by retrospectively narrowing the criteria for determining whether a defect is covered for 6 years (as opposed to only 2 years);

(b) Completely ceasing the provision of insurance for owner – builder work;

(c) Specifying that repair work by original builders does not require new insurance (even if the repair work is carried out after the period of insurance is complete therefore leaving the owner with no insurance cover for the adequacy of the repairs); and

(d) Tied to the previous point, and increasing its unfairness, creating a duty for owners to allow builders access to repair their own inadequate work.

The figures to June 2014 pre-date those reforms which will have a positive financial flow-on effect to the HBCF at the expense of consumers. Justifying further reducing consumer protection by relying upon 'financial crisis' figures that do not relate to the current level of cover is inappropriate.

OCN does not understand why the government does not wish to wait to evaluate the flow on effects to the HBCF's financial performance of the reforms already implemented. In addition to the reduced level of cover noted above, those reforms also included new (but still insufficient) licencing restrictions aimed at phoenix business models which, as detailed below, is the key financial threat to the HBCF.

Must the HBCF be revenue neutral?

It is inappropriate and anti-consumer to argue that a consumer protection mechanism looked at in isolation must be revenue neutral.

One would not close down a hospital due to it having too many patients and operating at a loss. The better approach would be to consider what can be done to reduce the number of patients requiring treatment. That would be even more obvious if the patients were all hurt by the carrying out of an activity that the government issues licences for and regulates. Here, consumers resort to the HBCF after a builder that the government has given a licence to and made eligible for insurance has (a) done shoddy work and (b) not met its defects responsibilities.

The revenue neutral argument also overlooks the 'bigger picture' that the HBCF is just one aspect of residential construction in the NSW economy. Considering the cost of the consumer protection mechanism within the state's residential construction economy in isolation is inappropriate. The NSW government and economy enjoys immense benefit from residential construction. One example of that is the $33m HBCF loss in the year to 30 June 2014 was 0.5 of 1% of the government's stamp duty revenue for the same period[3].

Attacking the already limited consumer protection available within residential construction can only reduce consumer confidence with the construction product, particularly in relation to the well documented prevalent defect issues in new apartment buildings. The cost to the government and the economy of any downturn in consumer confidence will be many times greater than the cost of maintaining the current level of protection (which may turn out to be revenue neutral anyway if the government waits for the flow-on effect of the recently implemented reforms).

What about the ELEPHANT in the room?

The 'elephant in the room' is the minority of builders who use companies to avoid responsibility for their shoddy work. Only 18% of home building contractor licence holders in NSW are companies. However, insolvencies within that 18% of the licenced contractor population somehow accounts for 85.6% of all accepted insurance claims[4].

There cannot be an innocent explanation for such an extremely disproportionate statistic over the 12 year period to June 2014. The extremely disproportionate amount of accepted claims relating to company insolvencies shows that the government's regulation of the sector is tolerating phoenix company behaviour. That leaves it to taxpayers to pick up the tab via the HBCF for the minority of shoddy builders who work through companies to avoid responsibility for their defects.

It is obvious that the government should be focussing on the causes of the noted statistic. That is the key to not just achieving substantial savings for the HBCF but also substantially reducing the prevalence of residential construction defects in NSW. That is the only good government solution.

[3] Table 5.4, Budget Statement 2015-16.
[4] Page 33 of the Discussion Paper.

The discussion paper should have confronted that rather than focussing on seeking to justify further reductions to consumer protection.

The cost-effective litigation minimising Queensland 'first resort' model has been given reverential status in reform discussions over the last 5 years. There is a reason why the system in Queensland works so well, with most disputes resolved by builders carrying out proper repairs without the need for an insurance payout. The reason is that in Queensland, shoddy builders are held to account and cannot avoid responsibility by hiding behind $2 companies. In Queensland, if a company does not properly deal with its defect issues, thereby causing the need for an insurance payment, the Queensland Building and Construction Commission may recover the cost of that payment from the directors of that company as a debt[5].

Before suggesting some steps available to the government to improve the financial performance of the HBCF by properly addressing phoenix company behaviour, OCN provides below some evidence of how in many instances the persons behind companies that became insolvent without addressing their defect issues have been allowed to simply move on to operating via other companies.

