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

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by

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My topic

[1] The prevailing orthodoxy is that 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.[1] This orthodoxy is premised on two propositions: first 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, secondly, the availability or unavailability of insurance in respect of losses of the kind in issue are also irrelevant.

[2] As I have expressed them, these propositions are too general to be completely true. In this paper I discuss some exceptions to them, and particularly the second, and do so mainly, although not exclusively, by reference to law as to the liability of local authorities for defective buildings.

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[1] Professor Jane Stapleton, *Tort Insurance and Ideology* (1995) 58 MLR 820.

The development of the law as to liability of public authorities in defective building cases

The early cases

[3] The early defective building cases – in particular, *Dutton v Bognor Regis Urban District Council*,[2] *Anns v Merton London Borough Council*[3] and, in New Zealand, *Mt Albert Borough Council v Johnson*[4] – in which duties of care were imposed on territorial authorities 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*.[5] On this basis, the statutory functions of territorial authorities and the likelihood of loss if these functions were not diligently performed established a prima facie duty of care.

The push-back against the early cases

[4] As someone who was, on this issue, perhaps an outlier in the New Zealand judiciary, I did not see the approach taken in the early cases as logically sustainable. The complaint of the owner in a defective building case is not that the builder and territorial authority damaged the building; it is rather about the quality of the building that the owner acquired. From the point of view of the owner, the loss involves disappointed expectations about the quality of the building and is economic in character.

[5] To my rather old-fashioned legal mind, complaints about the quality of a product are dealt with more appropriately under the law of contracts rather than in tort. I do not see this as just arid doctrine. Price and quality are usually reasonably closely correlated. The risk of latent defects can be addressed by obtaining warranties. A product which is fully warranted is likely to cost more than one which is not. Allowing a claim in tort provides a buyer with something akin to an unpurchased warranty.[6]

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2 *Dutton v Bognor Regis Urban District Council* [1972] 1 All ER 462 (CA).

3 *Anns v Merton London Borough Council* [1978] AC 728 (HL).

4 *Mt Albert Borough Council v Johnson* [1979] 2 NZLR 234 (CA).

5 *Donoghue v Stevenson* [1932] AC 562 (HL).

6 It is not exactly the same as a warranty (as negligence must be established), but I do not see my comment as overstated: see for instance Duncan Wallace "Negligence and Defective Buildings: Confusion Confounded?" (1989) 105 LQR 46 at 51 referring to "the equivalent of a tortious warranty of due care to ensure the suitability of the product or work ... for its required purpose". Lord Oliver in his very interesting but unfortunately not very accessible paper: "Judicial Legislation: Retreat from *Anns*" in Visu Sinnadurai (ed) *The Sultan Azlan Shah Law Lectures: Judges on the Common Law* (Professional Law Books Publishers, Malaysia, 2004) 51 at 72 referred to the duty of care as "amounting in effect, to a non-contractual warranty of fitness to each successive owner without limit of time".

[6] There was also a practical problem. Plausible responses to the imposition a duty of care on territorial authorities include overly defensive behaviour from building inspectors (in effect laying off risk by imposing unnecessary costs on building owners). This concern was articulated by the Privy Council in *Takaro Properties Ltd v Rowling* in this way:[7]

> It is to be hoped that, as a general rule, imposition of liability in negligence will lead to a higher standard of care in the performance of the relevant type of act; but sometimes not only may this not be so, but 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 whose building inspectors have been negligent in relation to the inspection of foundations, …; 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.

Essentially the same point was also made by Lord Oliver extrajudicially when he commented that the "principal beneficiary" of *Dutton* had been "the ready-mixed concrete industry".[8]

A brief digression

[7] Some of you will recall the judgment of the House of Lords in *Home Office v Dorset Yacht Co Ltd*.[9] The House of Lords had to determine whether the Home Office, in its role as the employer of staff at a borstal, could be liable for activities of inmates who had escaped and had criminally caused damage to a yacht owned by the Dorset Yacht Club. Particularly in issue was whether the borstal staff owed a duty of care to neighbours of the borstal in relation to the supervision of inmates. In holding that it did owe such a duty, the House of Lords rejected an argument that imposing liability would encourage borstal staff to 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. This argument was summarised by Lord Reid by reference to what had been said in an New York decision:[10]

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7 *Takaro Properties Ltd v Rowling* [1987] 2 NZLR 700 at 710 (PC).
8 Lord Oliver, above n 6, at 73.
9 *Home Office v Dorset Yacht Co Ltd* [1970] 2 All ER 294 (HL).
10 *Dorset Yacht Co*, above, n 9, at 302.

