

## **Personal liability of directors of construction companies - has the corporate veil been pierced or are we seeing a fair development of the law of negligence?**

**By Timothy Bates.**

### **Introduction.**

Today, I wish to cover the somewhat vexed subject of directors' personal liability for construction defects. There has been a lot of development in this area especially in the context of leaky building claims, and I wish to start this presentation by setting out the apparent tension between the *Trevor Ivory Ltd* decision versus the *Morton v Douglas Homes Ltd* decision, and how the later decided cases attempt to resolve this tension. I will give my view on the manner in which the tension ought to be resolved by the Courts moving forward. In the course of doing so I will reference some articles written on that particular subject. Finally, I will address a number of questions this development raises for people working in the construction industry.

### **A company's separate legal personality and limited liability.**

Ever since the statutory creation of the company vehicle, there has long been a principle of liability being limited to the company itself, rather than the shareholders that retain the ownership of the company.

The concept of limited liability was brought about by statute, namely the various incarnations of the Companies Act. Currently s97(1) of the Companies Act 1993 states that a shareholder is not liable for the obligation of a company merely because he or she is a shareholder in the company.

The cases have also endorsed this principle of limited liability. In particular the decision of *Salomon v Salomon & Co Ltd [1895-1900] ALL ER 33 "Salomon"*, is an early decision on corporate personality. Mr Salomon had operated for many years as a leather and boot manufacturer. A family company was then incorporated, but a creditor attempted to assert personal liability against Mr Salomon post incorporation, once the company had been liquidated.

At page 35 Lord Halsbury states:-

*"But, short of such proof, it seems to me impossible to dispute that once the company is legally incorporated it must be treated like any other independent person with rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are."*

And at page 44 Lord Herschell states:-

*"The very object of the creation of the company, and the transfer to it of the business, is that, whereas the liability of the partners for debts incurred was without limit, the liability of the members for the debts incurred by the company shall be limited."*

The reasoning in the lower court had been that the company was Mr Salomon in another form. He had used the name of the company as an alias. He employed the company as its agent; so the company, the lower Court held, was entitled to an indemnity from its principal. But in the House of Lords at page 48 Lord MacNaghten held:-

*"The company is at law a different person altogether from the subscribers to the memorandum, and, though it may be that after incorporation the business is precisely the same as it was before, the same persons are manager, and the*

*same hands receive profits, the company is not in law the agent of the subscribers or trustee for them.”*

This case was applied in the New Zealand decision of *Lee v Lee’s Air Farming Limited [1961] NZLR 325*. This was a Privy Council appeal from a Court of Appeal decision.

At page 336 Lord Morris of Borth-y-Gest states:-

*“The company and the deceased were separate legal entities. The company had the right to decide what contracts for aerial top-dressing it would enter into. The deceased was the agent of the company in making the necessary decisions. Any profits earned would belong to the company and not to the deceased. If the company entered into a contract with a farmer then it lay within its rights and power to direct its chief pilot to perform certain operations. The right to control existed even though it would be for the deceased in his capacity as agent for the company to decide what orders to give. The right to control existed in the company and an application of the principles of Salomon’s case (supra) demonstrates that the company was distinct from the deceased”.*

So the New Zealand Courts have applied this simple principle, when considering company liability versus individual liability. They have protected the sanctity of the corporate veil.

In the context of building law, this all appeared to change with the High Court decision of *Morton v Douglas Homes Ltd 2 NZLR 548 “Morton”*. It is the author’s view that rather than considering this as a decision that attacks the concept of separate legal personality of a company, this decision is simply a natural development of the law of negligence and the duty of care concept, in the building context.

The *Morton* decision was a subsidence case where the plaintiffs claimed compensation for damage suffered by their dwellings, consequent upon the subsidence of the foundations of four ownership flats in Cutts Road. The defendants comprised the landowner and developer, two directors of that company, the engineer and the local authority responsible for issuing the permits.

At page 593 Hardie Boys J when considering the personal liability of the directors to the plaintiff, states:-

***“Liability of the directors***

*The principle of limited liability protects shareholders and not directors, and a director is as responsible for his own torts as any other servant or agent (see for example Yuille v B & B Fisheries (Leigh) Ltd [1958] 2 Lloyd’s Rep 596,619). His liability to the person injured is personal and unaffected by any right of indemnity he may have against the company. Nonetheless, the separate corporate identity of the company must not be lost sight of, for the directors are not personally liable for the company’s torts, except in the limited type of case discussed by Lord Buckmaster in Rainham Chemical Works Ltd v Belvedere Fish Guano Co [1921] 2 AC 465, 476, namely where the company’s wrongful acts were expressly directed by them. Apart from this kind of situation, whilst a director may be liable in negligence to a person with whom the company is dealing, it will only be where he personally, as distinct from the company, owed a duty of care, and failed to observe it. His liability then arises not by reason of his office of director but by reason of a relationship of proximity or neighbourhood existing between him and the plaintiff. It may well be that it is because he is a director that the relationship arises, but the fact that he is a director does not of itself create the relationship”.*

And at 595:-

*“The relevance of the degree of control which a director has over the operations of the company is that it provides a test of whether or not his personal carelessness may be likely to cause damage to a third party, so that he becomes*

*subject to a duty of care. It is not the fact that he is a director that creates the control, but rather that the fact of control, however derived, may create the duty. There is therefore no essential difference in this respect between a director and a general manager or indeed a more humble employee of the company. Each is under a duty of care, both to those with whom he deals on the company's behalf and to those with whom the company deals in so far as that dealing is subject to his control".*

Hardie Boys J then moves into an analysis of personal involvement and control in the construction work, in order to determine whether a personal duty of care could be established on behalf of the directors. I note that the submissions were put to the Judge on the basis that the directors had personal knowledge of the subsidence issues at the site, knew what steps had to be taken to guard against subsidence, however they directly chose not to put in place those features to guard against subsidence. Depending upon the different roles that the directors played in construction, Hardie Boys J imposed personal liability on the directors for different defects arising from the construction work.

This decision was important in opening the door to personal liability for directors of companies in the construction industry, and in no uncertain terms holds that directors have no more immunity from committing common torts as a "humble employee". It also quickly distinguishes between the immunity of a shareholder, as opposed to a director.

