How insurance markets operate and the development of the law of torts

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by

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The orthodoxy: in actions for tort, the courts have no business inquiring into whether the parties are, or could have been, insured and therefore no justification for allowing judicial knowledge (or beliefs) as to insurance arrangements to affect decisions as to liability

This rests on two propositions:

- whether the parties to a particular dispute are insured and, if so, the terms of that insurance are irrelevant to both liability and quantum; and,

- the availability or unavailability of insurance in respect of losses of the kind in issue are also irrelevant.

The early defective building case in which duties of care were imposed on territorial authorities

These were

- *Dutton v Bognor Regis Urban District Council*;
- *Anns v Merton London Borough Council*: and
- in New Zealand, *Mt Albert Borough Council v Johnson.*

They rested on the view that manifestations of defective construction (for instance, subsidence due to faulty foundations) were property damage for the purpose of the principles established in *Donoghue v Stevenson*.

A possible down-side

Takaro Properties Ltd v Rowling:

> … the imposition of liability may even lead to harmful consequences. In other words, the cure may be worse than the disease. There are reasons for believing that this may be so in cases where liability is imposed upon local authorities …; because there is a danger that the building inspectors of some local authorities may react to that decision by simply increasing, unnecessarily, the requisite depth of foundations, thereby imposing a very substantial and unnecessary financial burden upon members of the community.

Lord Oliver, extrajudicially:

The "principal beneficiary" of *Dutton* has been "the ready-mixed concrete industry".

Another view – *Home Office v Dorset Yacht Club*

Lord Reid's response to a suggestion, based on a New York case, that if borstal staff were liable for the criminal activities of escaping inmates they would act defensively, to the detriment of the way they managed inmates (and thus to the inmates themselves), possibly by placing heavy restrictions on the activities of inmates to minimise risks of escape:

> It may be that public servants of the State of New York are so apprehensive, easily dissuaded from doing their duty, and intent on preserving public funds from costly claims, that they could be influenced in this way. But my experience leads me to believe that Her Majesty's servants are made of sterner stuff.

But perhaps property insurance would have provided a more efficient loss-spreading mechanism without the risk of distorting borstal management decision-making.

The defective building cases involved law and policy, including:

- The scope of the *Donoghue v Stevenson* duty. This was a quintessentially legal issue.

- Whether imposing duties of care on public officials carrying out statutory functions may distort their exercise of those functions. A policy issue likely to be addressed by courts on a broad-brush basis without empirical evidence (cf *Jones v Kaney*).

- Whether insurance would provide a more effective loss-spreading mechanism than tort liability. In assessing this argument, insurability is relevant and reasonably easy to ascertain – it is what in the paper is referred to as a "legislative fact".

What the paper is about

Not re-litigation of how debate over liability for defective buildings was resolved.

Instead, my focus is on

- how that debate was influenced by assumptions (sometimes, but not always, right) about how insurance markets work;

- How things might be done better in the future

The trajectory of the law

The paper discusses this under the following headings

- The retreat from *Dutton* and *Anns* in the United Kingdom
- The Building Act 1991
- *Invercargill City Council v Hamlin*
- Leaky buildings, *Sunset Terraces* and *Spencer on Byron*

How did insurance understandings feature in all of this?

I look at this by reference to

- *Dutton*;
- *Bowen v Paramount Builders (Hamilton) Ltd* and *Mt Albert Borough Council v Johnson*:
- The Building Industry Commission Report;
- Professor Smillie's article "Compensation for latent building defects";
- The 1991 Act; and
- *Hamlin.*

Dutton – Lord Denning

First, Mrs Dutton has suffered a grievous loss. The house fell down without any fault of hers. She is in no position herself to bear the loss. Who ought in justice to bear it? I should think those who were responsible. Who are they? In the first place, the builder was responsible. It was he who laid the foundations so badly that the house fell down. In the second place, the council's inspector was responsible. It was his job to examine the foundations to see if they would take the load of the house. He failed to do it properly. In the third place, the council should answer for his failure. They were entrusted by Parliament with the task of seeing that houses were properly built. They received public funds for the purpose. The very object was to protect purchasers and occupiers of houses. Yet, they failed to protect them. Their shoulders are broad enough to bear the loss.

..

Then, I ask: if liability were imposed on the council, would it have an adverse effect on the work? *… Would it mean that they would be extra cautious, and hold up work unnecessarily? Such considerations have influenced cases in the past (as in Rondel v Worsley). But here I see no danger. If liability is imposed on the council, it would tend, I think, to make them do their work better, rather than worse.*

Dutton – Lord Denning, continued

Next, I ask: is there any economic reason why liability should not be imposed on the council? In some cases the law has drawn the line to prevent recovery of damages. It sets a limit to damages for economic loss, or for shock, or theft by escaping convicts. The reason is that, if no limit were set, there would be no end to the money payable. But I see no such reason here for limiting damages. In nearly every case the builder will be primarily liable. *He will be insured and his insurance company will pay the damages. It will be very rarely that the council will be sued or found liable. If it is, much the greater responsibility will fall on the builder and little on the council.*

Finally, I ask myself: if we permit this new action, are we opening the door too much? Will it lead to a flood of cases which the council will not be able to handle, nor the courts? Such considerations have sometimes in the past led the courts to reject novel claims. But I see no need to reject this claim on this ground. *The injured person will always have his claim against the builder. He will rarely allege—and still less be able to prove—a case against the council.*

Was Lord Denning right?

Not as to floodgates; nor as to:

> The injured person will always have his claim against the builder. He will rarely allege—and still less be able to prove—a case against the council.