> I do not think that the argument for the Home Office can be put better than it was put by the Court of Appeals of New York in *Williams v New York State* ((1955) 127 NE (2d) 545 at 550):
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> > '… public policy also requires that the State be not held liable. To hold otherwise would impose a heavy responsibility upon the State, or dissuade the wardens and principal keepers of our prison system from continued experimentation with "minimum security" work details—which provide a means for encouraging better-risk prisoners to exercise their senses of responsibility and honour and so prepare themselves for their eventual return to society. Since 1917, the Legislature has expressly provided for out-of-prison work, Correction Law, § 182, and its intention should be respected without fostering the reluctance of prison officials to assign eligible men to minimum security work, lest they thereby give rise to costly claims against the State, or indeed inducing the State itself to terminate this "salutary procedure" looking toward rehabilitation.'

Lord Reid's rejection of this argument was magisterial:

> 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. So I have no hesitation in rejecting this argument. I can see no good ground in public policy for giving this immunity to a government department. I would dismiss this appeal.

[8] Lord Reid's approach provides a counter point to the concerns expressed in *Takaro* and by Lord Oliver. However, I have reservations about it. The Dorset Yacht Club's yacht was probably insured and, if not, I can see no reason why it could not have been. On the other hand, I think it not very likely that insurance would have been available to cover liability for those operating borstals for damage caused by only lightly supervised inmates. Lord Reid's lofty rhetoric notwithstanding, I think it at least possible that the judgment may have resulted in restrictions on inmates that were not congruent with promoting their rehabilitation. In light of this, perhaps it would have been better to rely on insurance markets to cover associated risks to the property of neighbours of borstals, and by logical extension, perhaps prisons, psychiatric hospitals, social welfare residential homes and so on. This involves a policy tension very similar to those involved the defective building cases.

Back to the point

[9] The defective building cases turned on a number of contested issues of law and policy. As will be apparent from what I have already said, these included:

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

(b) Whether imposing duties of care on public officials carrying out statutory functions may distort their exercise of those functions. This is a policy question of the kind that judges tend to evaluate on a broad-brush basis rather than looking for direct evidence, perhaps of an empirical nature.[11]

(c) Whether insurance would provide a more effective loss-spreading mechanism than tort liability. This too is a policy consideration that may call for broad-brush assessment. But such assessment is likely to be assisted if the courts have a good understanding of the way insurance markets operate. How insurance markets operate involves questions of what are sometimes called "legislative fact" – that is facts that are not directly connected to what the parties did or did not do, but rather are (i) of contextual significance to the policy issue the court must determine and (ii) are capable of being ascertained within the forensic confines of litigation.[12] As I will explain later, it is legitimate for information to be provided to judges that establishes legislative facts.

[10] In this paper, I am not seeking to re-litigate the detail of how that 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 and how things might be done better in the future. But before I get on to all of this, a brief review of the subsequent trajectory of the law is appropriate.

The subsequent trajectory of the law

[11] By the mid-1980s, the English judges were signalling distinct doubts about *Dutton* and *Anns*. The passage I have cited (at [6], above) from *Takaro Holdings* is an illustration of this.

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11 There is an interesting discussion about this in *Jones v Kaney* [2011] 2 All ER 671 (UKSC). In issue was whether expert witnesses should be held to owe a duty of care to the parties who instruct them. There was contest whether imposing such a duty of care would deter experts from giving evidence. Evidence of survey results as to this was not seen as persuasive. *Jones v Kaney* is discussed below at [54].

12 I discuss the concept of legislative fact later, see [57], below.

The retreat from *Dutton* and *Anns* was a gradual process but both were eventually over-ruled by the House of Lords in in 1990 in *Murphy v Brentwood District Council*.[13]

[12] The Building Act 1991 (the 1991 Act) largely implemented a 1990 report, *Reform of Building Controls*, by the Building Industry Commission to the Minister of Internal Affairs.[14] I discuss the 1991 Act and the preceding report in more detail later in this paper.[15] All I need to do at this point is note that the 1991 Act:

(a) introduced competition for local authorities in relation to building inspection and certification by providing for such functions to be carried out by building certifiers; and

(b) was generally premised on an understanding that the existing *Dutton* duty would continue to apply to local authorities and would apply to building certifiers.

[13] The decision in *Murphy* to over-rule *Dutton* and *Anns* cast a shadow over the correctness of *Mount Albert Borough v Johnso*n. However, the New Zealand Court of Appeal decided in *Hamlin*[16] to persist with existing duties of care associated with defective buildings but on a reformulated basis that did not directly confront the English cases that had over-ruled *Dutton* and *Anns* and was premised on circumstances that were specific to New Zealand. The upshot was that the judgment was upheld in the Privy Council.[17] I will come back to *Hamlin* shortly.

