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LAWYERS

A Legal Guide to Contract Works and Construction Liability Insurance in Australia



2nd edition

Patrick Mead

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NB: Due to the extensive nature of this publication and the pace of reforms and judicial consideration there may be an absence of reference to a recent case or some references to legislation and its provisions which are no longer current, yet proclaimed, amended or repealed. This publication attempts to draw out the most significant points in the relevant legislation. Whilst all care has been taken to ensure that the most up to date information has been included, not all cases or aspects of the legislation have been considered. The material contained in this publication is in the nature of general comment only, and neither purports nor is intended to be advice on any particular matter. No reader should act on the basis of any matter contained in this publication without considering and, if necessary, taking appropriate professional advice upon his or her own particular circumstance.

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Preface

This book has been prepared for insurers, their advisors, contractors and other professionals involved in the construction and engineering industry.

The aim of this book is to examine the issues arising from the interpretation of contract works and construction liability insurance policies by courts in Australia and the United Kingdom.

Each chapter explores different aspects of these policies through the use of case analysis and the judicial interpretation of policy wordings.

It is hoped it will afford the reader a greater understanding of the process of, and approach to, policy wordings by the courts through the detailed analysis contained herein.

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CONTRACT WORKS AND CONTRACTORS' ALL RISK POLICIES

Introduction

Contract works and contractors' all risk policies comprise a critical component of risk allocation under modern construction contracts, particularly major works. Of particular interest is where these policies cover more than one party to the project and whether, in those circumstances, an insurer which has paid out a claim is able to pursue a co-insured by way of a subrogated recovery action. In a similar vein, these policies often contain a cross liability/waiver of subrogation clause, which expressly prohibits an insurer from seeking recovery against a negligent co-insured under the policy.

Overseas authorities

In the last 25 years, there has been a series of cases in the United Kingdom, Canada and Australia in relation to the operation of contractors' all-risk policies, specifically the scope of coverage afforded to parties, the extent of the interest insured, and the ability of an insurer who has paid out a claim to be subrogated to the interests of the plaintiff, in an action against another party claiming to be entitled to the benefit of the insurance.

Petrofina

The most convenient starting point of the analysis is the decision of Lloyd J in *Petrofina (UK) Ltd v Magnaload Ltd*.¹

In that case, the plaintiffs (owners and operators of an oil refinery) contracted to have extensions undertaken. In the course of the construction of the extensions, the lifting of equipment was subcontracted to Magnaload, who, in turn, engaged Mammoet to provide specialist lifting equipment to lift the heaviest items. In the course of dismantling the equipment after the lifting had been successfully completed, part of the equipment fell to the ground causing extensive damage to the refinery.

The contract works were insured under a contractors' all-risks policy which defined the insured persons as, inter alia, the owners and contractors 'and/or subcontractors' and the insured property as 'the works and temporary works erected . . . in the performance of the . . . construction, erection and testing of an extension to [the refinery]'. The term 'subcontractor' was defined in the head contract as meaning:

¹ [1984] QB 127.

Any person to whom the preparation of any design, the supply of any plant or the execution of any part of the works is sub-contracted, irrespective of whether the contractor is in direct contract with such person.²

Although the policy also provided third-party liability cover, there was an exclusion relating to liability for third parties in respect of property forming part of the insured property, so that relevantly for present purposes there was only property insurance and not liability insurance.

The owners claimed under the insurance policy for physical damage to the contract works and, having settled the claim, the insurers sought to exercise their right of subrogation by suing the defendants on the grounds that they were negligent.

The defendants contended that they were subcontractors and therefore fully insured under the policy and that, accordingly, the insurer had no right of subrogation to exercise.

Lloyd J held that the word ‘subcontractors’ in the context of the policy must include sub-subcontractors as well as subcontractors and that, accordingly, both parties fell within the definition of ‘the insured’ under the policy.³ It should be noted that (a) it was conceded that Magnaload were subcontractors within the wording of the policy; and (b) it was found as a fact that Mammoet, the second defendant, was contemplated as a contractor during the initial stages of the project.

Lloyd J went on to hold that, on the ordinary meaning of the words, each of the named insured (including all the subcontractors) was insured in respect of the whole of the contract works. Relevantly, he thought that there were no words of severance to require him to hold that each of the named insured was insured only in respect of its own property.⁴ Correctly identifying the relevant portion of the policy as being one of property insurance only, Lloyd J then had to consider the basis upon which a subcontractor would be entitled to take the benefit of insurance in respect of works in which it had no proprietary interest. Noting that the subcontractor could not be regarded in any sense as a bailee of the property insured under the policy, his Honour nevertheless looked to the historical basis behind allowing bailees to insure for full value, concluding that, from a commercial point of view, it was always regarded as highly convenient. Lloyd J thought this consideration to be critical, stating:

² Ibid 133.

³ Ibid.

⁴ Ibid 134.

In the case of a building or engineering contract, where numerous different subcontractors may be engaged, there can be no doubt about the convenience from everybody's point of view, including, I would think, the insurers, of allowing the head contractor to take out a single policy covering the whole risk, that is to say covering all contractors and subcontractors in respect of loss of or damage to the entire contract works. Otherwise each subcontractor would be compelled to take out his own separate policy. This would mean, at the very least, extra paperwork; at worst it could lead to overlapping claims and cross-claims in the event of an accident. Furthermore . . . the cost of insuring his liability might, in the case of a small subcontractor, be uneconomic. The premium might be out of all proportion to the value of the subcontract. If the subcontractor had to insure his liability in respect of the entire works, he might well have to decline the contract.

For all these reasons I would hold that a head contractor ought to be able to insure the entire contract works in his own name and the name of all his subcontractors, just like a bailee or mortgagee, and that a subcontractor ought to be able to recover the whole of the loss insured, holding the excess over his own interest in trust for the others.⁵

The difficulty with Lloyd J's reasoning should become immediately apparent to those familiar with the underlying rationale of the bailee/bailor example. His Honour, with respect, clearly proceeded upon a false analogy insofar as he based his conclusion on an insurable interest relying on the principle that a bailee can insure the goods of his bailor, even though the bailee has mere possession of the goods as distinct from property in them. The bailee's ability to insure is based on a possessory interest (which itself affords the bailee rights recognised by law) and not on commercial convenience. Since a subcontractor has no title to, or possessory interest in, other property involved in a building project, it is difficult to see how it would have a sufficient interest in such property to found an insurable interest, at least based upon the traditional restrictive test in the United Kingdom.⁶

⁵ Ibid 136.

⁶ See *Macaura v Northern Assurance Co Ltd* [1925] AC 619.

Imperial Oil

Lloyd J, recognising that there was no English decision covering the present case, drew support from the decision of the Supreme Court of Canada in *Commonwealth Construction Co Ltd v Imperial Oil Ltd*⁷ for his finding that a subcontractor was entitled to insure the entire contract works and recover the full value of those works. The facts in that case were almost identical to those in *Petrofina*. Lloyd J repeated the main issue stated by the Supreme Court as follows:

*Did Commonwealth, in addition to its obvious interest in its own work, have an insurable interest in the entire project so that in principle the insurers were not entitled to subrogation against that firm for the reason that it was an assured with a pervasive interest in the whole of the works?*⁸

Having determined as a preliminary point that the policy of insurance in that instance was a policy of property insurance and not liability coverage, the court went on to consider whether Commonwealth had a ‘pervasive interest’ in the entire property. Evidently taking support from the bailment cases, the Supreme Court in that case concluded:

*On any construction site, and especially when the building being erected is a complex chemical plant, there is ever present the possibility of damage by one tradesman to the property of another and to the construction as a whole. Should this possibility become reality, the question of negligence in the absence of complete property coverage would have to be debated in Court. By recognising in all tradesmen an insurable interest based on that very real possibility, which itself has its source in the contractual arrangements opening the doors of the job site to the tradesmen, the Courts would apply to the construction field the principle expressed so long ago in the area of bailment. Thus all the parties whose joint efforts have one common goal, eg the completion of the construction, would be spared the necessity of fighting between themselves should an accident occur involving the possible responsibility of one of them.*⁹

⁷ (1976) 69 DLR (3d) 558. The court in this case would appear to have also failed to appreciate the distinction between the bailor/bailee cases, although it must be said, with less grave consequence, given the more expansive definition of insurable interest which the courts in that jurisdiction subsequently adopted.

