Property Law: The case for title insurance as a risk management tool – Illegal buildings and prescribed warranties following *Carpenter v McGrath*

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Property Law: The case for title insurance as a risk management tool – Illegal buildings and prescribed warranties following *Carpenter v McGrath*

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Title insurance has so far had a generally bad press in the features and letters of this Journal. It is strongly opposed by some who see it as corroding our professionalism. Others see it as a useful protection. Here PAUL WATKINS, a solicitor with one of the main title insurers, puts the legal argument behind his case.

Prior to the decision of the NSW Court of Appeal in *Carpenter v McGrath*, the potential power of a local council to order the demolition of an illegal structure on a property the subject of a contract for sale constituted a latent defect in the vendor's title.

On this basis, if all or part of the structure was illegally built and not disclosed in the contract, a purchaser could either rescind the contract or require the vendor to cure the defect prior to completion.[1] This of course offered a purchaser some measure of protection against risks which would otherwise only be discoverable by investigating the legality of the improvements prior to exchange of contracts.

By concluding that an illegal structure which could attract the council's power of demolition was no longer a defect in title, the Court of Appeal in *Carpenter* effectively removed this protection and reinforced the doctrine of caveat emptor in conveyancing transactions.

As a direct result of the decision in *Carpenter v McGrath*, the NSW government enacted regulation 1(d) of Schedule 3, Part 1 of the Conveyancing (Sale of Land) Regulation 1995 (the prescribed warranty), which was intended to restore protection to purchasers.[2] However, it is arguable that the statutory emphasis on the building certificate as the only means of testing the prescribed warranty may seriously undermine its effectiveness and leave the purchaser exposed to the risks associated with illegal buildings, including the imposition of risks on the purchaser as a result of the building certificate process itself.

The introduction of title insurance into the Australian marketplace should be regarded by practitioners as a means of assisting purchasers in effectively managing some of these risks.

Defect in title? – The decision in Carpenter v McGrath

The McGraths were the registered proprietors of land at Mangrove Mountain in New South Wales. The land was sold to the Carpenters in 1989. The property was described in the contract for sale as "a house, stables, sheds and land". However, the shed was never approved by the local council and this fact was not disclosed in the contract.

The Carpenters failed to complete the contract, and the McGraths terminated for breach and successfully sought damages in the District Court. The Carpenters appealed to the NSW Court of Appeal on the grounds that the McGraths were not entitled to terminate, as the illegally constructed shed constituted a latent defect in title.

In holding that the mere possibility that the land may be subject to some order pursuant to local government or some other statute was not a sufficient ground to hold that there was a defect in title, the Court of Appeal

rejected and overruled the existing New South Wales judicial approach.[3]

In practical terms, as purchasers were no longer held to have any common law right to raise objections or requisitions to the vendor's title in respect of any undisclosed illegality or non-compliance, purchasers were faced with the unenviable prospect of having to demolish illegal or non-complying buildings or rectify them at their own cost without any recourse to the vendor.

The legislative response: from caveat emptor to caveat vendor

In order to restore some measure of protection to purchasers faced with the prospect of rectifying illegal buildings, the Conveyancing (Sale of Land) Regulation 1995 was amended by the enactment of The Conveyancing (Sale of Land) Amendment (Vendor Warranty) Regulation 1998, which introduced additional prescribed warranty 1(d) into Schedule 3, Part 1:

"(d) there is no matter in relation to any building or structure on the land (being a building or structure that is included in the sale of the land) that would justify the making of any upgrading or demolition order or, if there is such a matter, a building certificate has issued in relation to the building or structure since the matter arose."

Part 5, Regulation 19 of the Conveyancing (Sale of Land) Regulation 1995 was also amended to provide that a purchaser may not rescind a contract on the basis of a breach of the new warranty if a building certificate has issued since the date of the contract in relation to the building to which the warranty related. +

These amendments have been carried forward to the Conveyancing (Sale of Land) Regulation 2000 which repealed and replaced Conveyancing (Sale of Land) Regulation 1995, effective from 1 September 2000.

Emphasis on the building certificate

The language of the legislation places a clear emphasis on the building certificate as the only means of verifying whether the vendor has breached the prescribed warranty.

If a building certificate is issued, the vendor is deemed to have complied with the warranty, and conversely, if a building certificate does not issue because of the prospect of an upgrading or demolition order, the vendor will be in breach of the prescribed warranty and a purchaser will have a right of rescission. In this respect, the building certificate can be seen as a virtual 'cure all'.

While it was initially contemplated that this shift towards caveat vendor would encourage vendors to either attach building certificates to contracts in order to demonstrate compliance with their prescribed warranty or make the contract conditional upon the issue of a building certificate prior to completion,[4] in practice, this has not necessarily been the case.