[14] Leaky building syndrome emerged as a problem in the late 1990s and the early years of the current century. Insurance that building certifiers had obtained provided at most limited cover and continuing insurance became impossible (or practically impossible) to arrange. By the early years of his century all building certifiers who had operated under the 1991 Act were out of business.[18]

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13 *Murphy v Brentwood District Council* [1991] 1 AC 398 (HL).

14 Building Industry Commission, *Reform of building controls: report to the Minister of Internal Affairs*, (1990).

15 See [32] – [37], below.

16 *Invercargill City Council v Hamlin* [1994] 3 NZLR 513 (CA).

17 *Invercargill City Council v Hamlin* [1996] 1 NZLR 513 (PC).

18 For more elaborate discussion of this, see *Attorney-General v Body Corporate 200200 (The Sacramento)* [2006] 1 NZLR 95 at [26] – [31] (CA).

[15] Of the many cases decided in relation to leaky buildings in the post-1991 Act environment, the two that are primarily relevant for the purposes of this paper are *Sunset Terraces*[19] and *Spencer on Byron*.[20]

[16] The buildings in issue in *Sunset Terraces* were (a) built after the 1991 Act came into effect; (b) residential in character; and (c) complex in structure. The Supreme Court held that the *Hamlin* duty continued to apply to residential buildings including complex buildings of the kind involved in the *Sunset Terraces* litigation. *Spencer on Byron* involved a building that was substantially commercial in character. Over my dissent, the Supreme Court held that local authorities owed duties of care in relation to such building in relation to inspection and certification functions.

[17] I mention *Sunset Terraces* and *Spencer on Byron* primarily to complete the narrative. Insurance considerations were not material to their outcomes and were discussed in any detail only in my dissenting reasons in *Spencer on Byron*. By this stage, the courts were aware of at least the general shape of the likely insurance arrangements of the parties to such litigation

How understandings (or misunderstandings) of the operation of insurance markets affected the development of the law as to liability for defective buildings

Overview

[18] I will look at this by reference to:

(a) *Dutton*;

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

(c) the Building Industry Commission Report;

(d) Professor Smillie's article "Compensation for latent building defects";

(e) The 1991 Act; and

(f) *Hamlin*.

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19 *North Shore City Council v Body Corporate 188529 [Sunset Terraces]* [2011] 2 NZLR 289 (SC).

20 *Body Corporate No 207624 v North Shore City Council* [*Spencer on Byron]* [2013] 2 NZLR 297 (SC).

Dutton

[19] Mrs Dutton was the purchaser of a house that had been built over an old rubbish tip. Shortly after she moved in, it was badly affected by subsidence. The house had been built in 1959, Mrs Dutton bought it in 1961, and the cause of the subsidence was identified later that year. The Court of Appeal judgment in her favour was delivered in late 1971.

[20] In concluding that that the local authority had owed later building owners a duty of care in relation to the foundations of the house, Lord Denning MR said this:[21]

> 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.
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> Next I ask: is there any reason in point of law why the council should not be held liable? Hitherto many lawyers have thought that a builder (who was also the owner) was not liable. If that were truly the law, I would not have thought it fair to make the council liable when the builder was not liable. But I hold that the builder who builds a house badly is liable, even though he is himself the owner. On this footing, there is nothing unfair in holding the council's surveyor also liable.
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> Then, I ask: if liability were imposed on the council, would it have an adverse effect on the work? Would it mean that the council would not inspect at all, rather than risk liability for inspecting badly? Would it mean that inspectors would be harassed in their work or be subject to baseless charges? *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.*
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> 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.*

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[21] See *Dutton*, above, n 2 at 475-476.

> *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.*
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> 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.*
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> Emphasis added

I the passages I have emphasised have not stood the test of time particularly well.

[21] I do not know whether Lord Denning's assumptions that builders were always insured was correct.

[22] Mrs Dutton did not have insurance cover for her loss. But had the house been built about six years later, it would, in all probability have been covered under the Buildmark scheme run by the National House Builders Council that operated as both a builder's warranty and latent defect insurance.[22] As early as 1970 (that is before *Dutton* was decided) virtually all new houses built in the United Kingdom for sale or letting were covered by the Buildmark warranty.[23] And it was almost impossible to obtain a mortgage over, or sell, a newish residential property that did not have such a warranty.[24] By 1990, nearly all defective building litigation in England and Wales was between insurers.[25]

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

[23] I think it appropriate to discuss these two cases together.

[24] *Bowen v Paramount Builders (Hamilton) Ltd* was decided in December 1976.[26] Once again, faulty foundations were the problem. There was no claim against the local authority, but the Court of Appeal held that those associated with a building project (such as builders, engineers and architects and so on) have a duty of care to prevent loss to future owners of the

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22 Details of the scheme are discussed in the report of the Law Commission for England and Wales *Civil Liability of Vendors and Lessors for Defective Premises* (Law Com No 40, 1970) at [22].