⁸ Ibid 560.

⁹ Ibid 562-3.

The relevance of the Canadian court's embrace of this notion of 'pervasive interest' is in what was held to flow from it. Grandpre J stated that *'the several insureds must be considered as one'* and that therefore an action could not be brought by one assured against another. So it was for Lloyd J to consider whether the fact that the defendants were co-assureds under the policy defeated the insurers' ability to bring subrogated proceedings in the name of the 'innocent' co-assured against the 'negligent' co-assured.

In *Imperial Oil*, and in the American cases referred to therein, it was assumed that it followed automatically that the insurers could have no right of subrogation in these circumstances. In *Imperial Oil*, it was described as being a 'basic principle'. In one of the American cases, it was said that the rule of law preventing one co-assured from suing another was too well established to require citation.

Lloyd J noted that when the question had arisen in a previous decision in which he gave judgment, in *The Yasin*,¹⁰ he was not satisfied there was any such fundamental principle as had been suggested and he felt that the reason for the rule seemed to rest on ordinary principles of circuitry.¹¹ Noting that this idea had since been adopted by the editors of *MacGillivray and Parkington on Insurance Law*,¹² Lloyd J went on to abandon the distinction which he had previously drawn in *The Yasin* (where the bailee had insured, not its liability to the bailor, but the goods themselves) stating:

*Whatever be the reason why an insurer cannot sue one co-insured in the name of another (and I am still inclined to think that the reason is circuitry) it seems to me now that it must apply equally in every case of bailment, whether it is the goods which the bailee has insured, or his liability in respect of the goods. The same would also apply in the case of contractors and subcontractors engaged on a common enterprise under a building or engineering contract.*¹³

¹⁰ [1979] 2 Lloyd's Rep 45.

¹¹ *Petrofina (UK) Ltd v Magnaload Ltd* [1984] QB 127, 139.

¹² M. Parkinton, A. O'Dowd, A. Legh-Jones, A. Longmore and E. MacGillivray (eds), *MacGillivray and Parkington on Insurance Law* (7th ed, 1981) [1214].

¹³ *Petrofina (UK) Ltd v Magnaload Ltd* [1984] QB 127, 140.

Finally, although it was not necessary to decide the point, Lloyd J indicated agreement with an alternative argument by the defendants' counsel that, having regard to the head contractor's obligation under the main contract to take out insurance in the joint names of all parties, including the subcontractors, there was a contract implied between the plaintiffs and the defendants that the plaintiffs would not hold the defendants liable in the event of loss or damage to the contract works resulting from the defendants' negligence.¹⁴ The basis for this 'implied contract' was not made clear, although it clearly presupposes that the defendant is a true co-assured, otherwise the notion appears to be something akin to a defence of estoppel rather than a contractual principle.

Stone Vickers (first instance)

In England, the issue next arose for consideration in the case of *Stone Vickers Ltd v Appledore Ferguson Shipbuilders Ltd*,¹⁵ a decision of Mr Anthony Colman QC (as he then was), sitting as a Deputy Judge of the High Court. While this decision was overturned by the Court of Appeal, it is nonetheless worthy of consideration so that the Court of Appeal's decision, and the same judge's decision in the *National Oilwell* case,¹⁶ can be properly appreciated.

This case concerned a subcontract entered into between Stone Vickers and Appledore, whereby Stone Vickers agreed to supply a pitch propeller for a vessel pursuant to a subcontract with Appledore, which undertook to insure the vessel against certain losses. While there was no requirement under the subcontract for Stone Vickers to take out insurance itself in respect of any part of the contract works, the policies taken out by Appledore referred to the assured as including not just themselves, but also '*subcontractors as additional co-assured for their respective rights and interests without recourse against any co-assured*'.

The propeller supplied by Stone Vickers was found to be defective and certain modifications were carried out to it which remedied the problem. Stone Vickers claimed against Appledore for amounts due under the contract for the supply of the propeller and Appledore counter-claimed alleging losses comprising the cost of modifications to the propeller and associated costs.

¹⁴ Ibid 141.

¹⁵ [1991] 2 Lloyd's Rep 288.

¹⁶ *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582.

In its reply to the counterclaim, Stone Vickers submitted that Appledore's claim had been settled by insurers; that the underwriters were bringing subrogated proceedings in Appledore's name, and that the claims were being made against another assured, contrary to the 'without recourse' clause. Accordingly, since the plaintiff was a co-insured under the policy, it was alleged that such a claim must fail.

Colman QC held that it was unnecessary to be identified by name in the policy of insurance in order to be entitled to cover. Provided a party fell within the class referred to in the policy, cover was provided if there was an insurable interest, even if that party had not been identified by name to the underwriter.¹⁷

Colman QC then went on to consider the issue of the plaintiffs' interest in the subject matter of the insurance. The judge noted that, in both *Imperial Oil* and *Petrofina*, the court was concerned with a policy on goods, works and materials and with a subcontractor who undertook the performance of contract works on site. In both cases, the claims which were sought against the subcontractor were for damage negligently caused to property owned by other assureds, as distinct from the subcontractor's own property or property of which it had custody.¹⁸

Although Colman QC was satisfied that he should follow the reasoning of Lloyd J in *Petrofina*, he noted that the present case differed in one important respect in that it concerned the position of a party (Stone Vickers) who was not employed to conduct any construction work in a shipyard, but merely to fabricate on its own premises the propeller and ancillary equipment and to supply them to another party. The propeller, once it had been delivered, was presumably no longer owned by, or subject to, the custody or control of Stone Vickers.¹⁹ Accordingly, the issue arose as to whether it could be said that the supplier had an insurable interest in the whole of the contract works.²⁰

¹⁷ *Stone Vickers Ltd v Appledore Ferguson Shipbuilders Ltd* [1991] 2 Lloyd's Rep 288, 297 (It should be noted that s 20 of the *Insurance Contracts Act 1984* (Cth) would have the same effect in Australia).

¹⁸ *Ibid* 299-300.

¹⁹ *Ibid* 300.

²⁰ *Ibid* 301.

The approach which Colman QC considered accurately reflected the reasoning in *Imperial Oil* and *Petrofina* was to ask whether the supplier of a part installed in the vessel or contract works under construction might be materially adversely affected by loss of, or damage to, the vessel or other works, by reason of the incidence of any of the perils insured against by the policy in question. Colman QC considered that, when it came to the supplier under a subcontract of a major part of the vessel, the failure of which may render that supplier liable for damage to the vessel beyond mere replacement of the defective part, there was no material difference between the position of such a supplier and that of the subcontractor which is actively engaged in construction of the vessel. Both have a pervasive interest in the entire works.

He then went on to consider the effect of the plaintiff being a co-assured under the policy and concluded that no rights of subrogation could be exercised by underwriters against it. Colman QC considered that the exercise of such rights would be so inconsistent with the insurers' obligation to the co-insured that there must be implied into the contract of insurance a term to give business efficacy that an insurer will not in such circumstance use rights of subrogation in order to recoup from a co-insured the indemnity which it has paid to the assured. As was previously noted, the ability of a party to rely upon such an 'implied' term would, under the English law, depend upon that party being a party to the contract with the insurer.²¹

Stone Vickers (appeal)

By the time of the hearing before the Court of Appeal, it was common ground that Appledore was not in fact entitled to recover under its insurance.

The Court of Appeal appreciated the point, which had not arisen in *Petrofina*, and which was, with respect, overlooked by Colman QC in the trial decision. This point was the need to establish an entitlement in the alleged co-assured to take the benefit of the insurance policy, to which it was not an actual party at the time that policy was taken out.

²¹ Ibid 301-2.

