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Précis Paper

Understanding Deeds of Indemnity

Discussion of the recent decision *AAI Ltd t/as Vero Insurance v Kalnin Corporation Pty Ltd* [2017] NSWSC 548

Discussion Includes

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- Key issues of the case as between the developer and the insurer
- Meaning of the word 'policy' in a deed of indemnity
- General principles relating to the reading of deeds of indemnity
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- Practical advice for insurers, developers, builders and practitioners alike when making or contesting a claim for indemnity under a deed of indemnity

Précis Paper

Understanding Deeds of Indemnity

1. In this edition of BenchTV, Michael Elliott (Barrister, Eight Selborne Chambers, Sydney) and Michael Callanan (Director, Rankin Ellison Lawyers, Sydney) discuss the recent case of *AAI Ltd t/as Vero Insurance v Kalnin Corporation Pty Ltd* [2017] NSWSC 548 in which they were both involved, and the practical considerations that apply when making a claim for indemnity under a deed of indemnity.

Key facts

2. The case is about a claim for indemnity by an insurer under a deed of indemnity.

3. A property development was the subject of a policy of insurance written by the insurer. As part of the process of issuing that policy, the insurer obtained a deed of indemnity from the developer in question.

4. In the period between 2002 and 2004, an individual developer carried out a residential development of land in inner Sydney. The developer was not an experienced property developer; he gave evidence that he had not heard of the *Home Building Act 1989* (NSW), or the warranty and insurance regime that operated under it.

5. Prior to the development proceeding, the developer discussed with a prospective builder the possibility of engaging the builder's services to carry out the development works he planned. In anticipation of being awarded the contract, the builder approached an insurer, himself being aware of the *Home Building Act*, and knowing that it was compulsory for him to obtain insurance that would cover the project in question.

6. The policy that was required to be obtained at the time was one that provided cover in particular for subsequent owners. For this residential project, there would be a strata title, and the subsequent owner of the common property would be the Owners Corporation.

7. The builder submitted an application for insurance with the insurer Vero. As part of that process, Vero communicated to the builder that they required of him a deed of indemnity signed by the developer. The deed of indemnity was in this case obtained, signed, and given by the developer before the insurer had completed the eligibility process. It was signed by the developer without any real explanation as to what it was, or contained, and returned to the insurer six months before any policy was issued.

8. The developer decided to formally engage the builder's services, and the builder subsequently signed a building contract with the developer, before later being issued with a policy of insurance by Vero. The building works then proceeded over a period of about two years, without any major complication.

9. After the works were finished, the strata plan was registered, and the occupation certificate was issued. Upon registration of the strata plan, the Owners Corporation became a subsequent owner for the purposes of the *Home Building Act*. The individual lots were sold off to various proprietors who then occupied the lots for a number of years, and by 2006, they had all been sold by the developer. A period of radio silence followed between the Owners Corporation, the individual owners, the insurer, and the developer for a number of years.

10. Then, in 2008, the developer was informed that the Owners Corporation had recently submitted a claim for indemnity under the policy of insurance on Vero. Vero informed the developer that the claim had been made, and that they would be investigating it. The developer then contacted the builder, gave him a list of the alleged defects, and asked him for advice.

11. The builder said (as it turned out, correctly) that all of the alleged defects were of a non-structural nature, and that upon his understanding of the law, the claim would be time-barred, because non-structural claims have to be brought within two years of completion of the works. The developer relayed that information to the insurer, and his view that the claim was out of time such that the insurer did not have any liability to pay out the claims.

12. Under the regime as it existed at the time, there were various limitation periods, each running from the date of completion of the works. The length of the limitation period depended on the nature of the defect in question – for example, the limitation periods for structural defects and non-structural defects were different (the non-structural defect limitation period was two years).

13. Another three years of silence ensued. In 2011, the developer was notified by the insurer that it:

- was proceeding to settle the claim that had been made by the Owners Corporation
- would be paying a sum of $1.6 million
- relied upon its rights under the deed of indemnity against the developer
- had referred the matter to its recovery department

This came as a shock to the developer after three years of silence.

14. The developer received a statement from the insurer confirming that it had made its determination, and that the matter was effectively finalised.

15. The matter turned to legal dispute very quickly, with the insurer maintaining its position that it was entitled to and had settled with the Owners Corporation. Not only did the insurer pay the $1.6 million, it went on to spend in excess of $4 million without having ever notified the developer that it had done so until after the proceedings had commenced.

16. Although the insurer had communicated to the Owners Corporation its acceptance of the claim, and had sent a deed of settlement with the terms it proposed, the deed itself was not signed until months later – the developer was unaware of all of this.