23 See the Law Commission Report No 40, n 22, above at [23].

24 "Latent Defects Insurance" (8 July 1987) Law Society Gazette <www.lawgazette.co.uk>.

25 This is discussed in detail in my reasons in *Spencer on Byron*, n 20, above, at [255] – [257].

26 *Bowen v Paramount Builders (Hamilton) Ltd* [1977] 2 NZLR 394 (CA).

building concerned. The reasoning closely paralleled that in *Dutton*. In his reasons, Woodhouse J observed:[27]

> 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.

[25] Sir Owen Woodhouse was largely responsible for the introduction of the accident compensation scheme in New Zealand, and he had obviously given a good deal of thought to efficient distribution of what, for the "unfortunate and innocent victims" would otherwise be "random losses". I will come back shortly to whether his assumptions were correct.

[26] In the *Mount Albert Borough* litigation,[28] the claim was against the local authority and the developer. In this case the building permit was granted in 1965, and the building was completed shortly afterwards. Once again there was an issue with faulty foundations. In 1966 the flat in issue in the litigation was sold for the first time. In 1967, cracks appeared and were remedied but without notification to the Council. In 1970, the flat was purchased by Miss Johnson. Shortly afterwards, further cracks appeared and in 1971, it was recognised that the foundations were faulty. The Court of Appeal judgment was delivered in 1979.

[27] The existence of a duty of care on the part of the Council was treated by the Court of Appeal as pretty much a given, in light of *Dutton*, *Anns* and *Bowen.* The main issues addressed in the judgment were as to limitation and as the particular situations of the developer (which was a party to the litigation) and its closely associated builder (which was not). Unsurprisingly,

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27 *Bowen*, n 26, above, at 419.

28 *Mount Albert Borough v Johnson*, n 4, above.

in light of the apparent obviousness of the conclusion that the Council owed a duty of care, there was little discussion as to policy considerations and no discussion at all as to insurance.

[28] The assumptions as to insurance that were explicit in *Bowen* and I think implicit in *Johnson* (because it adopted the *Bowen* reasoning) warrant brief discussion.

[29] As noted, the assumption of the Court in *Bowen* was that builders would be insured. As will be apparent, I do not think that this has been the general experience in relation to leaky homes litigation and indeed I doubt if it was ever the case. This was well explained (and in some detail) by Professor Smillie as long ago as 1990:[29]

> In New Zealand it is highly unlikely that a builder will hold liability insurance cover in respect of latent construction defects. Builders commonly carry two forms of insurance cover. First, a "Contractors' All Risks" or "Contract Works Material Damage" policy under which the insurer indemnifies the builder for damage to the building while it is under construction, but cover expires as soon as the work is taken over by the owner or put into service. Secondly, many builders carry a general "Public Liability" policy which covers the insured against liability for personal injury (now largely unnecessary as a result of the Accident Compensation Act 1982) and for property damage occurring during the term of the policy. However public liability policies limit the cover in respect of "property damage" to liability for damage to property other than the property constructed by the insured, leaving the builder uninsured against the cost of repairing or replacing his own defective work.
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> Nor do standard liability policies of this kind cover liability for errors in design, specification or advice. A builder or manufacturer may be able to take out specific cover against liability costs incurred in repairing or replacing a defective product or structure under a "Products Liability" policy. However, insurers are reluctant to accept this risk. They see their role as being to insure against the consequences of discrete fortuitous events and they are reluctant to assume the much more uncertain risk associated with provision of a long term guarantee of the quality of an insured's work. Consequently products liability insurance is not always obtainable, and where it is available the premium cost is high and cover is usually subject to a high deductible. As a result, this form of insurance is not commonly held and it would be most unusual for an ordinary building contractor to have such protection.

[30] The other of the assumptions of Woodhouse J was that latent defect (or first party) insurance was not a "feasible", by which I take it that he was of the view that it was not available. That probably was the case in December 1976. However, the position was shortly to change, as I will now explain.

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[29] See John Smillie, "Compensation for latent building defects" [1990] NZLJ 310 at 312.

[31] Under the Building Performance Guarantee Corporation Act 1977, a warranty, including latent defect insurance, was available in New Zealand and between 1978 and 1987 around 24 per cent of new homes were covered by this warranty. Most of there were houses funded by the Housing Corporation which had made obtaining the warranty a condition of providing finance. The Building Performance Guarantee Corporation was dissolved in 1987, and its functions were taken over by the Housing Corporation. As far as I can tell, the scheme was abandoned in the early 1990s although I have not been able to find out when this was. The warranty was not particularly comprehensive: the indemnity periods were 18 months for minor defects, three years for defects in materials and six years for major defects. Writing in 1990, Professor Smillie regarded the scheme as having been a failure and that this "may well have been contributed to by the "rapid expansion of tort liability for latent construction defects".[30]

The Building Industry Commission Report

[32] As I have mentioned, the 1991 Act largely implemented the report of the Building Industry Commission to the Minister of Internal Affairs. The report is permeated with a high level of confidence that a combination of light-handed regulation and the mechanisms of the market would produce better outcomes than the existing scheme. As to the future liability of local authorities in relation to defective buildings, it gave mixed signals:

(a) One the one hand, the Building Industry Commission was of the view that:

> Protection of the economic interests of people in getting value for money is not a justification for building controls since value and quality can be supplied through forces of the market.