Given that the courts in England had not embraced the exception to the rule of privity of contract established by the High Court of Australia in *Trident General Insurance Co v McNiece*,²² it was, as a starting point, going to be necessary for such a claimant to establish an intention by the parties to the insurance contract that Stone Vickers was to have the benefit of the policy. Intention is relevant for a number of reasons. First, whether or not a party with a limited interest in the subject matter of the insurance will be entitled to recover the whole value will depend upon whether the policy was intended to cover the whole value and all the interests in the subject matter of the insurance.²³ More importantly, for present purposes, a party not named in the policy of insurance could establish privity of contract by two routes: by establishing either that they were undisclosed principals of the named assured, or that they were entitled to and did ratify the policy.

Parker LJ (who delivered the Court of Appeal judgment), in construing the policy of insurance, looked at the underlying contractual position and noted a number of matters which were inconsistent with an intention on the part of Appledore to insure for the benefit of Stone Vickers.²⁴ Of relevance were (a) the failure of communication with regard to insurance between Appledore and Stone Vickers prior to entry into the main contract or the policy of insurance; (b) the fact that, at the time the declaration under the policy was tendered, the identity of the subcontractor was still uncertain; (c) the fact that the subcontract when entered into did not provide for Appledore to insure in the joint names of itself and Stone Vickers; and (d) the fact that Stone Vickers had in fact insured for the benefit of Appledore.²⁵

²² (1998) 165 CLR 107.

²³ See *Hepburn v A Tomlinson (Hauliers) Ltd* [1966] AC 451.

²⁴ Interestingly, the contract governing the construction of the works was not concluded until after the insurance had been effected by Appledore and yet the court still referred to the terms of that contract in construing the policy of insurance – a similar approach to that adopted by the British Columbia Court of Appeal in *Canadian Pacific v Base-Fort Security Services* (1991) 77 DLR (4d) 178, 183e.

²⁵ *Stone Vickers Ltd v Appledore Ferguson Shipbuilders Ltd* [1992] 2 Lloyd's Rep 578.

Importantly, Parker LJ held that, as for the insurance documents themselves, the words by which the parties to the insurance policy were identified, which read: ‘assured include associated and subsidiary companies and/or subcontractors as additional co-assured for their respective rights and interests’, could not mean that all subcontractors unidentified and incapable of identification at the time were automatically covered. It could only mean that declarations (under the policy) naming or properly describing subcontractors would be accepted.²⁶

The Court of Appeal’s examination of the terms of the construction contract between Stone Vickers and Appledore was not unusual. This and other extrinsic evidence may be relevant because the authority to act as an agent for the subcontractor may be found in the construction contract. This contention was dealt with by Parker LJ:

I have already concluded that the insurance documents here did not make it clear that SV [the plaintiff] were intended to be protected by its provisions. Nor did they make it clear that AS was contracting or purporting to contract both for itself and as agent for SV that the insurance should also apply to SV. Indeed in my judgment they made it clear that there was no such intention and that AS were not acting as agent for SV. In those circumstances it is unnecessary to consider the questions of ratification or consideration.²⁷

Accordingly, the judgment confirmed there would seem to be a requirement for a clear intention by an ‘innocent’ co-assured to insure on the negligent co-insured’s behalf, before that negligent co-insured can claim immunity from a simple subrogated action brought against it in the innocent co-assured’s name.

National Oilwell

In England, the situation was considered again by Colman J in the case of *National Oilwell (UK) Ltd v Davy Offshore Ltd*.²⁸

²⁶ Ibid 584.

²⁷ Ibid 585.

²⁸ [1993] 2 Lloyd’s Rep 582.

The facts of that case were similar to those which arose in *Stone Vickers*. The plaintiffs (National Oilwell), pursuant to an agreement, supplied to the defendants (Davy Offshore) a sub-sea well head completion system to be used as part of a floating oil production facility which Davy Offshore were constructing for use on the Emerald field in the North Sea. Pursuant to the agreement, Davy Offshore was obliged to procure insurance, on a limited basis, the terms of which will be considered shortly.

Some time later, National Oilwell commenced an action against Davy Offshore, claiming the amount of certain unpaid invoices allegedly due under the agreement in respect of work done and equipment delivered by National Oilwell. Davy Offshore thereafter served a defence and counterclaim asserting that National Oilwell had delivered defective parts, that there had been delayed delivery causing Davy Offshore losses in excess of £13 million and that that amount far exceeded National Oilwell's claim for unpaid invoices.

It was argued that National Oilwell, as supplier to Davy Offshore of the equipment under the agreement, was a subcontractor and fell within the description of 'other assured' under the policy of insurance taken out by Davy Offshore.²⁹

Colman J, however, picking up on the point which, with respect, appeared to have eluded him at first instance in *Stone Vickers*, noted that National Oilwell was not specifically identified as a co-assured on the face of the policy. The question therefore arose as to the means by which National Oilwell could become entitled to take the benefit of the policy as co-assured.

After an analysis of the authorities, including the Court of Appeal decision in *Stone Vickers*, which had overturned his own trial decision (suggesting that the Court of Appeal differed on his factual conclusions only), Colman J stated the result of the authorities as follows:

²⁹ Interestingly, notwithstanding criticism of both his earlier decision and the approach in *Petrofina*, Colman J held that there was no reason why a supplier should not and every commercial reason why it should be able to insure against loss of or damage to property involved in a common project not owned by it and not in its possession. If such a policy was effected, the assured would have a sufficient relationship with the subject matter to give rise to an insurable interest.

1. Where at the time when the contract of insurance was made the principal assured or other contracting party had express or implied actual authority to enter into that contract so as to bind some other party as co-assured and intended so to bind that party, the latter may sue on the policy as the undisclosed principal and co-assured regardless of whether the policy described a class of co-assured of which he was or became a member.
2. Where at the time when the contract of insurance was made the principal assured or other contracting party had no actual authority to bind the other party to the contract of insurance, but the policy is expressed to insure not only the principal assured but also a class of others who are not identified in that policy, a party who at the time when the policy was effected could have been ascertained to qualify as a member of that class can ratify and sue on the policy as co-assured if at that time it was intended by the principal assured or other contracting party to create privity of contract with the insurers on behalf of that particular party.
3. Evidence as to whether in any particular case the principal assured or other contracting party did have the requisite intention may be provided by the terms of the policy itself, by the terms of any contract between the principal assured or other contracting party and the alleged co-assured or by any other admissible material showing what was subjectively intended by the principal assured.³⁰

Colman J added that it was unnecessary to consider on the facts of the present case what the position was, where, at the time when the contract of insurance was entered into, the alleged co-assured could not be ascertained as a member of the class referred to in the policy, but only qualified for membership at a later stage. Nor did he deal with the situation where, at the time of the policy, it was only intended to insure all persons in the class or who might in future qualify as members of the class, although it would then have been impossible to identify the alleged co-assured as such. The learned judge considered these to be difficult points and expressed no view on whether privity of contract could be established in such cases.

³⁰ *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582, 597.

On the facts of the present case, Colman J concluded that National Oilwell could establish privity of contract by one of two routes: by establishing either that they were undisclosed or unnamed principals of Davy Offshore, or that they were entitled to and did ratify the policy. In both cases, it was considered necessary for it to establish that, at the time of effecting the policy, Davy Offshore intended to effect insurance cover on behalf of National Oilwell.

Colman J considered the most obvious source of authority to be the agreement which, by cl 14.2, imposed on Davy Offshore an obligation to effect insurance of the work. As a matter of construction, it was considered that there must be a strong inference that Davy Offshore's authority to insure was co-extensive with its obligation to do so.

It was held that the obligation to procure insurance was confined to cover only up to the time of delivery of each item comprised in the work and not beyond that time, nor in relation to any other property.³¹ This was made clear by the express wording of cl 14.2 and in a further section of the agreement in relation to the passing of property to the purchaser, which provided that the risk in the property in question passed to the purchaser upon delivery which was also the latest time for the passing of title in the works. Accordingly, the obligation to procure insurance cover up to delivery of each item was commercially consistent with the passing of risk and property in the equipment. An obligation to procure insurance cover after delivery would have been commercially inconsistent with the passing of risk and property at an earlier point of time, namely the time of delivery.