The decision in *Morton* was followed by potentially still the most important decision on personal responsibility of directors, the Court of Appeal in *Trevor Ivory Ltd v Anderson [1992] 2 NZLR 517 "Trevor Ivory Ltd"*. This decision decided by the Court of Appeal, considered the personal liability of Trevor Ivory separate from his company. The decision involved crop spraying advice provided by Trevor Ivory Limited (TIL) through its agent/director Trevor Ivory to the orchardist Anderson. Trevor Ivory advised Anderson to spray his raspberry

crop with round up which whilst getting rid of unwanted couch grass, also completely destroyed the Plaintiff's raspberry crop. The Court of Appeal was asked to consider whether Mr Ivory was personally liable to Anderson. In the lower Court, he was found to owe a duty of care to the Plaintiff and was personally liable for his negligent advice. This was overturned on appeal, and throughout the judgment are numerous observations on the issue of directors personal liability over and above that of a company.

The President of the Court of Appeal, Cooke P at page 523 held that no duty of care was owed to Anderson by Mr Ivory. He states:-

*"In this field I agree with Nourse J (as he was then) in the White Horse case that it behoves the Courts to avoid imposing on the owner of a one man company a personal duty of care which would erode the limited liability and separate identity principles associated with the names of Salomon and Lee. Viewing the issue as one of the assumption of a duty of care, which is the way in which Mr Fogarty for the respondents rightly asked us to view it, I cannot think it reasonable to say that Mr Ivory assumed a duty of care to the plaintiffs as if he were carrying on business on his own account and not through the company".*

It is important to Cooke P that this is neither an intentional tort case nor one where anything other than economic loss is claimed. At page 524 he states in this regard:-

*"But if an economic loss claim depends on establishing a personal duty of care, it is especially important to consider how far the duty asserted would cut across patterns of law evolved over the years in the process of balancing interests. Some discussion of that subject will be found in the South Pacific judgments to which I refer without repetition. In this instant case it is patent that the object of Mr Ivory in forming a limited liability company, an object encouraged by long-established legislative policy, would be undermined by imposing personal liability".*

Hardie Boys J, (who by this point in time had been elevated to the Court of Appeal), also talks about assumption of responsibility but then observes that element can be established where the director or employee exercises particular control or control over a particular operation. Thus referencing his ratio in the *Morton* decision. He concludes that in a situation where particular control is exercised by a director, he will attract personal responsibility.

McGechan J helpfully states at page 532:-

*“When it comes to assumption of responsibility, I do not accept a company director of a one-man company is to be regarded as automatically accepting tort responsibility for advice given on behalf of the company by himself. There may be situations where such liability tends to arise, particularly perhaps where the director as a person is highly predominant and his company is barely visible, resulting in a focus predominately on the man himself. All will depend upon the facts of the individual cases, and the degree of implicit assumption of personal responsibility, with no doubt some policy elements also applying. I do not think this is such a case, although it approaches the line.”*

This is the case that any good defence lawyer would immediately turn to, in attempting to avoid personal responsibility of a director of a construction company. However, it needs to be remembered that this is not a construction case, but instead relates to horticultural advice. One way of limiting its impact upon the clear principles set out in *Morton*, is to limit its application to negligent misstatement cases. For the Court of Appeal, while not finding Mr Ivory personally liable for the statements he made whilst performing the services that his company had contracted to perform, did clearly state that in certain circumstances a director could become personally liable for his acts, so long as he had accepted a personal responsibility for these acts.

For some, the decisions of *Morton* and *Trevor Ivory Ltd* have been difficult to reconcile. There have been a number of articles that have taken differing views of apparent flaws in the reasoning contained within *Trevor Ivory Ltd*.

Stephen Todd in his text *The Law of Torts in New Zealand, 5<sup>th</sup> ed., Brookers 2009 "Todd"* at paragraph 6.8.01 suggests that *Trevor Ivory Ltd*, especially the decision of Cooke P, is a judgment that champions limited liability, and contains a rationale that to impose personal liability would undermine this long established legislative policy. He considers the *Hardie Boys J* judgment as supporting the concept of assumption of personal responsibility. Todd is concerned with the reasoning in *Trevor v Ivory* and the House of Lords decision of *Williams v Natural Life Health Foods Ltd [1998] 1 WLR 830 (HL)*. At paragraph 6.8.02 page 342 he states:-

*"The bases for individual liability in Ivory and Williams are quite straightforward. In the former Mr Ivory gave negligent advice directly to the plaintiff, which advice was relied on and caused physical loss of the raspberries. Ordinary principles founded ultimately on Donoghue v Stevenson point to a duty. This would be even clearer had Mr Ivory given no advice but had simply done the spraying himself. In Williams the foundation for a duty lay in the application of the Hedley Byrne principle, and very arguably a duty also could be seen to exist. The director prepared a brochure and financial projections which he knew would be given to prospective purchasers of a franchise and which he knew would be relied on by them in deciding whether to purchase the franchise. Applying Caparo Industries plc v Dickman, the relationship was of a kind which could give rise to a duty. The director did not himself have to put the information into the purchasers' hands.*

*The reason given in both cases for denying a personal duty of care was that neither defendant had assumed responsibility of his conduct. Yet the defendants did not assume responsibility for torts in the sense of assuming legal liability for*

*what they do. The courts impose liability where there is a sufficiently proximate relationship between plaintiff and defendant and the balance of policy concerns point in favour of a duty. In Williams Lord Steyn said that the test should be objective and that the focus should be on things said or done by the defendant or on his behalf in dealings with the plaintiff, yet went on to say that the inquiry was into whether the defendant conveyed to the plaintiff, directly or indirectly, that the defendant was assuming personal responsibility. This seems to focus on the defendant's subjective intention or recognition that he would be personally liable for negligence. Reasoning of this kind is not easy to reconcile with ordinary principle."*

Todd then considers the supposed immunity of a director and applies the principles of vicarious liability. At page 343 he states:-

*"We should also consider how the director's personal immunity can be reconciled with ordinary principles of vicarious liability. When an employee commits a tort in the course of employment, the employer is vicariously liable for the conduct. Here the employee's personal liability is the very basis for the employer's vicarious liability. They are joint tortfeasors. Indeed, it has been held by the Court of Appeal, and not questioned by the Privy Council, that a company and its directors may be joint tortfeasors on the basis that the actions of the directors are identified with those of the company itself, as representing its directing mind and will. In Williams it was denied that the director was a joint tortfeasor with the company. Lord Steyn said that there was a special relationship between the company and the client but not between the director and the client. Yet if, as suggested, the elements of duty of care were satisfied, then fairly clearly there was a breach of duty by the managing director in the course of his employment. If this is right the company was vicariously liable for the misinformation and was a joint tortfeasor with the managing director"*

*Todd* goes on to state that directors ought not to be treated any more favorably than employees who commit torts in the course of their employment. He sees the company and the employee as joint tortfeasors.