Key issues

17. Multiple key issues arose during the legal proceedings as between the developer and the insurer – they related to:
    - the meaning of the word 'policy' in the deed of indemnity
    - whether the sums paid out to the Owners Corporation were sums paid in respect of structural or non-structural defects within the meaning of those terms under the *Home Building Act*
    - whether the condition precedent to the entitlement of the insurer to be indemnified had been satisfied (the condition precedent in question was a notification provision in the deed of indemnity)
    - whether the notification provision constituted a condition precedent, and if so, whether the condition precedent had been satisfied
    - whether the insurer had to establish that the alleged defects in fact existed, and that they had been caused by a builder's breach of statutory warranty, in order to make out its right to indemnity
    - whether the insurer, in considering the Owners Corporation's claim, took into account at all the question of structural or non-structural defects (which the developer had raised all those years ago) and if it had not in fact taken that relevant consideration into account, whether the insurer was entitled to seek indemnity from the developer

Meaning of the word 'policy' in the deed of indemnity

18. The deed of indemnity referred to a policy of a particular kind being issued. In this case the deed of indemnity referred to a developer policy, but the policy that was ultimately issued was not indeed a developer policy. The developer claimed that there was a mismatch between the kind of policy in respect of which it was granting indemnity to the insurer, and the kind of policy that the insurer in fact issued. At the heart of the issue, therefore, was

whether or not the substance of what was being indemnified could in fact be the subject of that indemnity.

19. That was a narrow question that turned on the proper construction of the deed of indemnity and the developer relying upon the familiar principles relating to the reading of deeds of indemnity strictly in favour of the party giving the indemnity.

Meaning of structural defect in accordance with the Home Building Act

20. The deed of indemnity provided for the developer granting the insurer indemnity in respect of claims that were properly and reasonably incurred by the developer.

21. The developer claimed two things in relation to this issue:
    - firstly, that in circumstances whereby the alleged defects were non-structural, and the limitation period had expired, the insurer did not properly and reasonably incur the costs in paying out the claim because it was in fact entitled to decline the claim
    - secondly, that the Owners Corporation had not in fact made a claim under the policy, and therefore the deed of indemnity was not satisfied

22. This raised the question of *what is meant by a structural and a non-structural defect* (in the context of the Home Building Act insurance regime) - a question which has up until now received surprisingly little judicial consideration.

23. The Home Building Act Regulations contain definitions of those terms, and those terms are incorporated by reference into the policy.

24. The difficulties arose largely over the definition of structural defect and structural element going beyond what one would conventionally regard as such in 'engineer-speak'. His Honour in this case found the term 'structural defect' to mean a *defect in a structural element.* He found that:
    - firstly, there had to be a structural element
    - secondly, the defect had to have one of a number of effects on the building

25. Structural element was also defined in the Regulations - it had two alternative limbs:
    - the first limb embraced the conventional meaning of structural element - that is, an internal or external light-bearing component of the building
    - the second limb permitted to be included within the concept of structural element any component, including weather-proofing, that forms part of the external walls or roof of the building

26. The insurer sought to use the second limb to its advantage. It argued that the defects concerned elements of the building that could be categorised as forming part of either the external walls or roof. For example, it sought to classify paint that had been applied to the external face of the brickwork as forming part of the external wall, and therefore also part of a structural element. The insurer described its approach as the 'single monolith argument' - that is, once something is applied to the surface of a structure, it necessarily becomes part of that structure.

27. On a literal reading of the section, that argument may well have been available. The difficulty faced by the developer was persuading the Court that a literal reading ought not be embraced, but instead one that referred to the purpose and overall context of the notion of structural element should be embraced. The developer focussed on the words 'that forms part of the wall', and sought to persuade the Court (in the end, successfully) that those words must have some sensible limitation i.e. that they don't necessarily involve every single element that might be attached or applied to a wall.

28. Rather than adopting the most literal reading of the clause, the judge preferred the developer's construction under which there had to be some sort of sensible limitation imposed.

Existence of a condition precedent

29. The judgment also discussed the existence of the condition precedent in the deed of indemnity, and the provision that required the insurer to give notice to the developer of a proposed settlement of a claim under the policy before proceeding to implement any such claim.

30. There was a threshold question as to whether the provision amounted to a condition precedent, so that if the condition was not satisfied, the entitlement to indemnity did not arise at all. The relevant notification provision was not expressed to be a condition precedent - indeed it did not even appear in the central clause that governed the right of indemnity.

31. The insurer argued that the Court should consider the terms of settlement document to be signed (which was not in fact signed for quite some time) as notice of a proposed settlement.

32. The developer argued that the question of whether or not it could be labelled condition precedent was immaterial, and that it was necessary to instead look at the substance of the clause, having regard to the language of the parties, in working out whether it was a necessary condition to be satisfied before a claim could be made for indemnity.