Having rejected an argument that National Oilwell impliedly authorised Davy Offshore to effect insurance which went beyond that which it expressly contracted to procure under cl 14.2 of the agreement, Colman J found that Davy Offshore at no material time intended to procure for National Oilwell insurance protection wider than it was Davy Offshore's duty to procure under cl 14.2, and that such protection extended up to but not beyond delivery by National Oilwell of each item of the equipment under the agreement. It followed that it was not now open to National Oilwell by means of ratification to become a party to the contract of insurance in respect of any wider scope of cover than Davy Offshore undertook to procure by cl 14.2 of the agreement.³²

³¹ Ibid 598.

³² Ibid 602.

Colman J then had cause to consider an express waiver of subrogation clause contained within the policy and the extent to which the benefit of the waiver clause was available to National Oilwell. The learned judge considered that the clause which stated that the insurer would not take any steps to recover an amount paid out under the policy '*against any assured and any other person, company or corporation whose interests are covered by this policy*' confined the effect of the waiver to claims for losses which were insured for the benefit of the party claimed against under the policy.³³ In other words, a person did not qualify for the benefit of the waiver clause merely by being a party to the contract of insurance; rather, the benefit was only available for insured losses.

Even if the parties had not inserted an express waiver of subrogation, his Honour thought that such a term would have been implied, but would have had the effect of a waiver of subrogation only in respect of losses insured for the benefit of the subcontractor. So construed, the waiver clause operated consistently with the commercial purpose of the contract, being confined to the waiver of claims based on losses insured for the benefit of National Oilwell, that is to say, pre-delivery losses.³⁴

³³ Ibid 603. It should be strongly noted that in the case of *Woodside Petroleum Development Pty Ltd v A and RE and W Pty Ltd* (1999) 20 WAR 380, the Full Court of the Supreme Court of Western Australia, in declining to follow *National Oilwell* on the point, held that there was no basis for limiting the ambit of the waiver clause to the cover provided. In other words, the court rejected the argument that the extent of the waiver was commensurate with cover. Subsequently, Courts of Appeal in Queensland and New South Wales have emphatically rejected the position adopted by Colman J in *National Oilwell* to the effect that waiver clauses should be construed so as to confine their effect to claims for losses which are insured for the benefit of the party claimed against under the policy.

³⁴ *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582, 604.

Colman J was then called on to consider a submission based primarily upon the decision of the Court of Appeal in *Mark Rowlands Ltd v Berni Inns Ltd*,³⁵ to the effect that even if National Oilwell was not a co-assured in respect of the post delivery losses claimed against it, the fact that it was a co-assured under the policy to a limited extent gave rise to an implied term in the agreement between Davy Offshore and National Oilwell (or to a principle of law on some other basis) to the effect that Davy Offshore must give credit to National Oilwell for any insurance monies which Davy Offshore had received or was entitled to receive from the underwriters of the policy in question.³⁶

The learned judge rejected that submission, holding that there was no obligation on Davy Offshore to expend what it recovered from the insurers in respect of post-delivery losses, or indeed to apply such moneys in any particular way. Nor was there an undertaking by National Oilwell to pay, or contribute an amount referable to the cost of insurance to be procured by Davy Offshore analogous to the 'insurance rent' in *Mark Rowlands*. The mere coincidence of an insurable interest in the same property at the post-delivery stage could not of itself provide the basis for a submission that National Oilwell had a defence to the subrogated claim.

Although this was all that was necessary to dispose of the case, Colman J expressed views on a number of issues which were raised and which are of importance in the wider context of insurance law.

The first of these was whether there was a right to ratify the policy after the loss. Noting that Canadian, American and Australian courts had all permitted ratification of non-marine policies after the loss had occurred to the knowledge of the ratifying party, the learned judge could see neither legal principle nor commercial reason why the English court should not take the same approach. Noting that the rule had worked perfectly well for over a century for marine insurance and considering it undesirable that different rules should apply to the two classes of insurance, his Lordship held that National Oilwell could ratify with knowledge of an insured loss, notwithstanding that the policy was non-marine.³⁷

³⁵ [1986] QB 211. In this case the defendants were tenants of the plaintiff and, under the terms of the lease, were required to pay to the latter a substantial sum towards the insurance of the property against fire. The Court of Appeal held that, although the defendant was not a co-assured under the policy, it had paid a substantial sum towards the insurance of the property and the plaintiff was to be regarded as having insured the whole building for the joint benefit of itself and the defendant.

³⁶ *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582, 604.

³⁷ *Ibid* 608.

In relation to the question of insurable interest, Colman J dealt with the argument that, even if National Oilwell were co-assured for the full scope of the property insurance section of the policy, it had no insurable interest in any insured property after the time when it had delivered its equipment to Davy Offshore, and indeed, never had an insurable interest in any other equipment involved in the project.

In confirming the analysis of principle by Lloyd J in *Petrofina* and his Lordship's own previous decision in *Stone Vickers*, Colman J thought that to say, as a matter of law, that there cannot be an insurable interest based merely on potential liability arising from the existence of a contract between the assured and the owner of property, or from the assured's proximate physical relationship to the property, was to confine too narrowly the requirements of insurable interest.³⁸

His Honour then went on to consider whether insurers could bring subrogated claims against a co-assured. Having considered the views of Lloyd J in *Petrofina* and *The Yasin*, Colman J remained firmly of the view that the conclusion arrived at by Lloyd J in *Petrofina* was correct: an insurer cannot exercise rights of subrogation against co-assured under an insurance on property in which the co-assured has the benefit of cover which protects it against the very loss or damage to the insured property that forms the basis of the claim which underwriters seek to pursue by way of subrogation. His Honour persisted with the view that the reason why the insurer could not have pursued such a claim is that to have done so would be in breach of an implied term in the policy and, to that extent, the principles of circuity of action operated to exclude the claim.³⁹

The learned judge confirmed, however, that there could be no exclusion of the right to bring subrogated claims unless loss and damage of the kind that occurred (caused in the way in which it was actually caused) was insured for the benefit of the co-assured subcontractor. Accordingly, if the policy provided the co-assured with cover of a narrower scope than the cover provided by it to the principal assured, it would only be in respect of loss and damage falling within the narrower scope of cover that subrogated claims are excluded.⁴⁰

³⁸ Ibid 611.

³⁹ Ibid 614-15.

⁴⁰ Ibid 615.

It was also made clear that whatever defences (by reason of the existence of the policy) National Oilwell might otherwise have had to the underwriters' claims by way of subrogation, such defences could not be relied upon in the event of the wilful misconduct of National Oilwell, or if National Oilwell had failed to take reasonable measures to avert or minimise its loss pursuant to s 78(4) of the *Marine Insurance Act 1906* (UK).⁴¹

Colman J went on to consider three further specific aspects in relation to the issue of subrogation. First, one of the insurers who had underwritten the policy had gone into liquidation without paying the claims made under the policy by Davy Offshore. It was held that in as much as Davy Offshore's claim included that insurer's proportion, it was not a subrogated claim and National Oilwell could not therefore raise against it a subrogation defence or indeed any other defence based on the existence of the policy.⁴²

Second, among the counterclaims advanced by Davy Offshore against National Oilwell was one for liquidated damages for delayed delivery of equipment. National Oilwell contended that as a co-insured under the policy, or by reason of the waiver of a subrogation clause, it was not liable for that part of Davy Offshore's claim because it was a subrogated claim. Davy Offshore, on the other hand, contended that this part of the claim was not subrogated, since the insurers had not paid out such sums as expenses under the policy and had never insured delay.

⁴¹ *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582, 619. Colman J considered this to be the case, since the application of the waiver of subrogation clause was clearly intended to be confined to losses in respect of which claims could be made by co-assureds under the policy. Accordingly, since it had never been open to National Oilwell to claim under the policy in respect of such expense, loss and damage caused by wilful misconduct on the part of National Oilwell, it could not then rely on the policy by way of defence to the subrogated claim. Nor could it avoid that problem by reliance on the waiver of subrogation clause because to make such a claim on underwriters would be in breach of the duty of the utmost good faith and that would preclude reliance on the waiver.

⁴² *Ibid* 108.