In summarizing the plethora of leaky building cases where personal liability of the directors is discussed, *Todd* is attracted to the simplicity of the Chambers J decision in the Court of Appeal decision *Body Corporate 202254 & Anor v SF Taylor [2008] NZCA 317 "Taylor"*. He concludes that this *Taylor* decision has left the law in a very unclear state.

At the end of his paragraph on the personal liability of directors, he attempts to rationalize the so called immunity of company directors, on the basis of a "representative capacity" defence, akin to an exclusion clause defence. In particular, by acting through a company the defendant might be regarded as giving notice that he or she is not personally liable. This is reasonably unconvincing as a rationale though.

It is important to consider the *Taylor* decision, as once again it is a Court of Appeal decision. Unfortunately this decision was an appeal from an unsuccessful strike out application by Mr Taylor, who was the principal behind a development company. So, it was only a trumped up interlocutory argument, and thus its importance is somewhat limited by this feature.

The facts of this case were as follows:-

- It concerned a 37 unit development;
- The units suffered from water ingress issues;
- Some owners had bought from the plans, some owners were subsequent purchasers;
- Strata Residential Ltd, Strata Grey Lynn Ltd and Strata Builders Ltd were the corporate entities behind the development but were all insolvent.

Therefore the claims against Mr Taylor were of significant moment to the Plaintiffs.

The appeal was heard in the Court of Appeal in August 2008. The statement of claim had been amended many times because of earlier orders and directions of the High Court.

In the judgment, the President William Young gave an early indication that he favoured the decisions of *Trevor Ivory Limited* and *Rolls-Royce NZ Limited v Carter Holt Harvey Limited & Genesis Power Limited* [2005] 1 NZLR 272 “Rolls Royce” and that he would be reluctant to tamper with the legal structure set out in the contract.

He concludes that a director’s actions are identified with the corporate identity unless there is clear evidence to show that director is acting in such a way that he attracts personal responsibility.

The majority held that the cause of action in negligence ought to be struck out which asserted that *Taylor* as developer owed a non-delegable duty of care to the owners. However applying *Trevor Ivory Limited*, they held that without all the facts being considered at a full trial (and likewise with the policy reasons for and against imposing a duty of care needing to be considered at a full trial), it could not be said that through Taylor’s control of elements of the construction process, he had not assumed personal responsibility for parts of the construction process. The claim against Taylor survived on that basis in respect of the negligence pleading, but it appears to have been a borderline decision.

The judgment of Chambers J is interesting for the simplicity of its approach. It closely follows the judgment of Hardie Boys J in *Morton*. Neil Campbell in his article *Leaking Homes, Leaking Companies?* [2002] CSLB 101 “Campbell”, also seems supportive of *Morton* but rather critical of *Trevor Ivory Ltd*. He does not

think that the personal liability of a director of a company for his acts where he has assumed personal responsibility, should be limited to negligent misstatement claims only. At page 102 he states:-

*“A builder owes a duty of care to the immediate and any subsequent purchasers to take reasonable care to comply with the building permit and building code. Equally, this duty is owed by a developer, who cannot avoid the duty merely by delegating the task of building. The point to note is that these duties are imposed by the Courts on builders and developers. They do not require any assumption of responsibility by the builder or developer to the ultimate homeowner.”*

This article of *Campbell* was criticized heavily by Segar and Eric in *Affirmation and clarification of Trevor Ivory [2006] NZLJ 268 “Segar”*. Those authors are intent on arguing that the law of agency has no place in terms of assessing the liability of directors for acts it commits as directors of company.

I rather prefer the approach of first Todd, Campbell, and robustly supported by Peter Watts in his article *Trevor Ivory Ltd v Anderson: reasoning from outer space [2007]NZLJ 25 “Watts”*. Mr Watts in clearly one of his most pertinent criticisms of *Segar’s* curious conclusion (that directors are not acting as agents of companies, and are therefore immune from liability) states at page 25:-

*“Before touching on each of the versions of the Trevor Ivory heresies found in Seagar and Eric, it is as well to start with the absurdity that their theory of company law leads to. The authors’ thesis rests on drawing a distinction between directors and others who might serve a company. Under the thesis only directors get immunity from tortious liability. This means that if a mere employee of a company accidentally but negligently makes a misstatement in the course of her employment she will be personally liable for it, whereas she will not be if she is a director. Similarly, if an employee innocently but tortiously defames a competitor of the company for whom she works, she will have no immunity from*

*liability but a director will. Likewise, with an act of conversion of a third party's asset committed in the course of employment.*

*The perversity of making junior employees liable but not their bosses for the very same acts hardly needs spelling out. No amount of subsidy to encourage entrepreneurship could justify the discrimination”.*

### **The leaky building cases.**

Moving back to the cases, it is within the realm of leaky building cases, that the personal liability of directors has been argued the most frequently and most forcefully. This is no doubt because, the unwitting leaky home owners often find themselves with no solvent development company or building company to recover their losses from. They therefore are forced to look at the individuals behind those companies.

I now will work through a number of these decisions. As an aside, the *Taylor* decision already discussed, was in fact a leaky building case.

One of the first full High Court decisions on a leaky building claim was the Baragwanath J decision of *Dicks v Hobson Swan Construction Ltd (In Liquidation) & Ors (Unreported, High Court Auckland, Baragwanath J, 22.12.06 CIV 2004-404-1065) “Dicks”*.

Mr Macdonald was the sole director of Hobson Swan Construction Limited (In Liquidation), and was the person that actually carried out the building work, apart from concreting.

The major cause of water ingress appeared to have been the lack of proprietary seals, in particular around the windows. It left them effectively with no form of sill

flashing, and this major defect in itself was held to be significant enough to cause a need for a total reclad of the house.