<u>The builders behind the insolvent companies – Where are they now?</u>

OCN is grateful to Stanton Legal, Bannermans Lawyers, Chambers Russell Lawyers and Makinson d'Apice Lawyers for identifying from their records the matters with which they have been recently involved where a last resort insurance claim has been lodged where the insured builder was a company and the names of those companies.

An analysis, based mostly on searches of the Fair Trading Home Building Contractors register with some references to ASIC searches, has been undertaken to assess whether the persons behind the collapsed companies whose work have resulted in last resort insurance claims simply continued residential construction in NSW through other companies.

The analysis sample was 43 companies. The detail of the analysis is provided at Annexure 'A' with each of the 43 building companies given a number rather than identifying them publicly. The outcome of the analysis was:

- In 27/43 or 63% of the sample of failed companies that led to last resort insurance claims, persons behind the company continued residential construction in NSW through one or more other licenced companies;

[5] Section 111C(6) of the *Queensland Building and Construction Commission Act 1991 (Qld)*.

- Of those 27 examples where persons behind a company continued residential construction in NSW through one or more other licenced companies, there were 17 examples (or 40% of the total sample) where the other companies were given eligibility for insurance.

Those statistics show:

1. In the majority of cases, the persons behind the company have simply let the company go and continued building through another company;

2. A substantial proportion of instances where not only have the persons behind the failed company simply moved onto another company, the HBCF is taking the risk of the other companies also being allowed to collapse in the face of further defect issues at great taxpayers' expense;

3. It is too easy for builders operating through companies to walk away from any consequences for their shoddy work;

4. The regulation for granting home building licences to companies is a failure;

5. The HBCF's underwriting procedures for companies have been too lenient.

Such a state of affairs does nothing to encourage builders operating through companies to take care with their work, and does nothing to encourage them to properly deal with defect issues once they are raised by owners. The financial cost of that to the HBCF cannot be properly measured. However, common sense suggests that it has had a large part to play in a large proportion of the 85.6% of accepted insurance claims where the insured contractors were companies.

The worst examples of lax regulation from the study undertaken are probably:

(a) Company 3: This company's licence ended in May 2014 and 5 insurance claims in relation to the company have been paid out. Two directors of the company have continued operating through a second licenced company which has been eligible for insurance since December 2013;

(b) Company 4: This company's licence ended in March 2010 and 7 insurance claims in relation to the company have been paid out. One of the directors has continued operating through a second (similarly named) licenced company which has been eligible for insurance since January 2011;

(c) Company 11: This company's licence ended in December 2007 and 6 insurance claims in relation to the company have been paid out. The directors have continued operating through a second licenced company from May 2007 which has been eligible for insurance since January 2009. They have also been operating a third licenced company (with a similar name to the second licenced company) since August 2009 which has not been eligible for insurance.

The ‘bad apples’ may only be a minority of the industry but they are causing enormous damage to the industry and consumers as well as causing enormous cost to taxpayers through the HBCF. It is time that the government addressed the regulation inadequacies that have allowed this to occur.

Options for ‘weeding out’ the ‘bad apples’, or at least making it harder for them to continue their phoenix behaviour, include:

1. Following Queensland’s lead by creating a system where defects are generally addressed by builders without the need for an insurance payment by making directors of companies personally liable for any amount that the HBCF pays out. It is reasonable to assume that companies will then deal with defect issues instead of folding, and the personal accountability for shoddy work will result in more careful construction and less defects in the first place;

2. Partially following Queensland’s lead by making directors of companies personally liable for any amount that the HBCF pays out up to a limited amount. If this ‘halfway’ approach is adopted, OCN suggests that the limit on a director’s liability for an amount paid out by the HBCF should be tied to the value of the subject contract work (perhaps 50% of the contract sum);

3. Only allowing qualified supervisors for private companies that are directors of the companies (which is a step considered by the discussion paper);

4. Not allowing a licence holder to be a qualified supervisor for more than one company at any one time;

5. Only providing home building licences to individuals and only providing each person with one licence number for life. The eligibility of someone from time to time to contract on their own behalf, or to be a qualified supervisor of a company, or both, and for different categories of work from time to time can all be easily administered via one licence number. That will make a builder’s track record much more transparent for consumers and for the HBCF at the underwriting stage. The ‘bad apples’ will also not be able to hide behind the clean record of a new licence number;