As to insurance:

I'm not sure as to whether builders were always insured.

But:

- by 1971, when the case was decided, virtually all new houses were covered by the Buildmark warranty discussed in the paper; and

- by 1990, virtually litigation based on *Dutton* was between first and third party insurers

Bowen v Paramount Builders (Hamilton) Ltd and *Mt Albert Borough Council v Johnson*

Woodhouse J in *Bowen*

Nor am I impressed in this general context by what has been described as the floodgates argument. It is an argument that has been heard before but the recognition of a duty of care in the face of it has not seemed to require any great readjustment. In my opinion, it is unlikely to do so in the present type of case. There is the further consideration that the practical effect of accepting that there is a duty of care owed by one class to another is usually not limited to shifting individual losses from each innocent plaintiff to the negligent defendant. By the conventional use of insurance it becomes possible for the losses to be widely spread and thereby a double social purpose is served. On the one hand, the serious strains that can arise if the random losses were left to lie where they fall are removed for the unfortunate and innocent victims. On the other, the opportunity for their wide distribution through insurance encourages savings in the form of premium reserves which can be used for the important purpose of supporting the economy generally. *And in this regard third party insurance by the building industry would seem to be entirely feasible while any general system of first party insurance by purchasers would not.*

Was Woodhouse J right about insurance?

He was not right about builder's liability insurance; see the 1990 Smillie article.

He was probably right about the absence of first party insurance as at December 1976 when the case was decided, but in 1977 a statutory first party insurance scheme was set up; see the 1990 Smillie article.

So, by the time *Mount Albert Borough v Johnson* was decided in 1979, first party insurance was available, although this is not referred to in the judgment.

The Building Industry Commission Report

Proposed insurance cover requirements for building certifiers

> 6.30 It is proposed that the type and minimum amount of professional indemnity insurance to be carried by Approved Certifiers should be laid down from time to time by the [Building Industry Authority]. *The Commission suggests that the public interest would be satisfied if the indemnity insurance provided forward cover for a period of 10 years from construction completion and issue of an occupancy consent, of not less than $200,000 for small buildings, including housing, and not less than $400,000 for other buildings*.

Connected to “not very long” long-stop limitation period of 10 years

Professor Smillie's article "Compensation for latent building defects"

- Shows that assumption in *Bowen* as to builders' insurance was wrong.
- Building Performance Guarantee Corporation Act (Buildguard) scheme probably squeezed out by *Dutton* and *Mt Albert Borough v Johnson*
- Critical of building certifiers insurance arrangements

> In fact it is by no means certain that insurers will be prepared to guarantee certifiers cover against liability for even 10 years from the date of certification. Professional indemnity insurance has always been written on a "claims made" basis: ie the policy is renewed annually and the insured is covered only in respect of claims notified during the term of the policy. *If insurers adhere to this position, some separate provision would have to be made (presumably by the Building Industry Authority) to meet claims within the 10 year period against certifiers whose policies have lapsed.*

As it happens, no such separate provision was made.

- Recommended warranty/latent defect insurance scheme, noting

> The BuildGuard scheme is well established, the NZ Master Builders' Federation intends to offer a similar indemnity in respect of buildings erected by their members, and 10 year cover in respect of major structural defects is presently available on the private market.

The 1991 Act

There is nothing in the 1991 Act to suggest that any regard was paid to the warnings of Professor Smillie.

Hamlin

Richardson J

There are obvious difficulties in examining a 1972 case concerned with local authority negligence from a 1994 perspective. The initial cases which imposed a duty of care on local bodies inspecting building sites were necessarily influenced by the Court's assessment at the time of the particular social conditions of the late 1960s and early 1970s. *Since then those cases have themselves been an important catalyst engendering public expectations regarding the role of local authorities in the building control process. Furthermore the cases have been the basis for legislative action. Law and social expectation have enjoyed a symbiotic relationship.*

Hamlin, and Richardson J, cont'd

... to change tort law as it has been understood in New Zealand would have significant community implications particularly affecting home-owners, the building industry, local bodies, approved certifiers and insurers. The relationships and fee structures developed under the building control regime provided for under the Building Act 1991 would have to change if it were decided there should be no remedy in tort by house-owners against local authorities. Insurance practices would have to change. No doubt owners having a house built and purchasers of existing homes could at a price obtain engineering surveys and insurance protection against the risk of subsidence and other design or construction defects. Or they could bargain for an indemnity from the builder/vendor. But, this would call for a major attitudinal shift which Parliament would need to weigh.

Not a great outcome

- Tort remedy not a good mechanism (failed in relation to building certifiers, short long stop limitation, and slow and expensive.

- Probably, although this is perhaps a “hunch”, adds unnecessary and duplicative costs to new buildings.

- Operates as a sort of Gresham’s Law, a bad solution (tort liability) driving out the good (warranty/latent defect insurance).

- Resulted from misunderstandings as to insurance in *Dutton* and *Bowen/Mt Albert Borough v Johnson* and by Building Industry Commission and Parliament.

Other cases where insurance information may have been of assistance

- *Jones v Kaney*
- *Yan v Mainzeal Property and Construction Ltd (in liquidation)*

Establishing legislative facts

- KC Davis, “An Approach to Problems of Evidence in the Administrative Process” (1942) 55 Harv L Rev 364.
- Argument as to legislative fact need not be based on evidence of the kind necessary to establish adjudicative fact.
- Rather it is open to counsel and the courts to address such arguments on the basis of whatever relevant material, including published studies and the like, are available
- Counsel should be prepared to deal with this at trial and not leave it until appeal, cf *Attorney-General v Prince and Gardner* and *Hansen v R.*