Baragwanath J spent some time considering the liability of Mr Macdonald, and identified a difficulty in reconciling the sanctity of the corporate veil approach of *Trevor Ivory Limited* versus the principled negligence approach in *Morton*. He concluded that *Morton* had been decided on the second basis of assumption of responsibility, being the control exercised over the building process. He observed that this basis of the finding of personal liability of the directors was not supported by Cooke P or the decision of McGechan J.

Then at paragraph 60 he set out a list of factors (policy considerations), pointing towards personal liability:-

- The protected interest is more than economic;
- Imposition of personal liability would tend to add incentives to performance;
- Subsequent purchasers would be able to sue unencumbered by the present point;
- It would allow a company to sue or seek contribution from its careless director;
- There is already concurrent liability in contract and tort.

He then listed the following as being factors pointing away from the imposition of personal liability:-

- The tort is closely connected with the contract by which Mrs Dicks and Hobson Swan formulated their legal relationship;
- There is no practical difference between the contractual and tortious breaches of duty;
- The wrong is an omission and is not willful;
- It is only a tort.

At paragraph 62 he states:-

*“The point can be argued either way. While a New Zealand appellate court might choose to take a different approach Morton v Douglas Homes has stood for two decades. It cannot be said that the decision is so lacking in principle that litigants should be subjected to inconsistent judgments of the first instance. I have therefore decided to follow Morton v Douglas Homes on the present point. It applies a fortiori: Mr McDonald did not merely direct but actually performed the construction of the house and was personally responsible for the omission of the seals. His carelessness is, on the Morton v Douglas Homes analysis, a breach of a duty of care owed by him to Mrs Dicks. He is therefore personally a tortfeasor (as well as having his conduct attributed to Hobson Swan as its tort).”*

Mr McDonald was found personally liable to Mrs Dicks in tort.

The decision of *Hartley & Hartley v Balemi & Ors* (Unreported, High Court Auckland, Stevens J, 29 March 2007, CIV 2006-404-002589) “Hartley” was an appeal from a WHRS decision of Adjudicator AMR Dean. In the appeal Stevens J had to consider the personal liability of Mr Brent Balemi, the sole director and the employee of Balemi & Balemi Limited (B&BL). B&BL was engaged as the builder on a cost reimbursement contract.

At paragraph 89, after considering the assumption of responsibility test in *Trevor Ivory Ltd*, and then the control test advocated in *Morton*, plus the many articles written on the subject, he held at paragraph 89:-

*“In the context of leaky building adjudications and disputes, it therefore seems entirely appropriate for decision makers to apply, where appropriate, the degree of control test articulated by Hardie Boys J in Morton”.*

He suggests that it could be considered a subset of the concept of assumption of responsibility. He referred to the decision of *Drillien & Anor v Tubberty & Ors*

*(Unreported, High Court Auckland, Faire AJ, 15 February 2005, CIV 2004-404-2873) "Drillien"* as an example where such an approach was followed. He went on to hold that in order to establish actual control, actual building work involvement was not necessary. Instead, administering of the building contract could be enough.

Then at paragraph 94 he states:-

*"The principles upon which Mr Balemi's personal liability should be determined relate to his personal involvement and the degree of control he exercised over the building process. This is not to say that the principal of a one person company will always be liable for his or her actions, as his or her liability in tort will be determined by the degree of control he or she personally assumes in the building process".*

The Adjudicator had found that Balemi personally assumed liability, because he was closely involved in all aspects of the building process: applying for building consent, selecting the subcontractors and suppliers, negotiating the scope of the subcontractors work as well as their prices, authorizing changes from the architect's plans, organizing and managing the building work on site most days. Mr Balemi was personally involved in decisions that led directly to the leaking damage the house suffered, such as the decision to install the sill flashings in a way that subsequently caused significant damage through leaks. Justice Stevens was unwilling to tamper with the Adjudicator's finding of personal liability on appeal.

In *Body Corporate No. 188273 & Anor v Leuschke Group Architects Ltd & Ors (Unreported, High Court Auckland, 28 September 2007, Harrison J CIV 2004-404-002003) "Leuschke"*, the Court had to address whether Mr Cooper, who was a director and shareholder in the company Colmark (along with Leuschke), was in fact a developer. It was argued by the Council that Cooper was in fact and law

a developer, despite the fact that Colmark was set up within months of the development plan being commenced.

At paragraphs 31 and 32 Harrison J states:-

*“[31] The word “developer” is not a term of art or a label of ready identification like a local authority, builder, architect or engineer, whose functions are well understood and settled within the hierarchy of involvement. It is a loose description, applied to the legal entity which by virtue of its ownership of the property and control of the consent, design, construction, approval and marketing process qualifies for the imposition of liability in appropriate circumstances.”*

*“[32] The developer, and I accept there can be more than one, is the party sitting at the centre of and directing the project, invariably for its own financial benefit. It is the entity which decides on and engages the builder and any professional advisors. It is responsible for the implementation and completion of the development process. It has the power to make all important decisions. Policy demands that the developer owes actionable duties to owners of the buildings it develops.”*

The Council relied upon the joint venture document to establish that Cooper was in fact a developer, for within this document he had a defined role in terms of managing the development.

Harrison J concluded that Leuschke and Cooper had formed Colmark to undertake the Rendall Terrace development. Its defining characteristic was its legal personality separate from its shareholders. He was satisfied that on its incorporation, it became the entity which assumed legal responsibility for and controlled all aspects of the development. It was held that Colmark was the developer of the Rendall Terrace project.

The Council in the alternative argued that Cooper was a developer, based upon the assumption of responsibility test from *Trevor Ivory Limited* and *Morton*. Harrison J, in attempting to reconcile these apparent competing authorities, held that the assumption of responsibility requirement is central to the proximity inquiry. He referred to the decision of *Rolls-Royce*

At paragraph 61 he states:-

*"It is apparent from Hardie Boys J's careful examination of the facts in Morton that control of the development simpliciter is not enough to found liability. There must be evidence of the director's assumption of a degree of personal responsibility for an item of work which was subsequently proved to be ineffective."*

It was this critical element of control by Cooper causing construction defects that was lacking here. There was no evidence of Mr Cooper's involvement whatsoever in the actual building process, nor could they show any knowledge of the defects in design or construction leading to the damage. He never visited site during construction or attended a site meeting.

It was held that the Council was unable to establish the sufficiency of evidence to prove a linkage or nexus between Cooper's general powers of control and the particular defect or defects as illustrated by *Morton*, and *Balemi*. All functions singled out were within the functions normally performed for the purpose of discharging that office.