Colman J said that where the contract provides for liquidated damages for a particular period of delay, the insurers must be subrogated to Davy Offshore's rights to such liquidated damages in substitution for what would otherwise be their entitlement to be subrogated in respect of unliquidated damages for that very same period of delay. It was made clear, however, that this would only occur in those cases where the loss by way of expenses sustained was attributable to a particular period of delay where it had been paid by insurers, and where liquidated damages were payable for that same period.⁴³

Finally, Colman J turned his attention to the situation of set-off under the contract and its interaction with the insurers' right of subrogation. The learned judge considered that if Davy Offshore suffered loss and damage to property covered by the policy and then claimed on the insurers, and was duly paid in full without regard to the right of set-off, the insurers were then entitled to require exercise by Davy Offshore for their benefit of all Davy Offshore's rights against National Oilwell in respect of that loss. Where the whole or part of the price is outstanding and available for set-off, the insurer is entitled to insist that the assured exercise rights of set-off and account to it for the benefit which it will obtain by the abatement of the price. His Lordship considered that if that same loss or damage could in turn found a claim on the policy by the co-assured, there was no reason in principle why such co-assured should not be entitled to rely on the implied term precluding the bringing by the insurers of subrogated claims against co-assureds who are insured for the same loss.⁴⁴

Australian authorities

Even prior to the effects of the introduction of ss 48–49 of the *Insurance Contracts Act 1984* (Cth) being felt in Australia, the High Court was called upon to consider the issue of whether a non-signatory party to an insurance contract who was a stranger to the consideration, but who is said by its terms and is intended by the parties to be insured, could enforce the contract of insurance for its own benefit.

⁴³ *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582, 625.

⁴⁴ *Ibid* 624.

Trident

This was the issue for consideration in *Trident*.⁴⁵ In that case, an insurer under a public liability insurance policy agreed to indemnify a company against all sums which it should become liable to pay in respect of injury to persons at specified building sites. The 'insured' was defined to include the company's contractors. A person who was injured as a result of the negligence of one of the company's contractors, which was not a contractor when the policy was issued, recovered damages against the contractor. Indemnity under the policy of insurance was declined. At first instance, Yeldham J held that McNiece had ratified the contract made between the head contractor and the insurer for its benefit and was hence entitled to be indemnified.⁴⁶ An appeal by Trident to the New South Wales Court of Appeal (Hope, Priestley and McHugh JA) was dismissed. The Court of Appeal rejected the conclusion of Yeldham J that Trident was bound by a contract with McNiece, but held that a beneficiary under a policy of insurance could sue on it even though not a party and not providing consideration.⁴⁷ Trident appealed to the High Court by special leave, which was limited to the questions:

1. Whether the doctrine of privity of contract applies to contracts of insurance.
2. Whether the respondent who was not a party to the contract of insurance was entitled to claim indemnity under it.
3. Whether the respondent was one of 'the assured' within the terms of the policy.
4. Whether the failure of the respondent to provide any consideration to support the applicant's promise of indemnity, precluded the respondent from enforcing any indemnity under the policy.

The High Court, by majority, held that the contractor was entitled to enforce indemnity against its liability to pay the damages.

Having recognised that the traditional barriers to recovery in these circumstances were twofold, ie an absence of privity of contract and consideration for the contractual promise, Mason CJ and Wilson J concluded thus:

⁴⁵ *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107.

⁴⁶ *Ibid* 108.

⁴⁷ *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1987) 8 NSWLR 270.

In the ultimate analysis the limited question we have to decide is whether the old rules apply to a policy of insurance. The injustice which would flow from such a result arises not only from its failure to give effect to the expressed intention of the person who takes out the insurance, but also from the common intention of the parties and the circumstances that others, aware of the existence of the policy, will order their affairs accordingly . . . This argument has even greater force when it is applied to an insurance against liabilities which is expressed to cover the insured and its subcontractors. It stands to reason that many subcontractors will assume that such an insurance is an effective indemnity in their favour and that they will refrain from making their own arrangements for insurance on that footing.⁴⁸

Accordingly, notwithstanding the operation of long-established principle, their Honours held that the contractor was entitled to succeed in the action.

Toohey J similarly emphasised the ‘common venture’ covered by the policy and considered that when an insurer issues a liability insurance policy, identifying the insured in terms that evidence an intention on the part of both insurer and assured that the policy will indemnify the parties involved for the purpose of a venture covered by the policy, and it is reasonable to expect that such a contractor may order its affairs by reference to the existence of the policy, the contractor may sue the insurer on the policy, notwithstanding that consideration may not have moved from the contractor to the insurer and notwithstanding that the contractor is not a party to the contract between the insurer and assured.⁴⁹

Gaudron J based her conclusion upon the concept of ‘unjust enrichment’, holding that it should now be recognised that a promisor who has accepted agreed consideration for a promise to benefit a third party is unjustly enriched at the expense of the third party, to the extent that the promise is unfulfilled and the non-fulfilment does not attract proportional legal consequences.⁵⁰

⁴⁸ *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107, 123-4.

⁴⁹ *Ibid* 172.

⁵⁰ *Ibid* 176.

Deane J accepted the view of the New South Wales Court of Appeal that a third party assured under a policy of liability insurance will ordinarily be entitled to maintain proceedings to enforce the promise to indemnify him, if the policy expresses or manifests an intention that the third party should have an enforceable right to insist upon the benefit of the indemnity.⁵¹ His Honour, however, had difficulty in seeing the contractor's right to obtain the benefit of the indemnity as arising otherwise than under a trust of the benefit of the insurer's promise.⁵² His Honour was prepared to allow the contractor to file a notice of contention, alleging existence of a trust (and joining Blue Circle – the head contractor into the proceedings), so as to afford to the insurer an opportunity of establishing the existence of further circumstances which could negate or modify the creation or effect of any such trust.⁵³

Brennan J (as he then was) also favoured the constitution of a trust as a criterion of the third party's right to sue (also highlighting the law's development in the areas of estoppel and damages),⁵⁴ but since the case did not raise those questions, felt constrained by the weight of precedent, in particular the doctrine of privity of contract.⁵⁵ Dawson J, while recognising the injustice which would flow from the strict application of those principles, felt similarly constrained.⁵⁶

It should be noted that in *Trident* the subcontractor was not identified at the time of the contract of insurance when it was taken out. John Birds suggests that this may be critical and that it seems quite proper to say that parties known about at the time of contract but not named, who are covered by the description of the 'insured', are co-assureds and parties to the contract of insurance. He says it is more difficult to do so when the existence and identity of potential beneficiaries are completely unascertained at the time of contracting.⁵⁷ Notwithstanding this, the decision of the Full Court of the Supreme Court of Western Australia in *Co-Operative Bulk Handling v Jennings Industries Ltd*⁵⁸ suggests that a third-party beneficiary, entitled to enforce a contract of insurance for its benefit, will be treated as a co-assured for practical purposes.

⁵¹ Ibid 151.

⁵² Ibid 151.

⁵³ Ibid 152.

⁵⁴ Ibid 140.

⁵⁵ Ibid 141.

⁵⁶ Ibid 162.

⁵⁷ See Birds J, 'Recent Common Law Developments Regarding Insurance Interest and Subrogation' (1988) 1 *Insurance Law Journal* 171,176.

⁵⁸ (1996) 17 WAR 257.

Although the claim in *Trident* arose in the context of a construction project, only limited emphasis was given to the ‘common venture’ aspect of such a project. Rather, the majority judgments (with the exception of Gaudron J, whose views have not generally commanded support), tended to emphasise the expressed intention that the contract operate for the benefit of others who might have been expected to order their affairs accordingly. Mason CJ and Wilson J emphasised the particular case of contracts of liability insurance expressed to be for the benefit of subcontractors to the named insured.

The decision of the High Court in *Trident* considered in detail questions which were not questions peculiar to insurance law, much less questions peculiar to the law of liability insurance, but rather were questions related to the law of contracts generally. Nor was it necessary for the court to consider issues in relation to the ability of the insurer to bring a subrogated claim against a negligent co-assured or questions of circuity.

