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CONTRACT WORKS INSURANCE: STAINLESS STEEL PIPING FAILURES

Having recently considered contract works policy response with respect to road failures and scratched glass, stainless steel pipe failures come under the microscope this month.

Introduction

A number of claims have been encountered with respect to deterioration and failures of welds and joints in stainless steel piping. Often times, a deterioration in the piping itself is observed and the occurrence of 'pin holes' noted.

Failures of this nature lead to a number of issues when considering whether a contract works policy is likely to respond (in whole or in part) to reinstate the damage either to the pipework itself or damage which may be occasioned in consequence thereof.

A preliminary question may be whether the pipe failure satisfies the definition of 'damage' under the policy.

Often times, insurers will have a valid basis to decline indemnity under their contract works policy, on the basis that the damage resulted from an error in design and/or the failure or non-performance of design and/or specification and/or a fault, defect, error or omission in material and workmanship. A specific exclusion in relation to corrosion or gradual deterioration may also fall for consideration

The following article further elaborates on these issues in considering what the likely scope for policy response will be, in these particular scenarios.

Policy Response - Is there "damage"?

Stainless steel pipework often develops leaks due to failures caused by corrosion over a period of time.

Often the only "damage" sustained is to the welds to pipework itself. Whether or not a contract works policy will ever, prima facie respond, may well be dependant upon the nature of the failure.

For example, the piping itself may have suffered corrosion (sometimes as a result of water containing chlorides not being flushed out fully after hydrostatic testing) leading to 'pin holes'. Alternatively the reason for the failure might be the use of a lower grade of stainless steel than was required (either because of a design error or materials supply error). Leaking frequently occurs at the welds or at zones adjacent to the welds. A failure to correctly pickle the welds (generally a workmanship issue) can lead to heavy oxidisation and pitting corrosion.

The first point often to consider, is whether there has been 'physical loss, damage or destruction' to the Interest Insured. An insuring clause in these terms requires something more than damage, it requires physical damage. In the case of *Lewis & Emanuel & Son Ltd & Anor v Hepburn* [1960] 1 Lloyd's Rep 304, Pearson J concluded that the word "*physical*" qualified, not only "*loss*" but also "*damage*".

In the decision in the New South Wales Court of Appeal in *Transfield Constructions Pty Ltd v GIO Australia Holdings Pty Limited* [1997] 9 ANZ Ins Cas 61-336 the Court considered what was meant by the expression "*physical damage*", concluding that "*functional utility is different from physical damage*".

English cases have drawn a distinction between property which is damaged and that which is merely defective at the moment of its creation (*Bacardi v Thomas Hardy Packaging* [2002] 2 Lloyds Rep 379.). If pinhole leaks emanate from the welds, it may accordingly be arguable that the welds were defective at the moment of their creation. Further if pinpoints of corrosion exist from inception, it is unlikely that they would be regarded as constituting "*physical damage*" to the piping.

In the case of *Pilkington v CGU Insurance* [2004] BLR 97, Potter LJ said at 107:

> *"Damage requires some altered state…It will not extend to a position where a commodity supplied is installed in or juxtaposed with the property of a third party in circumstances where it does no physical harm, and the harmful effect of any later defect or deterioration is contained within it".*

The particular circumstance of pinhole damage has been referred to in the case of *Steel Austria GmbH & Co KG v. Tokio Marine Europe Insurance Limited* [2009] 1 All E.R. (Comm) which concerned the case of rectification of defective windows in an office development. Pinholes had been created in the sealing membrane of the windows by welding carried out

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by contractors on site. Moore-Bick LJ, at para [48] considered that the pinholes did not constitute damage to the works but rather "*I think that is properly to be regarded as part and parcel of inherently faulty workmanship".*

There is an alternative argument, that if the pinholes have arisen through some subsequent action within the pipe (such as water containing chlorides not being completely flushed out), so that at an earlier point in time, the piping had in fact been free of these pin holes, then the definition of "physical damage" may be satisfied.

In that instance the leaks in the pipe may be evidence of damage to that pipe, and there would clearly have been some form of "physical alteration or change" to the pipe so as to satisfy the ordinary meaning of the word "damage", as held by a court in a case of *Ranicar v Frigmobile* [1983] 2 ANZ Ins Cas 60-525.

A similar question needs to be asked in relation to the welds. As has been observed, UK authorities have drawn a distinction between property which is damaged and that which is merely "defective at the moment of its creation".

While it may be sometimes arguable that welds may be defective at the moment of their creation, in the Queensland case of *Prime Infrastructure (DBCT) Management Pty Ltd v Vero Insurance Ltd* [2005] QCA 369, the appellants contended that faulty workmanship in the weld was not itself damage to the insured property (so that there could have been no subsequent damage when a reclaimer collapsed). The Queensland Court of Appeal rejected that argument, holding that the faulty weld impaired the value or usefulness of the reclaimer because it weakened it and rendered it more prone to collapse, and more likely to damage other adjacent machinery in the collapse process.