And finally at paragraph 71 he states:-

*"I agree with Associate Judge Faire that an assumption of responsibility to carry out a particular task is not of itself sufficient to attract liability: Drillien at [43]. Something more is required"*.

The claim against Cooper failed.

And then he refers to the apparent unfairness that Council bore the brunt of liability. He states at paragraphs 75 and 76.

*“[75] This result may seem unjust or unfair. There is an apparent anomaly in visiting the financial consequences for the failure of these apartments on a local authority which played a limited role, when the shareholder of the now extinct development company who derived a financial benefit is absolved. But it is the necessary consequence of applying established legal principles.*

*[76] Unless and until Parliament radically reforms the Companies Act 1993, to ensure among other things that all companies are capitalized to a level consistent with the financial obligations they assume, similar decisions will be reached. Mr Cooper acted in accordance with his legal rights in forming Colmark along with Mr Leuschke to obtain the personal protection available from incorporation. In my judgment, Mr Cooper did not lose that benefit by assuming a personal responsibility to the owner. However, the time may be appropriate to carefully examine whether a corporate model designed in the United Kingdom a long time ago is apt to meet the commercial and moral demand of and standards set by modern society.”*

In a lot of ways this decision could be considered a step backwards as far as the development of the law of negligence in the area, it certainly seems to be supportive of the separate corporate personality analysis, as outlined in *Trevor Ivory Ltd*. However, Harrison J did not shut the door on personal liability. He just held that the necessary element of personal control of the construction process causing the defects, was not present.

It is now appropriate to discuss the Faire AJ judgment in *Drillien & Anor v Tubberty & Ors* (Unreported, High Court Auckland, 8 February 2005, CIV 2004-

404-2873) "*Drillien*". Again this was a summary judgment application brought by Mr Tubberty. In this decision Faire AJ, helped by some in depth submissions on duty of care, carefully explored the rationale applied for imposing a duty of care as set out in *Rolls Royce*. He then challenged the *Neil Campbell* argument which undermined the importance of assumption of personal responsibility. He considered this a critical element. That said, he is obviously troubled by the *Morton* decision, and then finds that of those parts of the work that Tubberty had involvement with, they have not caused or contributed to the defects. Accordingly he holds that it would not be possible to sheet home a breach of a duty of care by him.

The decision had the makings of being a well reasoned decision, but the conclusions are reached too quickly. The Court was no doubt greatly assisted by the detailed submissions of the late Mr Fardell QC, who went to the trouble of setting out where in his opinion the *Trevor Ivory Ltd* decision had been applied appropriately.

Before finishing looking at the leaky building cases that have considered this issue of director's personal liability, it is important to consider the decision of *Body Corporate No.189855 & Anor v North Shore City Council & Ors* (Unreported, High Court Auckland, Venning J, 25 July 2008, CIV 2005-404-005561)(Byron Ave). In this decision Venning J had to consider the personal liability of Smythe and O'Hagan. At paragraph 196 he states:-

*"If there is a duty to be imposed it should be because the law imposes the duty because of what the defendant has said or done not because that person has decided to assume some legal responsibility towards another."*

*“[197] The company structure provides limited liability to investors (shareholders). Directors can be liable to the shareholders because of their role as governance of the company. Generally directors of a company will not owe a duty to parties dealing with the company merely because of their position as directors (apart from a duty to creditors in certain situations provided for in the Companies Act 1993). But there is no reason in principle for there to be a rule of law providing for a “director’s immunity” for operational acts carried out by directors’ actually or effectively as employees of the company.*

*[198] An employee of a company, if negligent in the course of his employment can be liable to the company’s client, and the company will be vicariously liable for the employee’s actions. Often a director of a small company will also act as an employee of the company. If a director is also acting as an employee of the company carrying out a task that would have to be undertaken by another person employed for the tasks, if not by the director, then there is no reason at law why that director should not be personally liable if he or she is negligent in carrying out that task.*

*[199] In such a case the director’s liability to third parties has nothing to do with his or her position as director but rather arises because of their actions in the discharge of business operation of the company. It arises because the director has a relationship of proximity to the plaintiff. It may arise if the director undertakes operational acts in the course of undertaking the company’s business under the contract the company had with the third party. In acting in such an operational way the director is not acting as a director of the company directing the will of the company, but rather is acting as an employee or servant of the company. In that capacity the director/employee should not need to assume any particular or special legal responsibility towards the third party to be liable.”*

In this statement of the law, the approach of *Morton, Todd, Campbell, Watt* and the judgment of Chambers J in *Taylor* was endorsed and applied.

However, after setting out the law in clear principle (as preferred by the writer), he then reverts to the *Trevor Ivory Limited* decision and seems restrained by this decision. He thus reverts back to the assumption of responsibility test.

When considering the liability of Mr O'Hagan, Venning J does refer to *Morton*, and the control test. Venning J finds that Mr O'Hagan assumed such personal legal responsibility towards the plaintiffs at all levels by his personal involvement in the work, the initial investigation, the design and particularly the level of personal control he exerted over supervision of the work.

For the sake of completeness, I have also attached to this paper Appendix 1 which is a summary of other leaky building cases decided by the Courts.

### **Summary of the state of the law on director's personal liability for their own torts.**

*Trevor Ivory Ltd* remains the highest and most authoritative decision on director's personal liability. This decision championed the sanctity of the corporate veil and said it would only be in very rare situations that the corporate veil would be pierced, namely where there had been a personal assumption of responsibility by a director. The only other time that this issue has been considered in depth by the Court of Appeal, (in the context of a leaky building claim), is in the *Taylor* decision. The majority of the Court of Appeal in that decision still seemed very confined by the *Trevor Ivory Ltd* decision, and worked hard to use the assumption of responsibility test to ensure that the claim remained available to be brought against Taylor.

The author's view, is that of *Todd, Watt and Campbell* in their articles, and the view of Chambers J, and Venning J in their respective judgments in *Taylor* and *Byron Ave*.

I cannot see any rational basis for providing directors of companies any better protection/immunity from their own tortious acts, than their employees. In the event that a claim is brought against them, then they can rely upon the principle of vicarious liability, and seek that their company that they are directors of, and which in many instances also employs them, meets that liability. It is acknowledged that in the current leaky building environment, the companies these directors may look back to are often insolvent, leaving them to meet the claims. However, it is this risk that their contract of engagement ought to have made allowance for from the outset, either in the nature of the reward they receive or by way of insurance.

