

## RECOVERY UNDER CONTRACT WORKS INSURANCE FOR MAJOR ROAD AND PAVEMENT FAILURES

**Recovery under contract works policies can provide fertile ground for dispute, particularly when property is allegedly damaged in consequence of defective workmanship, material or design.**

The question which most commonly arises in the construction of exclusion clauses in relation to defective workmanship or design, is the extent to which the reference to Property Insured is a reference to the whole of the property in which the defect manifests or whether it is permissible to make a division between the “Property Insured” and “other Property Insured which is free of a defective condition”, so as to enliven commonly encountered proviso’s or ‘carve outs’ to the exclusion.

Insurance claims relating to road and pavement failures in major infrastructure projects have provided particular challenges for courts called upon to consider the extent of policy response.

### The Australian Authorities

In Australia, there are two well known cases which consider this issue, but in the context other than a road or pavement failure. The first is a case of *Graham Evans & Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd* [1986] 4 ANZ Ins Cas 60-869. In that case the building required three coats of paint and, after a substantial part of its exterior had been painted with three coats, the paint work began to flake from it.

The plaintiff, as a responsible building company, had to strip a considerable amount of the paint work with a view to large areas being repainted. The evidence established that the primary cause of the problem was that the primer coat had been applied in too dilute a form and it had, therefore, failed to achieve adequate adhesion to the concrete surface of the walls and an adequate cohesion within itself.

In consequence, the other two coats were prevented from adhering to the walls of the building. The plaintiff claimed under the policy. In this case, noting that impugned workmanship could only relate to the preparation and/or application of the primer coat, Foster J held that the exclusion clause did not apply to the loss or damage claim in respect of loss or damage occurring to the second or third coats of paint.

In the subsequent Australian case which considered a similar issue, *Walker Civil Engineering v Sun Alliance*

*& London Insurance Plc* [1996] 9 ANZ Ins Cas 61-311, Rolfe J, interpreted Foster J’s decision in the *Graham Evans* case to be based upon His Honour’s findings that whilst the three coats of paint were necessary to establish a finished painted surface, only the first coat was defective and that lack of quality in it caused damage to the second and third coats. Rolfe J thought His Honour’s reasoning to be that each of the second and third coats had a function to perform which was independent of that to be performed by the first coat, notwithstanding that all coats were necessary to bring about the finished result.

This enabled Rolfe J to distinguish the facts of that case from those in *Walker*, where the concrete (the subject of the claim) had no other function to perform other than to stabilise fibreglass tanks which were found to be defective. The Court of Appeal in that case went on to find that the reference to “part” was not a reference to a part such as a tank or a gasket but rather a reference to that part of the work being carried out by the claimant, and that it was not appropriate to look separately at the tanks as a distinct item of loss but rather to look at the sewerage pumping stations as a whole.

### The London Market Defect Exclusions

The “Walker” line of reasoning seemed to be finding favour in the United Kingdom as evidenced by comments made by the Judge in the case of *Skanska Construction Ltd v Egger* [2003] EWCA Civ 310. That case considered a policy containing a DE3 exclusion clause, which is an increasingly common exclusion contained in policy wordings, particularly those emanating from the London Market. By way of background, the current DE clauses were introduced in 1995 by a committee of leading building and civil engineering underwriters which revised the originals. They provide different levels of cover from 1 to 5.





DE3 (1995): Limited defective condition exclusion provides:

*“This policy excludes loss of or damage to and the cost necessary to replace repair or rectify:*

- (i) Property insured which is in a defective condition due to a defect in design plan specification materials or workmanship of such property insured or any part thereof;*
- (ii) Property insured lost or damaged to enable the replacement repair or rectification of Property insured excluded by (i) above.*

*Exclusion (i) above shall not apply to other Property insured which is free of the defective condition but is damaged in consequence thereof.*

*For the purpose of the Policy and not merely this Exclusion the Property insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property insured or any part thereof.”*

In general terms a DE3 exclusion permits cover for damage to other property which is free of the defective condition and is damaged in consequence of the defect, but excludes damage to the defective property itself and any other property which is damaged to enable the replacement/repair to take place.

It is also worth noting the “clarifying rider” which appears as a final paragraph of that clause, and which is sometimes not well understood.