6. If the Fund has had to pay compensation to an owner in relation to a company, any other company that a former director is involved with should be ineligible for insurance unless the amount paid out by the HBCF has first been reimbursed to the HBCF (NB: This would not restrict former directors from continuing to operate by contracting in their own name thereby taking personal responsibility for their ongoing work as per 82% of current contractor licence holders);

7. Having an insurance eligibility category for 3 storey buildings with the licence conditions upon companies that do not have such an eligibility including that such companies may not construct buildings of more than 3 storeys. That would be a small start towards better protecting owners of new multi-storey buildings for which contractors do not need insurance to build.

   Currently, builders who do not have the expertise or financial stability to meet the HBCF’s

criteria to be eligible for insurance for a building of up to 3 storeys are allowed to construct more complex buildings of more than 3 storeys, as insurance is not required for same. Thus, the construction that should be most regulated is ironically the least regulated.

Not having any real restriction upon who can build multi-storey buildings is absurd. It encourages the use of $2 companies to evade responsibility for defects and ensures that those $2 companies will ignore their responsibilities. That lack of accountability encourages poor construction practices which results in more defects. It should also be noted that many consumers buying into large buildings are within the most financially vulnerable proportion of home owners and are most in need of protection from phoenix company builders;

8. Notification to the HBCF of building defects proceedings commenced against companies in relation to multi-storey buildings so that the issues arising from same can be factored into considering the company's ongoing 3 storey building insurance eligibility.

9. OCN agrees with The Law Society of New South Wales' suggestion that the government investigate whether it is possible to trace through an obligation to rectify so that it follows a company director to new or other entities as a deterrent to simply closing down one entity and continuing to operate via a new or other existing company.

RESPONSES TO SELECTED SPECIFIC CONSULTATION QUESTIONS

1. Do you think that the period of insurance cover for major defects is appropriate?

   OCN opposes any reduction in the already inadequate period of insurance cover for major defects. Time is needed for many defects to manifest. Due to the recent retrospective change in the major defect definition, the period of cover for many items has already been dramatically reduced from 6 years to 2 years. Further reducing the period of cover would be an exercise in hoping to save money by sacrificing important consumer rights instead of preventing phoenix company behaviour.

2. What do you anticipate would be the impact of reducing the insurance cover period:

(a) The consumer – Additional unfair financial loss;
(b) The builder – Encouragement to avoid defect rectification knowing how limited the consumer's 'safety net' will be if the consumer has to resort to the HBCF after years of costly litigation. The builder will emphasise this when pressuring the owner to agree to "band-aid" or simply no repairs;
(c) The industry – the 'bad apples' within the industry will be very happy. Reputable industry operators will still be undercut by minority cowboys, harming their businesses and the industry's ability to attract quality entrants.

3. Should insurance cover under the HBCF be split into separate cover for loss arising from non-completion and loss arising from defective work?

   No. This would further complicate an already complicated product. That will add to HBCF administration costs. This proposal is designed to save money by reducing cover for consumers instead of addressing the key threat to the HBCF's financial performance; phoenix activity.

4. Is coverage of $200,000 for loss arising from non-completion and $200,000 cover for loss arising from defective work appropriate?

   No. As noted above, the cover should not be separated. The proposal has only been put forward as, applied across the board, payments to consumers will be reduced notwithstanding that a very small number of consumers could conceivably benefit.

5. Should insurance under the HBCF be voluntary?

   No. That would further facilitate phoenix company behaviour and be financially disastrous for the many consumers who need to call upon a 'safety net'.

   11. What (if any) types of work could be excluded from the requirement to hold insurance?

   No type of work should be excluded. If the work is significant enough to meet the costs threshold, it should be insured. If it is a generally low risk type of work, that should be reflected in the premium pricing for that type of work.

14. Should low-rise multi-unit buildings apart from duplexes be exempted from HBCF insurance requirements?

No. The government should focus on properly regulating who should be allowed to build multi-unit buildings and preventing a small minority from profiting from phoenix company behaviour.