Accordingly, in relation to both to leaks at the welds, and those which may appear adjacent thereto, the breach in the pipe's physical integrity (as evidenced by the leaks) may in certain circumstances satisfy the definition of "physical damage" to the contract works.

The Exclusions

Defective workmanship, material or design

There are a number of different wordings which may be encountered when analysing exclusions in relation to defects in workmanship, material or design.

From an insured's perspective, an exclusion in the form of LEG 3, which, by its operation provides cover under a policy for both defective and non defective property that has been damaged but excludes betterment (ie costs incurred to improve the original material, workmanship, design, plan or specification) is likely to afford the most favourable outcome (subject to the impact of any other exclusions and always subject to the particular circumstances).

An exclusion in terms of LEG 2, on the other hand, (the model "consequences" defects exclusion which affords so called "resultant damage" cover), operates so that while the defect itself is not covered, the subsequent immediate damage is. The intention remains not to pay for those costs associated with the rectification of the defect and the wording says that the costs that would have been incurred in rectifying the defect are excluded.

When considering the operation of an exclusion in terms of LEG 2, if it is concluded that the cause of a pipe failure is defective design, workmanship and/or materials, the costs necessary by the defect will be the costs of having to replace the damaged piping, and these costs will be excluded.

Exclusions are also often encountered in like terms to those which arose for consideration by the New South Wales Court of Appeal in the case of *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd [*2006] NSWCA 356. It would seem likely that an insured in the scenario considered above would be presented with the same difficulty encountered by the insured in that case, being that there was not "*a costs B*", or at least none which might be established.

So called "write backs" to exclusions of this nature have also been considered by the courts. In *BC Rail Ltd v American Home Insurance Co* [1991] 79 DLR (4th) 729, a British Columbia Court of Appeal case, the insured argued that even if the design of the embankment was defective, the resulting damage was covered by the write back which stated that damage resulting from the defective design was covered. The insurers argued that the write back did not apply to damage to the very item which had been defectively designed: otherwise the exclusion was neutered by the write back. The court agreed with the insurers and made reference to the case of *Bird Construction v United States Fire Insurance* (1985) in which it was stated:

> *"The reason for the exclusion in the contract is to make it perfectly clear that the insurer will not be liable for indemnifying the insured for loss or costs incurred by the insured's faulty workmanship, or as a result of the use of faulty material. The exception to the exclusion is damage "resulting from" the faulty workmanship. That is in my opinion, a reference to something different than the cost of repairing the faulty work".*

Wear & Tear / Corrosion

Contract works policies also usually contain an exclusion in relation to the cost of rectifying rust, corrosion "*or other gradual deterioration*".

Although the expression "*corrosion*" usually appears as one of a number of enumerated items in the exclusion, the linking words "… *or other*…" which precede "*gradual deterioration*" may qualify the matters which immediately precede it (See for

example: *Underwriters at Lloyd's London v SMI Realty Management Corp* – No. 06-0016, from the First Court of Appeals, Texas No 01-03-01340-CV). The question that this then raises is what constitutes "*gradual*". As was observed by Jerrard JA in his minority judgment in the Queensland Court of Appeal case of *Prime Infrastructure (DBCT) Management Pty Ltd v Vero Insurance Ltd* [2005] QCA 369, rust or oxidisation or corrosion would be likely to lead, almost by definition, to a gradual deterioration in the Property Insured.

It is often unclear over what period of time pinholes may have manifested. There may accordingly be a question of whether there has been a sufficient period of time to satisfy the definition "*gradual deterioration*".

Guidance in this regard may be found in a consideration of what might be regarded as "sudden" in the context of other exclusions. If something occurred over some weeks to many months, is unlikely that that would be regarded as being sudden.

In the ACT Supreme Court decision of *Vee H Aviation (Pty) Ltd v Australian Aviation Underwriting Pool (Pty) Ltd* [1996] ACTSC 123, it was said by the Court [at 31] *"Sudden to my mind, is to be contrasted with gradual."* That case was cited with approval by the Supreme Court of Appeal of the Republic of South Africa in *African Products (Pty) Ltd v AIG South Africa Limited* [2009] ZASCA 27, in which the Court concluded at [25] that *"…The physical damage to the cables was …not sudden. It is the manifestation of the damage that was sudden and not the actual damage, which had occurred over a lengthy period of time as observed by* [the relevant expert]".