To attempt to claim some sort of immunity for such directors, based upon the doctrine set out in *Lee v Lee's Air Farming Ltd* and *Salomon v Salomon & Co Ltd* being separate corporate personality is artificial. These cases and the principles that can be taken from them, are motivated by the protection a company structure provides to shareholders.

The two stage test for assessing whether a duty of care is owed, as outlined in the *Anns v Merton London Borough Council [1978] AC 728* decision "*Anns*", proximity and then the analysis of policy considerations, is to be properly applied in the context of construction defects cases. Inevitably in many cases directors who have active involvement in the construction process will be found to owe a duty of care to owners or subsequent owners of those buildings. For, as was carefully analysed by Baragwanath J in *Dicks*, the policy considerations as applied in stage two of *Anns*, favour the imposition of personal liability.

## **Are the Courts likely to find a director of a construction company personally liable for building defects?**

I think that clearly there is now real risk of directors being held personally liable where their company has created a building with construction defects. Whilst, the *Trevor Ivory Ltd* may still provide some security to them in relying upon the corporate veil to protect them, it seems the tide has turned, and certainly in many of these cases before the High Court of this country, the *Morton* approach seems the preferable doctrine applied by the Courts.

This certainly applies in the Weathertight Homes Tribunal, and being someone who practices there regularly, as a matter of course you name the individuals behind the construction companies where you can show they went onto site and carried out work that has caused or contributed to water ingress issues. Whilst you cannot so readily assume such matters when litigating in the High Court, the Venning J judgment in *Byron Ave*, further endorsed by Heath J in *Body Corporate No. 199348 & Ors v GCO Nielsen (Unreported, High Court Auckland, 3 December 2008, CIV 2004-404-3989)* "Nielsen", represents the prevalent view in that jurisdiction as well.

It goes without saying that the Court of Appeal, will attempt more rigorously to apply their own decision of *Trevor Ivory Ltd* as we saw in the *Taylor* decision.

I now wish to deal with the four main questions posed in the outline to this presentation.

## **When is a company director safe from personal liability for building defects?**

It seems to me that, a company director of a construction company will only avoid personal liability for construction defects, if he/she can establish he/she was far removed from the actual work, and/or the decision that has caused the construction defect. It will be important for a director to be able to say he/she did not come to site. It will also be important that the Director can establish that he/she was running a construction business, rather than getting specifically involved in decisions around how any particular job is to be run. Whilst it is realistic for directors of larger construction companies to remove themselves from the construction process such as this, it is not realistic for the small construction companies to limit directors' roles in this way. The current depressed building climate that these companies are operating in, has meant that some directors who would not normally do any of the actual building work, have had to return to the tools. They are clearly more exposed to personal liability because of that fact, as it is so much easier for potential claimants to show that they were exercising the necessary element of control in that case.

Of course, if removing themselves entirely from control or decision making processes in respect of the construction work is impractical and/or impossible, then they should at least work towards removing themselves from construction work that is defective.

## **What are the practical consequences of this development in negligence law, in terms of the way builders will run a construction project?**

In a lot of ways, the larger construction companies are not going to do anything differently. Their directors/officers are well sheltered from the actual construction work itself, they have employed people who carry out the key disciplines in construction being design, product selection, project management, building, and

quantity surveying. They have isolated themselves from making construction decisions, and will not attract personal liability because of it.

In those rare instances where directors/officers of those large companies did involve themselves in the core construction disciplines, you will now probably find that they will no longer do so. This is not necessarily a good thing for the quality of the final build nor for the management of the company.

However, it is in the context of small one man construction companies where there is the most pressure to change. The development of the law of negligence now begs the question, what real advantage lies in incorporation anymore. Apart from fiscal simplicity, it is now clear that a director of a small construction company that actively gets involved in construction work, is as exposed to personal liability as he would be as a sole trader. Perhaps, we are now going to see less incorporation by these builders, or the disappearance of small companies carrying out this work.

An alternative for these small companies is to contract out all of the key disciplines of construction, and the directors of such companies moving away from being a builder per se, but rather becoming an operator of a financial vehicle set up to build a house. One suspects that such entities would struggle to either make a profit or compete on price with the larger companies should they adopt such an approach.

**What insurance is available to company directors inadvertently caught in this position to protect them against liability?**

There are two types of insurance that have application in the context of protecting against building defects claims. A construction company can take one of the varying forms of public liability cover which normally would name the company and its directors as insureds.

The trigger for such cover is an occurrence, and typically an occurrence is defined as follows:-

*“Occurrence” means an event, including continuous or repeated exposure to substantially the same general conditions, that results in Personal injury or Property Damage neither expected nor intended from the standpoint of the Insured.”*

However, ever since 2005 (or even earlier for some insurers), public liability exclusions have contained the following water ingress exclusion or something similar:-

***“Building Defects Exclusion***

*The Insurer shall not indemnify the Insured for any liability in respect of Personal Injury or Property Damage arising directly or indirectly out of:*

- 1. the failure of any building or structure to meet or conform to the requirements of the New Zealand Building Code contained in the First Schedule to the Building Regulations 1992 (or any amended or substituted regulation or standard) in relation to leaks, water penetration, weatherproofing, moisture or any effective water exit or control system;*
- 2. Fungi, mould, mildew, yeast, rot, decay, gradual deterioration, micro-organisms, bacteria, protoza or any similar or like forms in any building structure.”*

Accordingly, cover for leaky building claims have been excluded from these policies. The very recent High Court decision of *Arrow International Limited v QBE Insurance (International) Limited (Unreported, High Court Wellington, Mackenzie J, 23 June 2009, CIV 2007-485-74)* “Arrow” applied a very restrictive

approach in terms of assessing when property damage had occurred in the context of a leaky building claim. Mackenzie J held that in order to rule on policy response, he had to determine when a single point of happening of damage had occurred, rather than assessing damage as a continuous event over a period of time. This approach worked in favour of QBE, as the judge determined that property damage had occurred prior to QBE being on risk.

I understand that the leaky building exclusion is in some instances tagged out (on request) for houses built under the Building Act 2004.

