Defect Bonds & Insolvency Issues

The new strata building bond and inspection scheme will now commence on 1 January 2018 (the "**Scheme**").

This means that the Scheme will only apply to construction contracts signed (or where there is no contract and building work commences) from 1 January 2018. NSW Fair Trading will not require developers of new strata schemes to lodge defect bonds before 31 December 2017.

Defect bonds under the Scheme comprise:

- cash, bank guarantees or other security such as insurance bonds;
- to be paid by a third party such as NSW Department of Fair Trading, a bank or other institution;
- to cover the costs of defects to approved building work under a building contract;
- by or on behalf of a builder / developer;
- to an Owners Corporation.

In *Commissioner of Taxation v Kassem and Secatore* [2012] FCAFC 124, the Full Federal Court found that an arrangement where a lender paying moneys advanced to a creditor of the borrower in accordance with the borrower's directions was a payment by a related entity to the Commissioner and was a "transaction" for the purposes of the unfair preference provisions of s588FA of the Corporations Act 2001 (Cth) (**Corporations Act**).

A payment by the NSW Department of Fair Trading, or other third party, to the Owners Corporation under the Scheme may be deemed an "unfair preference" pursuant to the terms of s588FA of Corporations Act should the security provider become insolvent and a creditor successfully argues that the Scheme operates as a third party payment made at the direction of the insolvent debtor. Such an argument may have merit particularly where the security provider can claim back all or residual funds after the final inspection reports or otherwise has standing to seek an injunction to prevent a call on the security bond.

An unfair preference generally occurs when a creditor (in this case the Owners Corporation) receives a payment within 6 months prior to the appointment of a liquidator or administrator to a company providing the bond security.

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If the liquidator of the insolvent security provider is able to demonstrate that the payment by the NSW Department of Fair Trading or other third party to the creditor (being the recipient of works or services) pursuant to the Scheme was:

- an unfair preference pursuant to the Corporations Act; and
- made in the relevant relation-back period as defined in Corporations Act (6 months);

the liquidator may be entitled to relief including an order requiring the Owners Corporation to repay the benefit of the payment made under the Scheme. This would have significant implications for Owners Corporations who are exposed to significant defect claims where the security provider is insolvent, facing winding up proceedings or is under financial stress.

Consequences for Developers, Builders and Building Inspectors

Many development companies are special purposes vehicles for a particular site and are often wound up on conclusion of the development. However, given the significant amounts involved on offering up security for the Scheme it is more likely than not that developers who put up security will be well established companies with significant financial backing.

For smaller developers of new multi-storey strata buildings the capital required to submit to the Scheme represent significant sums of money being tied up for long periods of time from the usual 5% for 3 months to 2% for up to three years. These smaller developers will seek to pass on the Scheme's obligations onto builders and down the chain to contractors.

The commercial ramification of the Scheme will impact differently on the cash flow of developers, builders, contractors, owners corporations, inspectors and certifiers.

Developers will have to consider:

- the cost of paying the bond before sale proceeds are received requiring proper allowances to be made in development budgets.
- the costs in relation to the building inspections and reports under the Scheme before occupation certificates issue.
- risk of losing the bond if there is a call on the bond.
- inability to control the rectification of defects (and the cost) after the final report.
- legal advice and associated costs of aligning downstream contracts with builders with the Scheme, appointing a building inspector to prepare an interim and a final reports.
- effect on cash flow in the event of a fines for failing to comply with the Scheme.

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The **Builder / Contractor** will need to cover for:

- additional security to meet the requirements under the Scheme if contractual negotiations with developer impose such a condition.
- legal costs for advice in negotiating contracts within the Scheme period.
- completion timetables may need to be adjusted to account for the interim and final building inspection reports.
- for additional funds for security and risk insolvency.

Owners corporations are exposed to:

- risks that any money recovered under the Scheme for defects may be clawed back by liquidator as an unfair preference.
- possibility the Scheme will be ineffective in the event of an insolvent security provider.
- inadequate coverage of the Scheme requiring the owner's corporation to pursue the original builder for the balance of funds through current litigation processes.

Inspectors / certifiers are vulnerable to:

- security provider insolvency when their payments are to be made under Scheme.
- increased number of disputes because the Scheme introduces an added inspection process which is open to question.

It is important for developers, builders, contractors and building inspectors to be aware that the imposition of the Scheme will carry commercial consequences beyond the stated requirements.

Should you require advice on how the Scheme may affect we can assist.

Key takeaways

- The new strata building bond and inspection scheme will commence on 1 January 2018.
- Defect bonds can include cash, bank guarantees, or insurance bonds paid to an Owners Corporation.
- Payments made under the scheme may be deemed unfair preferences if the security provider becomes insolvent.
- Developers must consider the financial implications of the bond on their cash flow and project budgets.
- Smaller developers may struggle with the capital required for the scheme, impacting their financial operations.

****The information contained in this article is general information only and not legal advice. The currency, accuracy and completeness of this article (and its contents) should be checked by obtaining independent legal advice before you take any action or otherwise rely upon its contents in any way.*

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Prepared by Bannermans Lawyers
21 September 2017

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