(b) But on the other hand, it did not propose any review of the law as declared by *Mount Albert Borough v Johnson* and aspects of the recommendations were premised on that duty continuing to apply, for instance insurance arrangements and a new long-stop limitation period of 10 years.

[33] The Building Industry Commission recognised that building certifiers would have a liability in tort in relation to building defects which corresponded to that of local authorities.

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[30] See Smillie, n 29, above, at 313.

And recognising that as building certifiers would not have corresponding financial resources to meet resulting claims, it proposed:

> 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*."
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> Emphasis added

[34] The proposed insurance arrangements lined up with the proposed 10year limitation period. That period was promoted instead of the 15-year period that had been promoted by the Law Commission.[31] The rationale seems to have been that it would be difficult for building certifiers to get insurance that would provide cover for 15 years.

[35] The report recognised the building owners and subsequent purchasers would be left with some residual risk. In relation to building owners, it noted:

> 6.28 … *It is up to the owner, then, to decide whether the advantages of the Approved Certifier route for that particular project outweigh the residual risk of future claims based on negligent certification not being covered, taking into account other arrangements the owner could make for property protection insurance*.
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> Emphasis added

And for subsequent owners:

> 6.29 The position of second and subsequent owners must also be considered if the alternative certification procedure was chosen by the first owner. The purchaser would have the first owner's occupancy consent, together with the names of the Approved Certifiers. Some time for latent defects to appear would have already elapsed. The purchaser's interest would not be limited to Code deficiencies but would extend to deficiencies in meeting their own requirements as well, so they could be expected to carry out inspections on their own behalf and to weigh their risks accordingly. *Finally, latent defect insurance could be available to them if they required it.* The cost of this insurance would be a factor in determining the purchase price.
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> (Emphasis added)

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[31] Law Commission Report No 6, *Limitation Defences in Civil Proceedings* (1988).

[36] There are two features of this that warrant comment:

(a) Third party insurance for building certifiers along the lines envisaged by the Building Industry Commission was not available. In the result the insurance cover that building certifiers were able to obtain did not make a substantial contribution towards the losses of those affected by negligent inspections or certification.

(b) As far as I am aware, latent defect insurance was not generally available in New Zealand after the demise of the warranty scheme which I have already discussed.

[37] The Building Industry Commission report was published in January 1990. This was seven months before the 26 July 1990 release of the judgment of the House of Lords in *Murphy v Brentwood District Council.*[32]

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

[38] I have already referred to this article. It came after the Building Industry Commission Report and the release of the judgment in *Murphy* but before the 1991 Act.

[39] In the article, Professor Smillie reviewed the development of the law in relation to liability in respect of defective buildings covering much of the same ground as I have. As I have already noted, he took issue with the assumptions as to insurance arrangements and insurability that were made by Woodhouse J in *Bowen.*

[40] He then noted:[33]

> The practical consequences of this present regime are highly unsatisfactory. The builders responsible for creating latent defects are usually uninsured and are therefore effectively insulated against substantial liability costs. Consequently they have little incentive to improve their standards of work; in fact "jerry-builders" may enjoy a competitive advantage at the lower end of the market. A heavy burden is placed on councils and ratepayers. The cost to local authorities of professional indemnity insurance cover is already high and is likely to increase substantially in the near future.
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> Administration and enforcement of the present system of building control involves significant social costs. The detailed prescriptive nature of existing building requirements, combined with an understandable reluctance by councils to expose

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32 *Murphy v Brentwood District Council*, n 13 above.
33 Smillie, n 29, above, at 312.

> themselves to liability, results in delays in approving applications for building permits and an inflexible approach to interpretation which tends to inhibit the use of new materials and innovative techniques. (Building Industry Commission Report on Reform of Building Controls (1990) Vol I, paras 2.10, 2.11, 2.36.) It has been estimated that the direct and indirect costs of the present control system adds up to 10% ($405 million in 1989) to the cost of building in New Zealand (ibid, paras 2.33, 2.1).
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> Finally, a regime of fault-based liability backed by third party insurance is a very inefficient way of compensating losses. The innocent victim's access to the compensation fund is dependent upon proof of negligence on the part of the local authority, and even then recovery is usually subject to long delay. At the same time, approximately 40 per cent of liability insurance premium revenue is absorbed by legal costs and experts' fees.