Of course the water ingress exclusion only works to exclude liability for water ingress defects, so there may still be cover for other construction defects. But as a general point, these policies do exclude cover for damage to parts of the building that the contractor worked upon. The flow on damage to other parts of the building is typically covered.

### **Directors and Officers Liability Insurance.**

Another possible type of insurance available to company directors, is Directors and Officers Liability Insurance “D&O Insurance”.

In summary, these policies cover directors/officers liability to persons arising from wrongful acts by the director/officer. A wrongful act is typically defined as follows:-

*“Wrongful Act means:*

*(a) any error, misstatement misleading statement, act, omission, negligence, or breach of duty actually or allegedly committed or attempted by any Insured Person in their capacity as such or in an Outside Position; or*

- (b) any matter claimed against any Insured Person solely by reason of their serving in such capacity or in a Outside Position; or*
- (c) any error, misstatement, misleading statement, act, omission, negligence or breach of duty actually or allegedly committed or attempted by the company.*

***Except as specifically provided in Extension 3.3 (Outside Position Liability), Wrongful Act does not include any conduct actually or allegedly committed or attempted by any Insured Person in their capacity as a director, office, trustee, or employee of any organisation other than the Company, even if service in such capacity is with the knowledge and consent of, at the direction or request of, or part of the duties regularly assigned to the Insured Person by, the Company.”***

Typically, this policy is a claims made policy, i.e. it will respond to claims made within its policy period, and is not triggered by when property damage can be proved to have occurred. Accordingly, there is potential coverage under one of these policies for a leaky building that was built less than 10 years ago, where the claim is made against the company director. Of course the ultimate outcome as to insurance coverage in any given situation, depends upon the bargain that is done with the specific insurer involved.

But ultimately there may be some cover for a company director for historic construction defects. That said, these policies of insurance are designed to be profitable for the underwriter, and there are a number of mechanisms contained within the standard D & O policy that work to limit an underwriter's exposure. For example please refer to the proviso in the definition of wrongful act, highlighted in bold above.

In summary, the insurance market does provide some protection for construction companies and directors for liability for construction defects even in the context of leaky building claims. It is recommended for directors of construction companies to take out D&O insurance, especially where they are a small enterprise, and the directors are exercising significant control over the building process.

**What is the personal exposure for employees of construction companies for construction defects? How does the solvency of the construction company impact upon this?**

If the logic of the *Segar* article was to be followed, employees of construction companies ought to feel more exposed than their very own directors for torts they commit during the course of carrying out construction work. However, *Segar's* view is not supported by this author as has been clearly set out earlier in this paper.

Employees are fundamentally liable for the personal torts they commit whilst carrying out construction work. The two stage test of *Anns* will be applied to any given fact situation, and assuming a duty of care is owed, the employee will be liable to the parties that have suffered a loss as a result of their negligence. The concept of vicarious liability works to impose an indemnity obligation upon the employer company for the employee's liability.

However, the company's ability to indemnify the employee, is only as good as the solvency of the company. In the context of leaky building claims, should an employee who is named as a respondent find that the company it worked for is no longer solvent, then it will be faced with meeting its own personal liability.

This is undoubtedly viewed as a very harsh result for those employees who unwittingly find themselves in such a situation.

## **Conclusion.**

The leaky building crisis has imposed a lot of pressure upon the judicature of this country, to find remedies for the innocent leaky home owner.

One of the effects of this has been the rapid development of the law of negligence as regards directors/officers personal liability for their tortious acts.

This development has been very much a natural development of the general principles first laid out in *Donoghue v Stevenson [1932] AC 562* and *Anns*, rather than an attack on the separate legal personality of a company.

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## **Appendix 1 – Summary of other leaky building cases.**

*Cashfield House Ltd v David & Heather Sinclair Limited (Unreported, High Court Christchurch, Tipping J, 9 November 1994, CP No. 398/93)* endorses the control test, if there had been control by Hewat of the demolition contract then personal duty of care would have been established.

*Laughland & Laugland v Stevenson (Unreported, High Court Auckland, Hillyer J, 17 March 1995 CP 1114/91)* applies *Trevor Ivory Limited*. It holds that there was nothing special here such that there was an assumption of responsibility by Stevenson, no duty of care owed.

*Frost v McLean (Unreported, High Court Auckland, Gendall J, 23 October 2001, AP184/01)*. This decision held that the builder took control over the construction process, and a duty of care was imposed upon him.

*Wilbow Corporation (NZ) Limited v Harrison Grierson Consultants Limited & Ors (Unreported, High Court Auckland, Venning J, 7 May 2003, CP 461/98)*. This was a review of a strike out order made by a Master at first instance. The Court had to consider whether the Third Defendant, as an employee of Consultant Engineers being the First Defendant, owed a duty of care to the Plaintiff. Applied *Trevor Ivory Limited*, and held there needs to be a personal assumption of responsibility by employee so as to create a special relationship such that there was a duty of care owed. This was in the context of negligent misstatement. Need to apply objective test. It holds (looking at the statement of claim), that no facts pleaded such that would impose this special relationship between plaintiff and the Third Defendant. The Third Defendant was an employee of the consultant engineers.

At paragraph 5 Venning J states:-

*“There is nothing in the facts pleaded to suggest that the third defendant was acting in any capacity other than as an employee of the first defendant or to suggest any personal assumption of responsibility by him to the plaintiff when responding to the plaintiff’s questions.”*

*Carter v Auckland City Council & Ors* (Unreported, High Court Auckland, Christiansen AJ, and 29 September 2004 CIV 2004-404-2192) is a High Court decision that follows closely *Morton*. The Associate Judge was comfortable piercing the corporate veil. At paragraph 30 he states:-

*“Undoubtedly employers can be held vicariously liable for the actions of their employees but that does not mean that employed builders cannot separately attract a duty of care to third parties.”* And then it quotes *Morton*. This is a decision that limits *Trevor Ivory Ltd* to a negligent misstatement case, it follows the view of *Neil Campbell* in his article. However, its importance should be kept in context. It is a judgment of an Associate Judge on a Summary Judgment application by a Defendant.

*Rolls-Royce New Zealand Limited v Carter Holt Harvey Limited & Anor [2005] 1 NZLR 324* was again a strike out application. The claim against Roll Royce was that it failed to take reasonable care to perform its contractual obligations under the Turnkey Contract.