Although the questions considered by the High Court related to the law of contracts generally, in the Court of Appeal, McHugh JA carefully limited his discussion to the topic of contracts of liability insurance, that being the nature of the relevant part of the policy then under consideration, and in the High Court the arguments advanced on behalf of McNiece were also limited in the same way.

In the subsequent decision of the New South Wales Supreme Court in *Barroora Pty Ltd v Provincial Insurance (Australia) Ltd*,⁵⁹ it was held, in a context unrelated to contractors’ risk insurance, that the considerations which led their Honours in the High Court to hold that there was an exception to the old rules seem to be equally applicable to contracts of property insurance as to liability insurance.⁶⁰

Special Leave Application

The High Court was recently asked to explore the questions of principle which were said to arise in connection with privity of contract and the application of the decision in *Trident*, in an application for special leave to appeal from the decision of the Court of Appeal of Western Australia in *A. Goninan & Co Ltd v Direct Engineering Services Pty Ltd [No 2]*.⁶¹

⁵⁹ (1992) 26 NSWLR 170.

⁶⁰ *Ibid* at NSWLR 179.

⁶¹ [2008] WASCA 112. [2008] HCA Trans 380.

In that case, under the relevant contract of insurance there was a provision which included as the Insured a person *'to whom the Insured is in writing obliged to provide insurance.'* The question that arose was whether the respondent to the application fell within that description. The respondent was not a party to any contract under which there was an obligation to provide it with insurance, but contended that there was an obligation owed to it under another contract (of which it had no knowledge at the time of entry into its subcontract), and therefore in turn, it came within the definition of an *'Insured'* under the insurance policy.

One of the questions which arose therefore was whether it could be said that a person who is neither a party to a contract nor named as such (and in circumstances where there was no suggestion that the parties to the contract were acting as agent or trustee), could be said to be a person to whom the insured in writing was obliged to provide insurance. Appeal counsel also sought to re-ventilate a concession made at the trial that if the respondent was an Insured under the policy, then the claim made against it by virtue of subrogation could not succeed.

Hayne J, having regard to the course of the litigation in the courts below, held that the case was not a suitable vehicle to explore the questions of principle said to arise in connection with privity of contract and in refusing the Special Leave application found that the decision in the Court of Appeal of Western Australia turned in critical respects upon the terms of the particular insurance contract in question.

Co-Operative Bulk Handling

The position suggested by the decision in *Barroora*⁶² was confirmed by the decision of Scott J at first instance and on appeal to the Full Court of the Supreme Court of Western Australia (Franklyn J, Rowland and Murray JJ) in *Co-Operative Bulk Handling Ltd v Jennings Industries Ltd*.

In that case, Co-Operative Bulk Handling Ltd was the principal and Jennings Industries the subcontractor in relation to certain contract works. Jennings was responsible for an on-site accident as a result of which Co-Operative suffered property damage. The contract works insurer fully indemnified Co-Operative for the loss and then commenced proceedings, in Co-Operative's name, against Jennings.

⁶² Ibid 59 (ie that the exception to the old rules of privity was equally applicable to contracts of property insurance as to liability insurance).

The contract works were covered under a policy which insured Co-Operative and subcontractors for their 'respective rights and interests' in the contract works (the contract works policy). The policy would respond only if the loss claimed was not recoverable under any other insurance (condition 6).

Jennings had liability cover under another policy (the Taisho policy). At first instance, before Scott J, the parties agreed that the following questions be determined by the court before trial on the basis of the agreed facts:

- Whether Jennings had an interest in the whole of the contract works, being an interested insured under the contract works policy, and whether the nature of that interest precluded the contract works underwriters from maintaining a subrogated claim against Jennings.
- Whether the contract works underwriters were precluded from maintaining a subrogated claim against Jennings by virtue of the waiver of subrogation rights clause contained in the contract works policy.

Scott J answered the first question in the affirmative and it was therefore not necessary to answer the second. His Honour held that Jennings had an interest in the whole of the contract works, being an interest under the contract works policy, and that such interest precluded the contract works insurer from maintaining a subrogated claim against Jennings.⁶³ His Honour further held that an examination of the terms of the policy revealed that Jennings was a co-insured with Co-Operative and that the co-insurance was both in relation to the property itself as well as for liability cover. Since Co-Operative was indemnified under the contract works policy pursuant to the property cover, it followed that the liability cover under the Taisho policy was separate and distinct cover and Jennings' cover was not such as to enliven the contract works policy exclusion in respect of damage '*recoverable under any other insurance*'.⁶⁴

⁶³ *Co-Operative Bulk Handling v Jennings Industries Ltd* (1995) 8 ANZ Ins Cas 61-286, 76,156.

⁶⁴ *Ibid* 76,157.

Scott J considered that for Co-Operative's insurance company to seek a right of indemnity by way of subrogation, in circumstances where the contract works policy was issued so that Co-Operative and the contractors and subcontractors of Co-Operative would all be covered for damage arising in the course of the building contract work, was 'inappropriate'.⁶⁵ The reason why his Honour considered that such a subrogated claim should not be allowed was not only because of the risk of 'circularity' [sic] but because public policy required that parties in the ordinary course of commerce should be able to conduct their affairs on the basis that insurance cover granted in the circumstances would protect them without the risk of a subrogated claim being made on behalf of a co-insured.

His Honour also considered that there were good policy reasons why, in these circumstances, the courts in Australia should refuse to entertain the exercise of rights of subrogation, including the fact that it would permit the insurer to secure information from its insured in accordance with policy provisions which would be available for later use in the insurer's subrogated action against its own assured.⁶⁶

The insurer, in Co-Operative's name, appealed to the Full Court and argued that:

- Jennings was not a party to the contract of insurance and therefore was not entitled to indemnity under its terms.
- *Trident* did not apply because the effect of that decision was limited to liability insurance contracts, whereas the present action was based on the property insurance provisions of the policy.
- In any event, the application of that decision depended on the third-party insured having suffered detriment as a result of its assumption that it was covered by the policy.
- Jennings had only liability insurance under the policy because cover was for the 'respective rights and interests' of each insured and Jennings had no proprietary interest in the insured property.
- Therefore, condition 6 operated because of the existence of the Taisho policy.

⁶⁵ Ibid.

⁶⁶ Ibid.

The court, in dismissing the appeal, held that there was nothing in the judgments in *Trident* which supported the contention that the exception to the application of the ‘old rules’ requiring privity of contract and consideration moving from the promisee was limited to ‘liability’ insurance.⁶⁷ Nor did the court consider that anything led to the inference that it was only those persons who were intended to be insured under the contract, acting on such assumption and suffering detriment, who were entitled to the benefit of the exception.

The court found that there was no substance in the submission that, as the appellant had no proprietary interest in the contract works, the *Trident* decision had no application.

The court accepted as good law the three conditions cited by Manning J in *Davjoyda Estates Pty Ltd v National Insurance Co New Zealand Ltd*⁶⁸ and considered that it was not necessary that the respondent should have a proprietary interest in the contract works.⁶⁹

Next, the court dealt with the appellant’s contention that the decision in *Petrofina Ltd v Magnaload*⁷⁰ had not been found to apply in Australia. It was argued that even if it did apply, it should not apply in the present case as the policy in question was a composite policy, pursuant to which each insured was insured specifically in relation to its own respective interests and therefore could recover only the loss, if any, actually sustained by it.⁷¹

The Full Court recognised this factor as a significant point of difference (the point seemingly not given the same weight by the trial judge), noting that the *Petrofina* policy, which was found to insure the subcontractor by way of property insurance in respect of the whole of the contract works, did not purport to insure the parties ‘for their respective rights and interests’.⁷²

As to the first point, the court considered the reasons for the decision in *Petrofina* to be highly persuasive; however, it noted that in none of *Petrofina*, *Imperial Oil* or *National Oilwell Ltd v Davey Offshore Ltd*, was the insurance qualified by the words ‘for their respective rights and interests’, or any similar words.⁷³

⁶⁷ *Co-Operative Bulk Handling v Jennings Industries Ltd* (1996) 17 WAR 257, 266.

⁶⁸ [1965] NSW 1257.

⁶⁹ *Co-Operative Bulk Handling v Jennings Industries Ltd* (1996) 17 WAR 257, 266.