An exclusion in these terms is often also limited to the "part immediately affected" and is said not apply to any other parts sustaining damage. Such an expression was considered by the Australian Courts in a case of *Walker Civil Engineering v Sun Alliance and London Insurance Plc* [1998] 10 ANZ INS CAS 61-418. In that case, Sheppard AJA, who delivered the leading judgement of the NSW Court of Appeal said as follows [at 74, 693]:

> *"Here the parts which were defective were the fibreglass tanks. No other part was defective. Their defectiveness, for which it is acknowledged no claim can be made, led to the need, not only to replace the tanks, but also to remove the complex of equipment installed within them and to break up much of the concrete placed around the tanks in order to keep them stable … It is important, I think, to reach a conclusion on the meaning of the words "part" and "any other part or parts" where used in the limitation to the exclusion clause. In my opinion "part" is not a reference to a part such as a tank or a gasket; it is a reference to a part of the work being carried out by the appellant … The natural meaning of the word "part" in those circumstances is that it refers to the part of the works which, being defective, have been productive of loss or damage … The words "loss or damage" in the exclusion should receive the same wide interpretation that should be accorded to the same words in the insuring clause subject only to the requirement that it be "directly caused" by defective workmanship … In my opinion the loss or damage suffered by the appellant as a result of having to remove the tanks because of their defectiveness was all "directly caused" by the need to replace them."*

Sheppard AJA went on to say [at 74, 693]:

> *"On that view the loss and damage suffered by the appellant in the present case would all be within the exclusion. The critical question is whether the words of the limitation to the exclusion make any difference. It operates to limit the exclusion to the part of the works (on the construction which I have given to the word "part") which is defective. It does not apply to any other part or parts … lost or damaged in consequence of the defective workmanship, construction or design.*
>
> *The question then arises as to what the part of the work which was defective involves. In my opinion, it was the part of the works which involved the construction of the three sewerage pumping stations. It is perfectly true that the complex of equipment installed within the tanks was not defective, but the entirety of that part of the work was of no use once it was found that the tanks were admitting water. That made the whole of that part of the work defective."*

Accordingly, this could leave open to insurers an argument that if the loss or damage to the pipes was due to corrosion (being regarded as a gradual deterioration), then the entire pipe is of no use and that therefore, there is no scope for the operation of the proviso. This would be particularly so if the corrosion was affecting all of the pipe work. It should be noted however that in *Promet Engineering (Singapore) Pty Ltd v Sturge (The Nukula)* [1997] 2 Lloyd's Rep 146 (albeit a UK authority) in which the court was requested to consider whether a defective part, in that case the weld, had caused damage. Hobhouse LJ said:

> *"A submission based upon the use of the word "part" is in my judgment open to …objections. It leads to absurd results. It provides no criterion for distinguishing between what is and what is not damaged…".*

Conclusion

There are a multitude of issues which can impact upon recovery under contract works insurance with respect to stainless steel piping failures. In addition to matters considered above, the first point in time at which damage could be said to have manifested may be critical, as might a consideration of whether such

damage could be said to be "*sudden and unexpected or unforseen*". Assuming all of the primary indemnity triggers are satisfied, there remain likely difficulties for an insured in demonstrating policy response in the face of a number of exclusions, including those considered above. In the absence of some form of resultant damage quite removed from that sustained to the pipe work itself in most instances, it would appear that loss of this nature is more likely than not to be uninsured.

Update:

s54 and s40(3)of the Insurance Contracts Act 1984 (Cth)

In February's *Constructive Notes*®, s54 and s40(3)of the *Insurance Contracts Act 1984* (Cth) were examined in some detail with respect to the operation of these sections as they related to so called "claims made and notified" professional indemnity policies of insurance.

It was noted in conclusion, that as a result of the decision of the High Court in *FAI General Insurance Company Ltd v Australian Hospital Care Pty Ltd* (2001) 204 CLR 641 an insured can avail itself of s54 to excuse a failure to notify circumstances which could give rise to a claim outside of the policy period. Subsequent cases by lower courts have however sought to confine the effect of that decision to situations where the policy of insurance contains a deeming provision in terms similar to that contained in s40(3).

It was further noted that in February 2007, a draft reform package was released by the Commonwealth Treasury Department with a view to an overhaul of the *Insurance Contracts Act 1984* (Cth), including provisions directed to ameliorating the consequences of the *Australian Hospital Care* decision.

The effect of the proposed provisions, if they had subsequently been made law, would have been to have precluded an insured relying on s54 where it had failed to notify circumstances which could have given rise to a claim, either prior to the expiration of the policy of insurance or within a 28 day period of grace provided for.

Since the publication of February's Constructive Notes, the *Insurance Contracts Amendment Bill 2010* was introduced into Parliament on 17 March 2010.

Somewhat surprisingly, (given that one of the drivers for the review of the Act in the first place was to address the operation of s54 in particular circumstances), the proposed insertion of S54A and the amendments to s40 has been omitted from the Bill

Accordingly, s54 and s40 will remain unchanged, and the position will remain as per the authorities considered in February's newsletter.

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