He then explained that "the rapid expansion of tort liability for latent construction defects may have contributed to failure of the government-sponsored warranty scheme provided under the Building Performance Guarantee Corporation Act 1977, an observation to which I have already referred.

[41] After discussing in detail the National House Builders Council warranty scheme in the United Kingdom and the building inspection services that the Council provides, Professor Smillie discussed the situation in relation to commercial buildings:[34]

> With regard to commercial buildings, it seems that the House of Lords believes that informed businessmen have adequate opportunity to protect themselves from the risk of loss from latent defects by one or more of the following means: assignable "collateral warranties" and "duty of care agreements" from contractors and consultants; employment of independent surveyors and valuers prior to purchase; and purchase of first party "Property Protection" or "Latent Defects" insurance. First party cover against major construction defects is now readily available on the British insurance market. For example, since 1978 the Norman Insurance Co has offered a 10 year cover in respect of inherent structural defects which cause damage to the premises or threaten the collapse of the building. The premium cost is approximately l% of the value of the building. Coverage of consequential losses such as loss of rent is available as an optional extra. In order to minimise the risk to which it is exposed, the insurer insists that design plans and site works are monitored by independent consultants and so provides an important additional control on the quality of work.

[42] Looking to the future, he anticipated that New Zealand courts would stick with the *Dutton* duty in relation to residential buildings:[35]

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34 Smillie, n 29, above at 314.
35 Smillie, n 29, above at 314-315

> It would … be unfair to abolish the common law duty presently owed by builders and local authorities to residential homeowners before an adequate alternative system of compensation for latent defects is made available.

However, he had a different view in relation to commercial buildings:[36]

> But with regard to commercial buildings, the case for preserving *common* law liability in New Zealand is much weaker. Owners of commercial buildings in New Zealand have the same opportunities to allocate and spread the risk of loss from latent *defects* as their British counterparts. While it has taken the New Zealand insurance market rather longer to respond to the need for latent defects insurance, one company already offers such a policy and another is preparing to enter the market in the near future. The new entrant will offer 10 year cover of the cost of remedying defects which cause damage rendering the building unstable, or present a threat of imminent collapse. The premium rate will be less than l% of the value of the building.
>
> Abolition of liability for negligence in respect of commercial buildings could be expected to stimulate demand for this form of cover and produce a quick response from the insurance industry. There seems no good reason to continue to expose local authorities to the risk of liability to commercial owners for very large sums of damages (which may include substantial awards for consequential business losses) many years after the building was completed. When the Court of Appeal is presented with the opportunity to reconsider its present position, it could take a major step in the right direction by applying the *Murphy* decision to commercial buildings. The liability risk to which local authorities are presently exposed would be significantly reduced, and owners of commercial buildings would be given a strong incentive to employ the alternative means of protection available to them.

[43] He was sceptical of the proposals in relation to building certifiers:[37]

> The draft Building Act requires certifiers to hold liability cover under an approved "scheme of insurance", and the Commission suggests that 10 years forward cover of $200,000 for small buildings, including housing, and $400,000 for "other buildings" would be acceptable. *(Report,* Vol I, para 6.30) This seems inadequate**.** Secondly, the 10 year term of forward cover clearly provides inadequate protection under the present limitation law, and while the Commission anticipates legislative enactment of a longstop cut-off provision, the term favoured by the Law Commission is 15 years. (Law Commission Report No 6, *Limitation Defences in Civil Proceedings* (1988) 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.*

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[36] Smillie, n 29, above, at 315.

[37] Smillie, n 29, above, at 316.

As it happens, no such separate provision was made.

[44] The solution in relation to residential building envisaged by Professor Smillie involved requiring:[38]

> … building owners of new residential accommodation to take out a prescribed minimum level of first party insurance cover against building defects as a condition of the grant of a building permit. The potential for a competitive market for latent defects insurance already exists. 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. Competition between insurers can be expected to result in wider cover being offered at reasonable cost. Since private insurers refuse to insure buildings constructed by disreputable builders, and insist upon independent approval of designs and workmanship, builders would have a strong incentive to maintain proper standards.
>
> Once all owners of relatively new homes were covered by compulsory first party insurance against building defects, there would remain no need for tortious liability. However, there would obviously be a considerable lag-time after initial introduction of compulsory insurance during which the tort action must be retained for the protection of homeowners. In fact there would be no need to formally abolish the tortious duty owed in respect of residential premises. If the legislation requiring compulsory insurance also removed insurers' rights of subrogation under these policies, abolished the collateral source rule, and imposed an acceptable longstop limitation cutoff, the tort action would simply fall into desuetude.