⁷⁰ [1984] QB 127.

⁷¹ *Co-Operative Bulk Handling v Jennings Industries Ltd* (1996) 17 WAR 257, 269.

⁷² *Ibid* 269.

⁷³ *Ibid*.

Franklyn J (who delivered the judgment on behalf of the court) summarised his view of the effect of each of those decisions as follows:

[A] subcontractor to construction works has a full insurable interest in the whole of the property insured because of the possibility of damage by one subcontractor to the property of another and/or to the construction as a whole, its existence being founded on the commercial inconvenience and disruption which would or might flow from the resulting claims and possible counterclaims and the effect thereof on the various insured parties and completion of the contract works. The insurable interest is based on that real possibility and the commercial convenience of recognition of such an interest. It is not dependent upon there being a liability for the damage . . . The result is that . . . a subcontractor engaged on contract works may insure the entire contract works as well as his own property, the head contractor may insure the entire works in his own name and for his contractors and subcontractors, and a contractor or subcontractor so insured can enforce the contract, recover the whole of the loss insured, holding the excess (if any over his own interest in trust for the others entitled thereto and this is so regardless of his responsibility for the loss. The policy is one of property insurance not liability insurance (Petrofina (supra) at 136 and 139; at 42 and 44; Imperial Oil (supra) at 563).⁷⁴

His Honour then noted that, in *Petrofina*, Lloyd J, in determining, as a matter of construction, that each of the named insured was insured in respect of the whole contract, took into account that ‘there are no words of severance, if I may use that term in this connection, to require me to hold that each of the named insured is only insured in respect of his own property’.⁷⁵

⁷⁴ Ibid.

⁷⁵ Ibid.

The Full Court considered that the inclusion of the words '*for their respective rights and interests*' in the policy had to be given meaning, and considered a number of the bailment cases, including the decision of McPherson J in *AMEV v Mercantile*,⁷⁶ where his Honour considered a policy of insurance taken out by the lessee of a yacht in his name and that of the lessor (for their respective rights, title and interest). Noting that in the bailment cases the effect of the policy insuring parties' 'respective interests' was to insure the aggregate of all the interest subsisting in that chattel, the court concluded that, in the present case, the proper construction of the policy was that the intention of the parties was to insure the interests of the assured parties in the contract works, arising out of their engagement as subcontractors insured by the owner to cover the whole risk. This was achieved by insuring contractors and subcontractors in respect of loss of or damage to the whole or any part of the contract works by whatever cause. Its 'respective right and interest' in the insured property is in the whole thereof.⁷⁷

The Full Court therefore concluded that, absent its right to indemnity being excluded by some provision of the policy, the subcontractor was entitled to be indemnified under the property cover in respect of the damage sustained and that this carried with it the right to be indemnified in respect of any sum it might be called on to pay in the event of the damage being a result of its own negligence.⁷⁸

The Full Court considered that the resulting position of the parties was, as is set out in *MacGillivray & Parkington*⁷⁹ as follows:

English Law. It is submitted that the correct analysis is that rights of subrogation do in theory exist between co-assureds but will usually in practice be defeated by circuity of action.

Consequently, the court concluded that, in the absence of any applicable exclusion or exemption under the policy, the respondent was entitled to be indemnified by the appellant in respect of the loss and that there was no right for the insurer to proceed against it by way of subrogation for recovery of the moneys paid to the appellant, as such a claim must fail by reason of circuity of action.

⁷⁶ *AMEV Finance Ltd v Mercantile Mutual Insurance (Workers' Compensation) Ltd* (No 2) [1988] 2 Qd R 351.

⁷⁷ *Co Operative Bulk Handling v Jennings Industries Ltd* (1996) 17 WAR 257, 275.

⁷⁸ *Ibid* 269.

⁷⁹ *Parkinton*, above n 12, [1244].

Pacific Dunlop

Finally, reference should be made to a decision by Teague J, of the Supreme Court of Victoria, at first instance, in *Pacific Dunlop Ltd v Maxitherm Boilers Pty Ltd*.⁸⁰ This was handed down subsequent to the decision of Scott J at first instance in *Co-Operative Bulk Handling* but prior to the decision of the Full Court. The case is instructive, as the issues which arose for consideration were similar to those the subject of scrutiny in *Petrofina*, *Trident* and *Co-Operative Bulk Handling*, but they arose in the context of an industrial special risks policy, rather than contract works insurance.

In this case, the plaintiff had agreed to purchase an autoclave from the defendant. The plaintiff held an industrial special risks policy which covered property damage and business interruption, but did not provide liability insurance. The 'subject extension provisions' provided that the insurable interest of lessors, financiers, trustees, mortgagees, owners and 'all other parties more specifically noted in the records of the insured' be automatically included.

After the plaintiff had paid for and taken possession of it, the autoclave was destroyed as a result of an inherent defect and the plaintiff commenced proceedings against the defendant. The defendant claimed indemnity under the policy as a 'non-party insured' and joined the insurer as a third party to the proceedings.

One of the preliminary questions for determination was whether the defendant was entitled to bring an action against the insurer under the policy.

There was no specific reference in the insurance policy to the defendant, which meant that the defendant had to show in the third-party proceeding that it was properly to be treated as an un-named third-party beneficiary under the policy of insurance.

After a review of the law and the facts, Teague J concluded that, as at March 1990, risk and property in the autoclave had long since passed to the plaintiff and, at that date, the plaintiff had accepted the autoclave. It followed that the defendant did not have an insurable interest in the autoclave and was not a non-party assured entitled to the benefit of the subject extension provision from that date.⁸¹

⁸⁰ (1996) 9 ANZ Ins Cases 61-357.

⁸¹ *Ibid* 76,956.

In arriving at his view, Teague J had regard to the character of the activity, and hence the purpose of the cover which was provided in the policies which were the subject of scrutiny in *Petrofina*, *Trident* and *Co-Operative*, and noted that they were quite different from that in the case before him. His Honour noted that, in those cases, major construction projects were under way, head contractors were the contracting insureds, and subcontractors were pressing claims against insurers as non-party insureds. His Honour noted that where there is a particular project, the presence of the project as a focal point with its contract works provides a community of interest, which will make it significantly easier to treat the contracting insured and reliant third parties covered by a composite policy as having something akin to co-ownership in those works, at least for the duration of the project.⁸²

His Honour also considered relevant in the present case the distinction between liability insurance and property insurance and in particular, quoted from Derrington and Ashton:⁸³

*It is sometimes vital to identify the nature of the cover with precision and, more particularly, to distinguish between liability insurance and property insurance. In the latter case, the insured may recover only upon the loss of his own property, whereas in the former case it is necessary that there be liability to another party.*⁸⁴

His Honour then considered the qualification which had been developed through the cases of *Imperial Oil*, *Petrofina* and *Jennings* and which led to the distinction not making a crucial difference in certain circumstances.

His Honour noted that the circumstances in each of those cases included the taking out of a policy of insurance, which was effectively issued to the contracting insured for the benefit of a group of contractors and others engaged in a project, so that the different interests of the members of the group in the property which was utilised as part of the project regardless of whoever was the actual owner of that property, were 'pervasive'. The consequence was that a non-party insured could be seen to have an insurable interest in the potential liability arising in the event of damage being caused to any of that property, even property which it did not own.⁸⁵

⁸² Ibid 76,952.

⁸³ D Derrington and R S Ashton, *Law of Liability Insurance*, (1st ed, 1990) 3.

⁸⁴ *Pacific Dunlop Ltd v Maxitherm Boilers Pty Ltd* (1996) 9 ANZ Ins Cas 61-357, 76,950.

⁸⁵ Ibid 76,958.