This case analyses closely the two pronged *Anns test* that must be applied in terms of establishing that there was a duty of care owed. The first part of that test was proximity, and the strongest argument as to whether there was sufficient proximity, was the test of foreseeability. But the very close contractual nexus that points towards there being a strong reader on the foreseeability test also works against the proximity question, in that the contract had clearly set out how risk for

defective work was to be allocated between the parties. This factor applied as a policy reason in stage two of the test in negating a duty of care being applied.

The strike out application was successful except the claim based upon negligent misstatement being a *Hedley Byrne* type claim. Although the statement of claim had to be repleaded.

*Body Corporate No. 187947 & Anor v EP Maddren & Sons Limited & Ors (Unreported, High Court Auckland, Hansen J, 13 May 2005 CIV 2004-404-1149)*. Hansen J was not prepared to limit *Trevor Ivory Limited* to negligent misstatement cases only, he saw it as having general application, and then went on to list a long line of building cases that had applied it.

There was affidavit evidence adduced by the site foreman to the effect that Mr Manning had attended site meetings, and in particular at one prior to the application of the cladding material being Eterpan, Mr Manning had insisted that no control joints be installed because he thought this detracted from the physical appearance. The technical literature had specified horizontal and vertical control joints but this was overruled by Mr Manning. This was critical evidence as the Plaintiff's expert gave evidence to the effect that the lack of horizontal control joints had resulted in uncontrolled cracking of the Eterpan cladding.

Hansen J ruled that the facts and matters pleaded in paragraph 26 (as supported by the affidavit evidence) provided a sufficient basis for the matter to proceed to trial. At paragraph 18 he states:-

*"[18] These, it seems to me, are circumstances which clearly suggest an assumption of responsibility sufficient to found personal liability. They are not dissimilar to those in which a duty of care by directors was found to arise in Morton v Douglas Houses Limited [1984] 2 NZLR548 where directors of a company which developed residential units and who failed to follow expert advice*

*in their construction were held to be personally liable to subsequent purchasers for the damage which resulted. In Ivory Cooke P said that on the particular facts of Morton, he was content to accept that there had been an assumption of responsibility (at p 523).*

The strike out/summary judgment application of Manning was unsuccessful.

*Young v Holden & Ors (Unreported, High Court Auckland, Gendall AJ, 9 November 2007, CIV 2006-404-6989)* concerned a summary judgment application brought by the First Defendant who was a director and shareholder in Conrad Properties 1998 Limited. He was one of two directors in the now liquidated company.

It was argued that the First Defendant was not the developer, and at no time acted otherwise than as one of the two directors of Conrad, the development company. It was also argued that the settlement done with Conrad released the First Defendant as well. It was also argued that the Fair Trading Act cause of action was untenable.

It was ruled by Gendall AJ that Conrad was the developer rather than the First Defendant. He then turned to the assumption of responsibility argument. It was held that there was no evidence before the Court that the first defendant had any involvement in the building or design work which is alleged to have given rise to the plaintiff's loss and therefore the plaintiff was unable to establish any assumption of personal responsibility on the part of the first defendant.

*Body Corporate No. 199348 & Ors v GCO Nielsen (Unreported, High Court Auckland, 3 December 2008, CIV 2004-404-3989).* This was a claim effectively argued by Council against Nielsen who was a director of companies involved in the development and construction of the units.

Heath J at paragraph 61 made findings as to Mr Nielsen's role on the construction site. He was the director of the development company, with primary responsibility for supervising construction work, coordinating the subtrades and making sure the work was carried out in accordance with the approved plans and specifications. He would attend on site for 1-2 hours per day. He would provide instructions for that day's work to Mr Scarrott, who would then take responsibility for implementing them. Where there were construction problems on site, Nielsen spoke to the subcontractor concerned, and would provide direction on what should be done.

At paragraph 75 Heath J states:-

*"Mr Greg Nielsen., on the facts I have found, was intimately involved in the project, was responsible for giving day to day instructions on work to be undertaken, was instrumental in arranging for Mr Scarrott to have appropriate trades on site at relevant times and had an involvement in important decisions affecting the value of the completed units. He was also responsible for reporting to Mr Whitney on practical completion had been complete".*

Heath follows the decisions of *Morton*, *Balemi* and *Leuschke*, and although he considers *Trevor Ivory Limited* as problematic, he says that *Nielsen* fits the analysis of assumption of personal responsibility.

He thinks a favorable way of viewing *Trevor Ivory Ltd* is like *Venning J* did in *Byron Ave*, simply a scenario of an employee committing torts for which an employer is liable for.

*Offord v Patel & Ors (Unreported, WHT, Adjudicator Lockhart QC, 5 December 2008, TRI 2007-100-000038)* was a Tribunal decision. Patel admitted occupying the project manager role. It was alleged that Rite Price was builder and developer of the houses, but that Patel was a second developer of the house.

Lockhart whilst considering the competing authorities of *Trevor Ivory Ltd* and *Morton*, found support for the *Morton* approach in *Taylor, Leuschke* and *Hartley*. At paragraph 39 he finds:-

*"[39] The Tribunal is satisfied that the first respondent, Mr Patel, undertook a major part in the selecting of subcontractors and overseeing of their work, and was also instrumental in making changes to the plans prepared by the architects, and was present most days in managing site work. Accordingly, it is held that not only was he the project manager but he was also, together with Rite Price Construction Limited, a developer of the property."*

*McNamara & Anor v Malcolm J Lusby Limited & Ors (Unreported, High Court Auckland, Robinson AJ, 10 September 2009, CIV 2006-404-002967)* concerned the personal liability of David Chapman who was a consultant to the development company. This was a summary judgment application brought by him as to his personal liability.

The Court was quick to apply *Morton* and indeed in applying *Morton* said at paragraph 12:-

*"As held by Hardie-Boys in Morton and cited with approval by Harrison J in Body Corporate No. 188273 & Ors v Leuschke Group Architects Ltd, paragraphs 58-60, person in the position of the eighteenth defendant when exercising personal control over the construction of a house being built for sale at a profit owe a duty of care to the purchaser."*

Whilst it was generally argued by Chapman that he was more an accountant for the developing company, there was plenty of oral and documentary evidence that conflicted with Chapman's assertions, showing that he was heavily involved in the construction process. There was even evidence of him drawing a parapet detail for the property in question. The mere fact that there was conflicting evidence was enough to render the summary judgment application redundant.