15. Do you agree with low-rise multi-unit buildings being covered by the strata building defects inspection regime?

Yes but not as an alternative to HBCF cover.

16. Should a fee-for-service distribution model be considered for the provision of insurance under the HBCF?

OCN was very surprised to see that 15% of the HBCF's income is paid as commission to insurance brokers in circumstances where the government is the only insurer. Brokers can hardly be shopping around or using their contacts to find the best price for their clients. The HBCF's revenue should not be used to pay unnecessary middle-men. That change alone will substantially improve the HBCF's financial performance without waiting for the flow-on effects of the recently implemented reforms or reducing consumer protection.

17. Should insurance under the HBCF be directly sold to builders by the Government?

Yes.

19. Should the application/eligibility assessment function and the claims management function be separated for the purpose of outsourcing those tasks?

Yes. There may be scope for relatively minor administration costs savings by increased competition without reducing service levels and quality. However, there is a more significant issue for an insurer outsourcing both underwriting and claims management tasks. It is a conflict of interest for the one service provider to do both tasks as the claims management provider will be reluctant to point out to SICorp mistakes that it made at the underwriting stage that have affected financial outcomes.

21. Could the introduction of licence classes based on the type of construction improve the quality of building in NSW?

Yes. Currently, a contractor deemed too risky to be insured for a $20,000 contract is free to construct a complex high-rise building for which the owners have no insurance ‘safety net’. As explained at point 7 of OCN’s licencing reform suggestions on page 5 (page 7 of this document) above, there should at least be a category of insurance eligibility for a 3 storey building and if a contractor does not have the expertise or financial stability to obtain that eligibility, it should not be allowed to instead build something higher than 3 storeys (which requires a greater level of expertise and financial stability).

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ANNEXURE 'A'

ANALYSIS OF A SAMPLE OF RECENT HOME OWNERS WARRANTY CLAIMS INVOLVING COMPANIES

No.	Observations
1.	Licence ended 08/07. Two directors have been the directors of a 2nd licenced company with the same name except for 1 letter since 04/06. That 2nd company has been eligible for insurance since 04/10. The same 2 directors have also been the directors of a 3rd licenced company since 12/08. It also has a similar name and has been eligible for insurance since 10/12.
2.	Licence ended 08/10. A director and the supervisor have been operating through another licenced company since 06/10 which is not eligible for insurance. Same director also operating through a 3rd licenced company since 11/15 which is not eligible for insurance.
3.	Licence ended 05/14 (5 insurance claims paid). Two directors still operating through a 2nd licenced company which has been eligible for insurance since 12/13.
4.	Licence ended 03/10 (7 insurance claims paid). One of the directors is operating through similarly named licenced company since 02/09 which has been eligible for insurance since 01/11.
5.	Licence ended 01/06. No ongoing company licences.
6.	Licence ended 08/10. The director and supervisor operated through a 2nd licenced company from 11/10 to 11/13 which was not eligible for insurance.
7.	Licence ended 05/06 (3 insurance claims paid). No ongoing company licences
8.	Licence ended 02/14. (8 insurance claims paid) No ongoing company licences.
9.	Licence ended 02/12. No ongoing company licences.
10.	Licence ended 08/13. The director and supervisor have been operating through a 2nd licenced company since 08/14 that has been eligible for insurance since 07/15.
11.	Licence ended 12/07 (6 insurance claims paid). Directors operated through a 2nd licenced company from 08/07 to 08/13 which had insurance eligibility from 07/09. One director still operating through a 3rd licenced company (with a similar name to the second) from 04/13 which has had insurance eligibility since 10/13.
12.	Licence ended 07/12. No ongoing company licences.
13.	Licence ended 11/09 (3 insurance claims paid). The director and supervisor has been operating through a 2nd licenced company from 05/07 which has been eligible for insurance since 01/09 and a third licenced company (with a similar name to the 2nd licenced company) since 08/09 which has not been eligible for insurance.
14.	Licence ended 02/11 (10 insurance claims paid). No ongoing company licences.
15.	Licence ended 05/08. Director and supervisor operating through 2nd licenced company (with similar name) from 04/08 to 04/15 that did not have insurance eligibility and now through a