In reality, many contracts leave the problem of the existence of illegal buildings to the purchaser.

Practical problems with 'testing' the vendor's warranty

Risk to purchaser of complying with 'work orders'

One of the problems associated with applying for a building certificate following exchange of contracts lies with clause 11 of the 2000 edition contract for sale, which provides that "normally, the vendor must by completion comply with a work order made on or before the contract date and if this contract is completed the purchaser must comply with any other work order."[5] A work order is defined in clause 1 of the contract to mean "a valid direction, notice or order that requires work to be done or money to be spent on or in relation to the property or any adjoining footpath or road".

As the right to rescind only applies to "upgrading or demolition" orders, clause 11 renders the purchaser liable for the costs of complying with any other order issued by the council arising from the building certificate application inspection.

Under s.124 of the *Local Government Act 1993*, a council can issue 24 different orders, including orders to repair or make structural alterations to a property. Under s.121B of the *Environmental Planning and Assessment Act 1979*, a council can issue 17 specified orders, including orders to repair or make structural alterations to or cease the use of a building.[6]

As practitioners will be aware, local councils are more likely to issue a work order than an upgrading or demolition order. Consequently, under clause 11 of the 2000 edition contract, a purchaser who wishes to "test" the vendor's prescribed warranty will be exposed to the risk of having to comply with a work order that

may not give that purchaser a right of rescission.

Clause 13 of the standard 1996 edition of the contract offered some protection for purchasers in these circumstances, but clause 13 was deleted following the decision in *Carpenter v McGrath*, and does not appear in the 2000 edition contract.

This predicament will often deter a purchaser from applying for a building certificate following an exchange of contracts, particularly where the purchaser intends to carry out renovation works in the future, and is not inclined to outlay additional rectification costs prior to completion. Of course, after settlement, if any subsequent application for a building certificate gives rise to an upgrading or demolition order, the owner will have no remedy whatsoever and may face penalties for non compliance.[7]

The rising costs of building certificate applications

In addition to the contractual risk taken on by purchasers when applying for a building certificate, another major problem facing purchasers is the lack of any legislative connection between the vendor warranty regulations and the statutory rules that govern building certificates. The Conveyancing (Sale of Land) Regulation 2000 does not inform the *Environmental Planning & Assessment Act 1979* or the *Local Government Act 1993* and vice versa.

Local councils are therefore free to adopt their own policies, fees and requirements for the issuing of building certificates[8] without regard to the practical difficulties that these requirements are likely to have on purchasers in a conveyancing transaction.

There are at least three practical difficulties faced by purchasers resulting from local council requirements for the processing of building certificate applications:

Firstly, local councils generally require that a current or “up to date” survey report accompany a building certificate application. If the vendor does not provide a survey report or attach one to the contract, then the purchaser must bear the cost of obtaining the survey report in order to apply for the building certificate. An average survey report costs approximately $400 to $600.

Secondly, the prescribed fee for a building certificate application has just risen to $210. This figure will inevitably rise again in the future. Where a purchaser is also required to pay for a survey report, the purchaser may be required to pay a total cost of approximately $600 to $800. In some cases, this may well exceed the professional fee charged by the purchaser’s solicitor or licensed conveyancer.

Thirdly, and most importantly, the local council may adopt policies that require additional documentation to accompany a building certificate application, the cost of which must be borne by the purchaser.

One example is Pittwater Council’s geotechnical risk management policy which requires that a geotechnical risk engineers report must accompany a building certificate application for land identified on Pittwater Council’s geotechnical risk management map. The cost of obtaining such a report can be as much as $3,000,[9] and the report can take two to three weeks to prepare, depending on the demand.[10] It is fair to say that most purchasers will not have the funds to pay for a report, and in many cases the report may not become available in sufficient time to meet settlement deadlines.

Many purchasers in the Pittwater area are therefore denied the opportunity to even apply for a building certificate.

Nonetheless, unless a building certificate is issued in respect of a building the subject of a contract for sale, the purchaser will be exposed to the risk that the building has not been built in accordance with council approval, and subsequent investigation by council may require the purchaser to demolish or rectify the building at their own cost without any recourse to the vendor.

An alternative approach

For many purchasers the risk of having to comply with a work order, and the additional costs of obtaining survey and other reports may prove to be a significant disincentive to apply for a building certificate. Many purchasers may also be reluctant to bring the property to the attention of the council prior to completion where future renovation works are planned.

In these circumstances the vendor warranty legislation will be of no practical benefit.