It is provided in the Insurance Institute of London Construction Insurance Advanced Study Group Report 208B at page 164 as follows:

*“Additionally, a clarifying rider has been added to the end of all clauses (other than DE1) to remove any question of contention that defective property is per se ‘lost or damaged’ property or that property which contains a defect is therefore ‘lost or damaged’.”*

In the case of *C A Blackwell (Contractors) Ltd v Gerling Allegeeie Verisherungsag* [2008] 1 All ER (Comm) 885, the Court was referred to the report by the Advanced Study Group of the Institute of Insurance (which gives a history of the defect exclusion clauses). While finding the report “*instructive*” as to the purpose of defect exclusion clauses and how they have evolved, the Court found that it could not be used as an aid to construction of the clause in question, which had to be construed according to its terms. The Court concluded that the intention of those who drafted it and other similar clauses is neither relevant nor admissible.

### The UK Authorities

The case of *Skanska Construction Ltd v Egger* [2003] EWCA Civ 310 concerned a floor slab which was completed at the end of October 1997 and shortly thereafter cracks were noticed. Temporary repairs to the slab were made between October 1997 and November

1998, by which time it was clear that the slab would have to be completely replaced.

In that case the judge concluded that the DE3 exclusion would exclude cover for damage to the floor. The judge concluded that the phrase “*loss and damage*” could not extend to rectification of the defects in themselves.

It is worthwhile to repeat verbatim what appears at paragraph 33 of the Court of Appeal judgment:

33. *“It was, faintly, argued, before us for the first time, that one of the respondents pleaded particulars of causation would lend itself to an argument that one part of the Works collapsed and damaged another.... The argument relates to one plea....of failure by the appellants ‘to sufficiently compact the sub-base material underneath the slab with the sub base having a typical air void content greater than 15%’. It was suggested, on that basis, that one part (the sub base) collapsed and damaged another part (the slab above it). That argument was not only not raised below, it attempts to divide the indivisible ... I see no prospect of any court accepting that the sub-base ‘damaged’ the [rest of the] slab above it within the meaning of clause 22(2)”.* [author emphasis]

Two more recent decisions in the UK have however, been determined very much in favour of the insured’s position having regard to the operation of a DE3 exclusion.

The first case is that of *Seele Austria GMBH & Co KG v Tokio Marine Europe Insurance Ltd* [2008] All ER(D) 68. That case concerned a claim brought against a contract works insurer in relation to damage to windows. Comments made by the Court of Appeal in relation to the wording contained within the DE3 exclusion are significant and are repeated below:

50. .... *The precise point at which a line is to be drawn between ‘insured property (a)’ which is in a defective condition and ‘other Insured Property’ which is free of the defective condition may be difficult to identify in some cases, particularly where the work being carried out by a single sub-contractor is of a complex nature. However, I think the intention behind the rider was to provide cover in respect of damage accidentally caused in consequence of the defects to parts of the work which in commercial terms are to be regarded as separate and distinct from that part in which the defect exists. For this reason it is not right, in my view, to regard the whole façade as a single item of property for this purpose. In commercial terms, the plasterboard ceilings and the external cladding are each to be regarded as separate items of property...”.*

While that case is instructive, and demonstrates a willingness of the courts to make a division between the “*Property Insured which is in a defective condition*” and “*other Property Insured which is free of the defective condition*”, it still does not answer the approach that a court would take in circumstances in the context of road or pavement construction where there are multiple

layers, some of which are alleged to be defective and others which are said to have been damaged in consequence of that defect.

That position, in the UK at least, appears to now be largely settled by decision of the Court of Appeal in *C A Blackwell (Contractors) Ltd v Gerling Allgemeine Verischerungs AG* [2008] 1 All ER (Comm) 885.

That case considered the operation of the DE3 exclusion in the context of a contract to complete earthworks in the construction of part of a motorway.

After the initial earthworks comprising of basic cuttings or embankments, the road was to be constructed of three layers. These were:

- (i) The sub-formation;
- (ii) The formation, which involved the spreading of imported material known as “capping”; and
- (iii) The laying of asphalt layers, which was the responsibility of the main contractor.

The Court of Appeal held that “*Property Insured*” meant that part of the works which had suffered damage. If that part was wholly or partly defective, the exclusion applied. In that case, the Court said that there was nothing defective about the sub-formation so that part of the works was not defective; nor was there anything intrinsically defective about the condition of the capping (save for a possible issue not herein relevant).