	3rd licenced company (with another similar name) from 03/15 which has been eligible for insurance since 10/15.
16.	Licence ended 03/11. The supervisor and one time director has been operating (as supervisor only) through a 2nd licenced company since 03/12 which has had insurance eligibility since 6/12.
17.	Licence ended 08/11 (5 insurance claims paid). A director has been operating through a 2nd licenced company which has not had insurance eligibility since 11/12 and a 3rd licenced company which has not had insurance eligibility since 11/14.
18.	Licence ended 05/07. A supervisor has been operating through a second licenced company since 02/07 which has been eligible for insurance for most of that time and is currently eligible.
19.	Licence ended 02/11 (6 insurance claims paid). No ongoing company licences.
20.	Licence ended 12/05. The director and supervisor operated from 08/11 to 08/15 through a 2nd licenced company that was not eligible for insurance.
21.	Licence ended 05/06. No ongoing company licences.
22.	Licence ended 08/08 (3 insurance claims paid). A director and supervisor operated through a 2nd licenced company that was eligible for insurance from 10/08 to 10/12 and has operated through a 3rd licenced company from 09/11 which was eligible for insurance from 10/11 to 06/15.
23.	Licence ended 01/06. No ongoing company licences.
24.	Licence ended 10/05. Director and supervisor operated through 2nd licenced company (#25 below) from 06/07 to 06/12 (5 insurance claims paid). He had a 3rd licenced company from 08/11 to 08/12 which did not obtain eligibility for insurance.
25.	Licence ended 06/12 (5 insurance claims paid). Director and supervisor operated through a 2nd licenced company from 08/11 to 08/12 which did not obtain eligibility for insurance.
26.	Licence ended 04/07. No ongoing company licences.
27.	Licence ended 04/14. A director and supervisor has been operating through a 2nd licenced company since 03/13 which has been eligible for insurance since 01/14.
28.	Licence ended 06/06. No ongoing company licences.
29.	Licence cancelled 07/15 (notice of resolution to wind up lodged with ASIC in 04/15). Director and supervisor operating through a 2nd licenced company since 02/15 which became eligible for insurance in 02/16.
30.	Administrator appointed 07/12. Licence still on register. No other ongoing company licences.
31.	Licence ended 03/10. The director and supervisor for most of the company's duration has been operating since 11/11 through a 2nd licenced company that has not had insurance eligibility.

32.	Licence ended 09/15. The supervisor has since then been the supervisor for a 2nd licenced company which became eligible for insurance in 10/15.
33.	Licence ended 05/14. Director and supervisor was operating through a 2nd licenced company from 10/14 to 02/16 when that company's licence was cancelled due to the 1st company's external administration.
34.	Licence ended 05/14. Director and supervisor has been operating through a 2nd licenced company which has not had insurance eligibility since 05/14.
35.	Licenced ended 04/06. Nominated supervisor has been operating through his own company since 01/02 which has had insurance eligibility at various times including since 04/11.
36.	Licenced ended 07/14 (9 insurance claims paid). A director and supervisor has been operating through a 2nd licenced company that has not had insurance eligibility since 10/13.
37.	Licence cancelled 11/15. No ongoing company licences.
38.	Licence cancelled 01/16. No ongoing company licences.
39.	Liquidator appointed 10/15 (register lists licence as active). No other ongoing company licences.
40.	Licence ended 05/15. Director and supervisor operated through a 2nd licenced company that was not eligible for insurance from 02/13 to 02/16 and has been operating through a 3rd licenced company since 02/06 which has been eligible for insurance since 09/09.
41.	Licenced ended 04/13. Some of the directors and a supervisor have been operating through a 2nd licenced company with the same name except for one letter since 07/13. The 2nd company has not had insurance eligibility.
42.	Licence was from 03/00 to 03/13. One of the directors also operated a 2nd licenced company with similar name from 02/09 to 02/16 which was eligible for insurance throughout that period.
43.	Licence ended 09/05 (4 insurance claims paid). A director and a supervisor operated through a 2nd licenced company with a very similar name from 06/05 to 06/06. That company did not obtain insurance eligibility. That director also operated through a 3rd licenced company from 1988 to 02/11 which did not have insurance eligibility since 02/2000.