Stewart Title Australia (Stewart Title) and First American Title Insurance Company of Australia Pty Ltd (First Title) have both recently introduced comprehensive residential title insurance policies into the Australian property market.[11]. These are currently the only title insurance companies operating in Australia. Both

policies insure the owner of residential property against certain risks that are inherent in residential real estate transactions. These risks include defects that may not be discoverable by a search of the title, such as illegal buildings, encroachments, zoning non-compliance, unregistered rights of way and easements, and other transactional risks such as post-settlement dealing registrations by a third party, and fraud and forgery.

Both policies have been designed to transfer risk from the purchaser to the title insurer.

Title insurance coverage for illegal buildings

In the context of illegal building works, both the Stewart Title and First Title policies provide coverage to the insured in circumstances where the insured is ordered to demolish or rectify all or part of an existing structure due to non-compliance with relevant building/or development approvals. Clause 2.1 (q)(c) of the Stewart policy provides cover where the insured purchaser is "prevented by a public authority from using the land as a residence or is forced to rectify or remove all or part of the existing structure(s) on the land (other than boundary walls or fences) because: (a) it contravenes an existing zoning law; (b) of any outstanding notice of violation or deficiency notice;(c)any portion of the existing structure(s) was built or modified without building or development approvals required by law".

Clause 4.6 of the First Title policy provides cover for "any loss or damage to the insured, other than relating to a boundary wall or fence, because under the provisions of either section 149D of the Environmental Planning & Assessment Act 1979 or the Local Government 1993: the insured is ordered to demolish, alter, add to or rebuild any building, or part thereof, on the land (4.6.1); proceedings are commenced against the insured for an order or injunction requiring any building, or part thereof, on the land to be demolished, altered, added or rebuilt (4.6.2)", and these matters "existed at the policy date because the insured did not have a building certificate, as defined in the legislation referred to in this clause and this would have been disclosed if an appropriate inquiry had been made (4.6.4)".

Accordingly, under the terms of both policies, a purchaser will be indemnified against certain loss in circumstances where a property has been purchased without a building certificate, and following settlement an order is subsequently issued by a consent authority because the building has not been built in accordance with council approval.

Extent of cover for illegal buildings

Both the Stewart Title and First Title policies provide an indemnity in respect of "actual loss" suffered by the insured, that is, the actual cost to remedy the order and any subsequent diminution in value of the property (if any).[12] The Stewart Title policy provides coverage up to the amount of the purchase price of the property which is the policy amount. The policy amount will automatically increase in line with the market value of the land up to a maximum of 200 per cent of the policy amount.[13] There is no excess payable under the Stewart Title policy.

The First Title policy provides coverage to a maximum amount of $50,000 for risks relating to illegal buildings and the insured is liable to pay an excess of $2,500.[14]

Infestation and dilapidation orders excluded

Both the Stewart Title and First Title policies exclude certain matters from cover. Clause 3 .1 of the Stewart Title policy provides that where illegal or non-complying building works are "disclosed in the contract for sale" or are otherwise "known to the insured",[15] they will be excluded from coverage, and the purchaser will not have the benefit of obtaining the indemnity.

Clause 5.4 of the First Title policy similarly excludes risks "that are actually known to you, but not to us, on the policy date – unless they appeared in the public records".

The First Title policy also specifically excludes loss attributable to "workmanship, infestation and dilapidation". Given the wording of clause 2.1(q) of the Stewart Title Policy, Stewart Title will also not provide any coverage for the costs of complying with an order that is issued solely due to the dilapidation or infestation of the building.[16] The order, whether it be to demolish or repair a building, must relate to the absence of or non-compliance with, relevant building and/or development approvals by the relevant consent authority.

Accordingly, as both the Stewart Title policy and the First Title policy will not provide any cover in respect of a structure that has been built in accordance with council approval, but has been built negligently or has subsequently fallen into disrepair or has become infested, then practitioners are advised to continue to recommend that purchasers obtain a pest and building report prior to exchange of contracts.

Title insurance as a risk management tool

In circumstances where a vendor fails to attach a current building certificate to a contract and declines to make the contract conditional upon the issue of a building certificate prior to completion, practitioners should give serious consideration to advising their clients to take out residential title insurance.

A purchaser who takes out title insurance, rather than apply for a building certificate following exchange of contracts, will avoid the risk of having to comply with a possible work order prior to completion, and will also avoid the costs of obtaining a survey report or any other report required by council. While neither the Stewart Title policy or the First Title policy will indemnify the purchaser against a work order that is issued due to the dilapidation of the building, the purchaser will be able to bring the building to the attention of the council at a time of their own choosing, rather than prior to completion.

Following settlement, the title insurer, rather than the purchaser, will assume the risk of the existence of any unknown illegal building works, and will accordingly indemnify the purchaser against actual loss caused by a subsequent demolition or upgrading order following any post settlement application for a building certificate by the purchaser.