[45] Professor Smillie's article makes for interesting reading in light of what was to follow.

The 1991 Act

[46] The 1991 Act largely adopted the Building Industry Commission 1990 report. There is no indication that the legislature took any account of the concerns expressed by Professor Smillie. In relation to the availability of insurance for building certifiers, this is noteworthy. Subsequent events validated the professor's doubts as to the availability of insurance for building certifiers on the terms envisaged by the Building Industry Commission and thus the 1991 Act. It is open to question whether the building certifier scheme would have proceeded if those responsible for implementing it had appreciated the true position. Given that Professor's Smillie's article preceded the 1991 Act, it is difficult to see why the true position was not appreciated at the time. As well, it appears that the same misunderstanding about

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[38] Smillie, n 29, above, at 317.

insurance availability was a significant justification for what has proved to be the very short long stop limitation period of ten years.

Hamlin

[47] In *Hamlin*, the house in issue had been built in 1972. A problem with the foundations was identified in 1989. The proceedings were commenced in 1990, and the case came before the Court of Appeal in 1994. As I have already noted, the Court of Appeal decided persist with existing duties of care associated with defective buildings but on a reformulated basis. And at least on my reading of the judgment (albeit a reading that was rejected by the other judges in *Spencer on Byron*), that reformulation was primarily directed to residential building.

[48] There are passages from Richardson J's judgment that I see as interesting in the context of this paper. First:[39]

> 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.*

He then developed this point in slightly different terms:[40]

> ... 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.

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39 *Hamlin*, n 16, above, at p 528

40 *Hamlin*, n 16, above, at 528.

[49] As I have said in other contexts, I consider that *Hamlin* was correctly decided; this very much for the reasons given in the passages from the judgment of Richardson J that I have just set out.

Drawing the threads together

[50] I participated either as either counsel or a judge in many of the cases dealing with local authority liability for defective buildings and I have a few views about what has happened.

[51] In the first place, I do not see the outcome as satisfactory. The tort liability approach to loss-spreading losses caused by defective buildings has a number of disadvantages:

(a) It provided no solution if building certifiers had been responsible for inspection and certification.

(b) In other cases, the extent of the coverage has been heavily constrained by the not very long "long-stop" limitation period.

(c) The costs of often complex and time-consuming litigation detract from the efficiency of tort liability as a loss spreading mechanism; in other words, it is both slow and expensive.

[52] As well, I am still rather of the view that imposing liability on local authorities in relation to defective buildings has had disadvantages:

(a) I remain of the view (although perhaps it is just a hunch) that it encourages local authorities to lay off the risk of third part liability in ways that impose inefficiently high costs on new buildings.

(b) It has operated as a sort of Gresham's Law in which, instead of bad money driving out the good, a patchy and expensive tort solution has excluded or limited the development of what may have been more effective insurance based solutions.

As to the second of those points, I have in mind what Professor Smillie recommended in 1990. Whether implementation of his recommendations would have coped with the leaky building crisis is necessarily uncertain. But a system along the lines of his recommendation could not

have done any worse than that established by the courts and the 1991 Act, admittedly a low bar.

[53] Where did all go wrong? Here is my take:

(a) It fundamentally went wrong in *Dutton* which was founded on misunderstandings of how insurance markets were working at the time the case was decided. As insurance markets were working at that time, home buyers did not need to rely on the broad shoulders of local authorities to cover the risk of defective buildings. In that sense, the Court of Appeal solved a problem that had been largely already resolved.

(b) *Mount Albert Borough v Johnson* rested in part on mistaken assumptions about insurance. By the time it was decided, first party (latent defect) insurance was available, albeit not on ideal terms. The availability of what in effect was a free local authority warranty left little commercial space for a first party insurance market to develop.

(c) The 1991 Act was a disaster. It was preceded by disappointingly inaccurate and incomplete policy development. It was also a missed opportunity to put in place an economically and practically sensible system for reducing the risk of, and sharing losses associated with, defective buildings, perhaps along the lines suggested by Professor Smillie in 1990.

(d) *Hamlin* was rightly decided but only because it made the best out of what by then was a bad situation. By this stage, a U-turn impracticable. *Dutton, Mount Albert Borough Council v Johnson* and the cases that followed them, along with the probably consequential unavailability of first party (latent defect) insurance, had created a situation in which there had come to be second order reliance by home builders and purchasers on local authorities. As the courts had themselves given rise to this reliance, they had to give effect to it.