At paragraph 16 the Court of Appeal said:

*“... it is I think important to construe the exclusion clause without regard to its application to the facts of this case. Its purpose is clear. It prevents the insurer from having to pay for the replacement, repair or rectification of property which was already in a defective condition at the time the fortuity covered by the policy occurred. If the defect is one of design, plan, specification, materials or workmanship the property would have to be repaired, etc by the contractor or others in any event.”*

17. *“What is important to note is that the exclusion is not of loss or damage caused by defect in workmanship, etc. The cause of the loss or damage is irrelevant. Provided the insurer can show that the property was in a defective condition the exclusion applies... All this is, I think, self-evident from the wording of the exclusion. What is more difficult is to discern how wide the words ‘Property Insured’ are intended to be.”*

It was submitted by the insurer's counsel that that expression had a very wide meaning and that one should not attempt to “*divide the indivisible*”. That counsel also referred the Court to the two cases previously mentioned of *Walker Civil Engineering*, and *Skanska Construction*. In relation to this the Court of Appeal said:

21. *“... [the Walker clause] ... was a clause which, unlike the DE3 clause, excluded liability for damage caused by the defect. The Court held that ‘part’ did not refer to a part such as a tank, it referred to the part of the*

*work being carried out by the contractor. I do not see how this aids the construction of the DE3 clause. Nor do I gain any assistance from the other case relied on ... [Skanska Construction], which was concerned with the contractor’s obligation to insured, assumed in its contract with the employer.”*

The Court of Appeal continued:

22. *“So, returning to the wording of the clause in this case, the first thing to note is that it draws a distinction between ‘Property Insured or any party thereof’ and ‘other Property Insured’. This suggests, and indeed requires, divisibility. Division is easy in some cases. The Institute report gives the example of a steel framed building with its roof, cladding and dwarf brick walls completed which collapses because the nuts and bolts used in the construction of the steel framework are defective. Under the DE3 wording, damage to the steel framework is excluded but damage to the roof, cladding and dwarf brick walls is covered. I agree that this is the effect of the clause in that sort of case. By analogy, one might argue in this case, that the Property Insured refers to the entirety of the earthworks. That cannot be what was intended by this wording. I think it must be restricted to that part of the works which has suffered damage. If that part is wholly or partly defective the exclusion applies.”*



The Court went on to conclude:

24. *“So how should one apply the exclusion construed in this way to the facts of this case? There was nothing defective about the sub-formation so that part of the works was not defective; nor was there anything intrinsically defective about the condition of the capping...”*
25. *“But the failure, if there was one, to implement other measures which were designed to protect the capping such as the use of punts and bowzers and the means to channel and dispose of the water on the verges, cannot be characterised as a defect in the condition of the capping... If I am wrong about this and one can characterise the works contemplated by these measures as Property Insured and the failure to carry them out made it defective, I would distinguish, as the Judge did, between this property and the capping and sub-formation (other property), so that the exclusion does not apply because of the limitation.”*

## Conclusion

If it is established that the contract works policy potentially responds to the damage sustained, then a DE3 exclusion may permit cover for damage to other property which is free of the defective condition and is damaged in consequence of the defect. On the basis of the English Court of Appeal authority, the Court is likely to regard as being divisible, the separate layers said to comprise the pavement, but will exclude damage to the defective property itself and any other property which is damaged to enable the replacement/repair to take place.

The writer considers that the distinction is more readily able to be made when the defect arises as a result of faulty construction rather than design, although the cases do not necessarily make that distinction.

The recent decisions in relation to the operation of an exclusion clause in the form of DE3, can be contrasted with the decision of the New South Wales Court of Appeal in *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd [2006] NSWCA 356*, which was an appeal from the decision of *McDougal J Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd [2004] 2 ALR 267*.

In relation to the willingness of the courts to make a distinction between the separate layers of the pavement, the Judge at first instance (McDougal J) said [at 223]:

*"The present claim is, precisely, one for the cost of rectifying Insured Property – **the pavement** [author emphasis] in which there was, or that was affected by, defective workmanship."*

It can be seen from his Honour's comments, that he treated the pavement itself, rather than its constituent layers, as Insured Property for the purpose of construing the exclusion in that case.

The clause under consideration in that case was not in terms of the DE 3 exclusion which was considered by the English Court of Appeal in *Gerling* which drew a distinction between "*Property Insured*" or "*other Property Insured*" which the Court said "*suggest, and indeed required, divisibility*"

The claim against the insurer at first instance failed in *Rickard* because the Judge said that the onus was on the insured to prove:

- 1 what is the loss or damage caused directly by the defective workmanship;
- 2 what are the "costs" of that loss or damage;
- 3 what would have been necessary to rectify that defective workmanship immediately prior to the collapse of the pavement; and
- 4 what costs would have been incurred on that rectification.

The Judge found that there was no evidence of "*the costs of loss or damage caused directly*" by the defective workmanship and that the insured had not proved the other matters set out above.

It can therefore be observed that potential policy response may be largely determined by the precise nature and wording of the exclusion clause in relation to defective workmanship and design contained within the policy. A close consideration of those exclusions may therefore be essential to understand whether road or pavement failure in any given project, is an insured or uninsured risk.

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