This indemnity should be contrasted with the only remedy available to a purchaser under the vendor warranty legislation for a breach of the vendor's vendor, which is a right of rescission.[17] While a right of rescission will free the purchaser from any contractual obligations to complete the transaction, this right comes at the cost of losing the property. By taking out residential title insurance rather than applying for a building certificate, the purchaser will exchange the statutory right of rescission with a contractual right to indemnity against the costs of remedying the vendor's 'breach' and will of course be able to keep the property at the same time.

A comprehensive residential title insurance policy therefore obviates the need to 'test' the vendor's warranty without the associated risk of having to cover the costs of complying with any subsequent upgrading or rectification order.

Conclusion

Despite the introduction of vendor disclosure and vendor warranty legislation in New South Wales, the existence of illegal structures remains an area of significant practical concern to purchasers and their solicitors following the decision in *Carpenter v McGrath*. While the introduction of the prescribed warranty legislation represented an important turning point in the legislative shift from caveat emptor to caveat vendor, clearly the statutory emphasis on the building certificate as the only means of testing the vendor's prescribed warranty has seriously undermined its effectiveness.

Ideally, every contract should contain a current survey report and current building certificate or be conditional upon the provision of a survey report and building certificate prior to completion. However, in practice, this is not always the case. Most practitioners will be aware that vendors are typically reluctant to enter into conditional contracts of any kind, particularly where the parties are negotiating prior to an auction. There is also generally insufficient time to arrange for a survey report and a building certificate prior to exchange of contracts. Purchasers are also typically reluctant to pay for the survey report and the building certificate only to be 'gazumped' by another purchaser.

For practitioners, the question of whether to advise a purchaser to apply for a building certificate following exchange of contracts is becoming more problematic. In many cases the decision will depend on the nature of the property being purchased and the extent of the purchaser's knowledge of the property. Residential title insurance is simply one option now available to purchasers in circumstances where the purchaser either elects not to apply for a building certificate prior to completion or is unable to do so.

As purchasers continue to be exposed to the risks associated with illegal buildings in conveyancing transactions, practitioners should be familiar with residential title insurance policies offered by private title insurers to comprehensively meet the needs of their clients intending to become property owners.

Endnotes

1. Pursuant to the former *Schedule 2 (c) of the Conveyancing (Sale of Land) Regulation* 1995 and former Clause 13 of the 1996 Edition standard form of Contract for Sale.
2. LPI_NSW Information Bulletin No 72 (edition 2) December 1998.
3. See for example *Maxwell v Pinheiro* (1979) 46 LGRA 310 and *Borthwick v Wals h* (1980) 41 LGRA 144 quoted in Skapinker, D*: Purchasers bear the risk of illegal buildings: Carpenter v McGrath* (1996) 34 (11) LSJ 50.
4. The term 'upgrading or demolition' order is defined in Part 3 of Schedule 3 of the 2000 Regulation
5. Khan, Izaz: *Illegal Structures after Carpenter v McGrath*: Law Society Journal (NSW, Australia) September

1999, page 53 (1999) 37 (8) LSJ 53.
6. emphasis added.
7. Peedom, J. – *Local Council Orders: A caveat for council and conveyancers,* Law Society Journal (NSW, Australia), August 2000, page 37. Cite as (2000) 38 (7) LSJ 37.
8. See for example s. 678 of *the Local Government Act* 1993 and s. 121ZJ of the *Environmental Planning & Assessment Act* 1979.
9. Within the confines of the *EPAA* and *Local Government Acts*.
10. For new buildings – existing buildings are approximately $1,500 plus GST.
11. Enquiries with Hodgson Jack Consultants October 2004.
12. Stewart Title's "Residential Purchaser's Policy' and First Title's 'Home Owners Gold (NSW) Insurance Policy'.
13. Actual loss is referred to in clause 1. 1 of the Stewart Title Policy under the heading "Your Coverage" and is referred to in clause 3 of the First Title Policy under the heading "Coverage Statement".
14. Clause 1. 4 of the Stewart Title Policy provides under the heading "Your Coverage" that "market conditions and inflation may increase the value of your land. The amount of your insurance cover automatically increases in line with increases in the fair market value of your land after the policy date, up to a maximum of 200 per cent of the policy amount shown in Schedule A of the policy. This added coverage is provided without additional premium.
15. The First Title policy provides at the end of clause 4. 6 that "The insured is liable to pay the first $2,500. 00 of any loss suffered and First Title's liability is limited to a maximum of $50,000. 00 under this paragraph 4. 6".
16. Knowledge means actual knowledge rather than mere suspicion. .
17. Such as Order 2 (b) &(c) and Order 4 (a) & (b) of the Table in s 121B of the *Environmental Planning & Assessment Act* 1979.
18. Pursuant to Regulation 19 of *the Conveyancing (Sale of Land) Regulation 2000.*