The present and future

[54] The possible relevance of insurance and insurability may be material in contexts other than defective building cases. By way of example, when the Supreme Court of the United

Kingdom held in *Jones v Kaney* that an expert witness called by a party in support of a claim for damages owed a duty of care to that party, three of the judges in the majority of the view that professional indemnity insurance was available and that such experts were usually insured.[41] As Rob Merkin has pointed out:[42]

> In fact, professional experts at the time for the most part carried liability insurance which was primarily designed to protect them against the costs of disciplinary proceedings and wasted costs orders, but there was no consistency in whether policies extended to a professional negligence liability which was assumed by experts and their insurers not to exist. Ad hoc experts, such as academics, were almost certain at the time not to have carried liability cover.

[55] The reasonably recent New Zealand Supreme Court decision in *Yan v Mainzeal Property and Construction Ltd (in liquidation)*[43] is also worth a mention. Amongst the many issues that required determination was the exercise of the discretion in s 301of the Companies Act 1993 as to the amount of compensation to be awarded for breaches by directors of ss 135 and 136 – sections that, at least on their face, create statutory torts. In the High Court, there had been some inquiry into the insurance arrangements of the directors. Since the duties that had been breached were owed to the company (that is Mainzeal), it was perhaps arguable that the extent of the directors' liability cover that presumably had been paid for by Mainzeal was material to what was an appropriate ultimate award. As well, at a more general level, the extent to which directors can and do obtain directors and officers liability insurance might have been material to whether the court should have adopted some general rules of thumb as to the exercise of the s 301 discretion. There may have been policy arguments both ways as to these issues. For instance, I imagine that insurers offering directors and officers cover might be perturbed if the courts adopted the view that such cover was a good reason for awarding more damages than would otherwise be the case. Anyway, as it turned out – and despite what had happened in the High Court – no arguments were addressed to us in relation to the level of cover or the relevance or otherwise it might have had to the exercise of the s 301 discretion.

[56] Since judges dealing with novel cases are at least likely be influenced by how they **think** insurance markets operate, it might be thought to be sensible for them to know how they

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41 *Jones v Kaney*, n 11 , above.
42 Rob Merkin, *Tort, Insurance and Ideology: Further Thoughts* (2012) 75 MLR 301.
43 *Yan v Mainzeal Property and Construction Ltd (in liquidation)* **[**2023] 1 NZLR 296 (NZSC).

do operate. And although some, perhaps most, judges might be resistant to information of this kind being placed before them, I think that that they can be told – one way or another.

[57] More than 80 years ago, Professor KC Davis in his well-known article, "An Approach to Problems of Evidence in the Administrative Process"[44] drew a distinction between "adjudicative facts" – which relate to what is directly in dispute between the parties – and "legislative facts" – that are relevant to policy considerations, such as, for instance, the way in which a particular rule operates as compared to how a differently formulated rule might operate. As will be obvious from what I have said, I think that the operation of insurance markets will sometimes be a legislative fact of the kind Professor Davis was talking about.

[58] There has been some debate both in the cases[45] and the literature[46] as to how courts can properly and effectively deal with legislative facts. Of course, the usual close examination of the facts associated with the particular case at hand which occurs at trial may throw some light on legislative facts that bear on wider policy considerations.[47] As well, it may be open for a party to lead (in the sense of calling witnesses) evidence which deals directly with policy.[48] More generally, however, I think that argument as to legislative fact is not required to be based on evidence of the kind necessary to establish adjudicative fact. Rather, I consider that 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.[49]

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44 KC Davis, "An Approach to Problems of Evidence in the Administrative Process" (1942) 55 Harv L Rev 364.

45 In *Attorney-General v Prince and Gardner* [1998] 1 NZLR 262 (CA): a strike-out appeal in a case concerning alleged negligence as to (a) the approval of an adoption and (b) the failure to follow up on a later complaint that the plaintiff was not being well-looked after, where the then John McGrath QC sought to adduce evidence in the Court of Appeal as to the resources and responsibilities of the Social Welfare Department and social work practices and accountabilities. Although the evidence was rejected, it was clearly seen as being of a kind which might be relevant at trial. A similar issue was also addressed in *Hansen v R* [2007] NZSC 7, [2007] 3 NZLR 1 at [9] per Elias CJ, [50] per Blanchard J, [132]–[133] per Tipping J and [230]–[232] per McGrath J.

46 As to this, I think it sufficient to refer to Justice Heydon's article, "How the courts develop commercial law by looking outside the trial record into the external world" [2012] LMCLQ 30.

47 A point explained by Heydon, above n 46, at 35.

48 In *Perrett v Collins* [1998] 2 Lloyd's Rep 255 (CA) at 277, Buxton LJ noted that the defendant (which provided aircraft certifying services under delegated statutory powers) had not led evidence to the effect that it would withdraw from the field if found liable in relation to an aviation accident resulting from negligent certification. The inference to be drawn from that comment is that such evidence could have been admissible even though directed solely to the question whether a duty of care was owed and not the actual factual controversy before the court.

49 I take this from *Hansen*, above n 45.