33. The developer was able to successfully argue that the notification provision was not only a condition precedent, but also served a particular purpose. The judge found that the purpose of the clause was to afford the developer an opportunity to respond to the *proposed* settlement to which the clause referred. The developer claimed that all of those opportunities were lost to it because it was not given notification of the proposed settlement.

34. The finding that the condition precedent had not be satisfied was fatal the insurer's case because it rendered the insurer's claim under the indemnity failed in its entirety, regardless of any other issue in the case.

35. This case is a classic example of the seemingly straightforward matters mentioned above not being followed, with dramatic consequences. The lesson to be learnt for practitioners is to pay extreme attention when acting for a party seeking indemnity under a deed of indemnity to ensure that all the conditions and requirements are satisfied.

Question as to existence of alleged defects, and whether they were a result of breaches by the builder

36. This issue turned on:
    - whether the insurer needs to prove that the defects in question had actually been occasioned
    - whether those defects were a result of a failure by the builder to comply with the statutory warranties under the *Home Building Act*

37. The insurer claimed it did not need to prove those matters. Unfortunately for the insurer, the terms of the deed were quite clear – they provided that indemnity was only available in respect of costs that were incurred as a result of the builder's acts or omissions.

38. The Court accepted the developer's argument in this case, finding that the insurer had to prove in fact breaches of statutory warranties by the builder causing the defects.

39. The insurer in this case had not sought to lead evidence to prove this. Instead, it sought to tender a report in which an expert had at the time confirmed the defects to be a result of a breach by the builder. None of the evidence presented by the insurer to the Court constituted admissible expert evidence for the purposes of the claim against the developer. The Court found that the report was not sufficient to prove the underlying cause of the defects. Again, the insurer's claim failed in its entirety, this time on the basis of lack of evidence.

40. So another lesson to be learnt by practitioners and insurers alike when seeking to recover indemnity in a cause of this kind is the importance of proving all of the integers necessary (including that the builder had in fact breached the contract).

41. It is also important to remember, when acting for an insurer who is considering a claim in circumstances where it has a deed of indemnity handy, to obtain a report that will be valuable not only for responding to a claim under the insurance policy, but also for when the deed of indemnity is presented in due course.

42. This case demonstrates how critical it is for an insurer to ensure at the time indemnity is sought and obtained that there is an appropriate correspondence between the subject matter of the indemnity and the type of policy issued.

Insurer's failure to consider whether the defects were structural or non-structural

43. Another question faced by the Court was whether, if the insurer had failed to consider whether the defects were structural or non-structural, it could still be said that the insurer had acted properly and reasonably (as the indemnity required it to do).

44. The judge concluded that it would not be a proper construction of the indemnity if the insurer was denied the benefit of the indemnity simply because it had failed to make that consideration.

Court's analysis of the cross-claim brought by the developer

45. The cross-claim was the developer's fallback option should it not be successful in its other arguments.

46. In conducting the eligibility process, the insurer determined that the builder was undercapitalised and that the builder would need a further $800,00 of capital. The builder subsequently lodged a form stating that it had recapitalised. However, that $800,000 was never actually paid into the builder's bank account. The developer had not been informed of any of this.

47. The factual difficulty that arose for the developer was that the building contract had already been signed prior to the issuing of the policy of insurance.

48. The judge concluded that it would be most unlikely that the developer, having signed the building contract, would deny itself the benefit of the home warranty insurance. Further, he

could not conclude that the insurer had a duty to disclose the financial position of the builder – and so the cross-claim failed.

49. But, as it turned out, the developer did not need to rely on the success of this cross-claim because it succeeded in its main claim.

BIOGRAPHY

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Michael has been practising at the commercial bar for over 15 years, specialising in appearance and advice work in major insurance, professional indemnity, contractual, construction and trade practices disputes. The majority of his practice involves trial advocacy in the Supreme and Federal Courts, and opinion work in relation to matters in that jurisdiction. He is widely recognised as one of the leaders in his field. He continues the long tradition of excellence of the 8th Floor Selborne Chambers, a leading commercial set in Sydney, whose current and former members include a range of former High Court and Supreme Court judges.

Michael Callanan

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Michael is the director of Rankin Ellison Lawyers and brings a broad commercial focus and cross-industry experience to the firm. He has practiced in a career spanning 30 years primarily in the area of corporate and commercial litigation, and property, employment and industrial law. He was admitted into practice in 1982, and has been in private practice as a partner at the firms M F Callanan & Co, Tillyard & Callanan, Ellison Tillyard Callanan, and now as Director at Rankin Ellison.

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