In the case before him, his Honour considered that the vendor-purchaser relationship between the plaintiff and the defendant was so essentially different from that of head contractor and subcontractors in the three cases that it was not appropriate to treat the property and liability distinction as being subjugated to a higher principle or qualification of the kind spelt out most positively by the Supreme Court of Canada and justified on what were essentially policy grounds.⁸⁶

The impact of the *Insurance Contracts Act 1984 (Cth)*

Since the position in Australia appears to be that a subcontractor under a head contractor's (or principal's) contract works policy has an insurable interest in the whole of the works insured by that policy (subject to words of severance), ss 16–17 of the *Insurance Contracts Act 1984 (Cth)* (which alter the law of insurable interest for the insured under a contract of general insurance) would not appear to be of any great import. However, as has been noted above, contracts of general insurance may, in certain circumstances, benefit persons who are not parties to the contract of insurance. This entitlement of a person other than an insured can arise either according to the authority of the High Court in *Trident*⁸⁷ or pursuant to s 48 of the *Insurance Contracts Act 1984 (Cth)*. Such a person is not one of 'the insured' for the purposes of ss 16–17 of that Act.

The decision in *Trident* will have application to contracts of liability and it would seem property insurance entered into after the coming into force of the *Insurance Contracts Act*.

Section 48 of the *Insurance Contracts Act 1984 (Cth)* abrogates the doctrine of privity of contract in respect of contracts of insurance coming within the ambit of the Act, and it was recognised in *Trident* that, had the contract of insurance been made after the Act had come into force, McNiece would have had a statutory right to sue on the contract.

Section 48(1) provides a person who is not a party to a contract of general insurance with a right of recovery if that person is appropriately specified or referred to in the contract as a party to whom its benefit extends. Therefore, in considering the application of s 48, it is necessary to determine whether or not the person in question is a party to the contract.

⁸⁶ Ibid 76,959.

⁸⁷ (1988) 165 CLR 107.

Commonly, the question will be resolved according to the policy definition of 'the insured' and by reference to the section headed 'the insured' in any policy schedule. In the *Barroora* case, the relevant policy contained a definition of 'the insured' which referred to the person or persons 'so named in the certificates'. The person seeking cover was not named in the relevant certificate as 'the insured' and this was determinative of the issue.⁸⁸

Where the insured is defined to merely include 'all contractors and subcontractors', it seems likely that a subcontractor, particularly one not in contemplation at the time of the taking out of the policy, would not be a party to the contract of insurance under the policy; rather it would be entitled to take the benefit of s 48, or the co-extensive right afforded to it at common law (if applicable) pursuant to the principles of *Trident*.

Recently, in *QBE Insurance (Australia) Ltd v Lumley General Insurance Ltd*,⁸⁹ the Supreme Court of Victoria – Court of Appeal considered a submission that the parties to a contract of insurance could not, by virtue of naming a third party to the contract as an insured, make the provisions of the insurance contract binding on that third party unless that third party authorised them to do so or ratified their doing so. It was found by the court⁹⁰ that the absence of an act to authorise or ratify a party as an insured under the policy did not alter the legal effect of that party's inclusion as an insured.

If the other subcontractors are true co-assureds, it appears that ss 48–49 will have no application, because they deal with situations where a person is not a party to the insurance contract and is either specifically included in the cover (s 48), or has an interest in the property insured and the cover is not specifically limited to the interests of the assured (s 49).⁹¹

⁸⁸ (1992) 26 NSWLR 170.

⁸⁹ (2009) 256 ALR 574.

⁹⁰ *Ibid* 575.

⁹¹ See also Schedule 6, Part 2 of the Insurance Contracts Amendment Bill 2010 (Cth) (introduced into Parliament on 17 March 2010) for the proposed changes to s 48 in relation to the entitlement of third party beneficiaries.

CIRCUITY OF ACTION AND WAIVER OF SUBROGATION

Circuity of action

The reasoning of the Full Court of Western Australia, in the case of *Co-operative Bulk Handling Ltd v Jennings Industries Ltd*,⁹² suggested that a subcontractor may be held to have a ‘pervasive’ interest in the whole of the works and would therefore be entitled to plead the defence of circuity to any subrogated claim which may be brought by the insurer against it.

Subsequently, in *Woodside Petroleum Development Pty Ltd & Ors v H&R-E&W Pty Ltd & Ors*,⁹³ Ipp J (with whom Malcolm CJ and Pidgeon J agreed) stated:

I have difficulty with the proposition that, where a wrongdoer is insured for physical damage to property and causes damage to that property without himself sustaining loss, he can rely on the principle of circuity of action . . . it is an essential ingredient of the defence of circuity of action that there must be a complete identity between the amounts recoverable by the respective parties. I do not comprehend on what basis the respondents could make a claim against the underwriters under section 1 of the policy in circumstances where they have sustained no damage to property owned by them. It seems to me that, in the present case, there is, prima facie, no identity between the amounts recoverable by the respective parties.

As his Honour dismissed the appeal on other grounds, he expressed no concluded view on the circuity of action argument.⁹⁴

⁹² (1996) 17 WAR 257.

⁹³ (1999) 20 WAR 380 *Woodside Petroleum Development Pty Ltd & Ors v H&R-E&W Pty Ltd & Ors*.

⁹⁴ This quotation was subsequently highlighted by Murray J in the case of *Direct Engineering Services Pty Ltd v A Goninan & Co Ltd* [2006] WASC 105; in which his Honour observed [127] ‘*The same comment might be made of the position of the defendant in this action*’. On appeal *A. Goninan & Co Ltd v Direct Engineering Services Pty Ltd [No 2]* [2008] WASCA 112, the Western Australia Court of Appeal, said it was not open for the respondent to resile from its concession that if the appellant was an Insured, then the insurer had no right of subrogation and the proceedings could not be maintained, and contend that there was no circuity of action.

The issue is potentially very significant, as circuitry has been pleaded by an insured as a defence to a subrogated claim brought in the name of another co-insured, even in circumstances where a specific exemption in relation to that particular category of insured applies to a waiver of subrogation clause contained within the policy.⁹⁵

Summary of position

It is first helpful to summarise the position as to the potential liability of one co-insured to another in relation to damage covered by the policy, where a joint names insurance policy is in place. Such a policy provides cover to several insured jointly, often on a construction project to all those directly involved in the project. If damage occurs, the insurer provides an indemnity for the resulting loss incurred by each and every insured for that loss. The insurance is usually taken out as a result of a requirement of the building or other primary contract that imposes an obligation on one contracting party, in a building contract either the employer or the main contractor, to effect it. Once the insurance is in place, both the primary and the insurance contracts must be considered.

An English Court has recently noted that three methods have been used to prevent a situation in which a co-insured, having been indemnified by the joint names insurer, seeks to claim from its co-insured either on its own behalf or to enable the insurer to be subrogated. The first two methods focus on the insurance contract and involve the court staying any action brought by the co-insured.

By the first method, the court stays the action to avoid circuitry of action that would result from the insurer claiming from the co-insured since otherwise the co-insured would seek to pass the claim back to the insurer relying on its rights to be indemnified under the joint names insurance. However, where the insurer has settled a claim in full, it ceases to be liable to indemnify any insured in relation to that property and if a co-insured was then sued in furtherance of the insurer's right of subrogation, the insurer could not then be met with a further claim for an indemnity by that co-insured. Hence, in such circumstances, the circuitry of action defence would not be available to the co-insured.

⁹⁵ (1999) 20 WAR 380.

For that reason, the courts have developed a second method of controlling the abuse of an action brought on behalf of an insurer against one of its co-insured. By this second method, the court relies on an implied term of the insurance contract, where such a term can be found to exist, to the effect that the insurer promises to all co-insured that it will not exercise rights of subrogation against a co-insured having indemnified another co-insured. The foundation of this term is that co-insurance carries with it the obvious and presumed intention of the parties to the insurance contract that there will be no actions brought amongst themselves to pursue or facilitate rights of subrogation. In principle, an implied term could arise in appropriate circumstances in the building contract whereby the employer promises not to bring a subrogated claim against the main contractor.

The third method available to the court focuses on the terms of the primary contract, and looks to see whether the effect of those terms is that the parties have agreed not to sue each other for matters covered by the joint names insurance. This was the method used in the case of *Co-operative Retail Services Ltd v Taylor Young Partnership & Ors.*⁹⁶ As a result of this case, the defence of circuity now also appears to be on very shaky grounds in the United Kingdom.

Facts of Co-operative Retail Services

The facts of that case were that in April 1993, the claimant Co-operative Retail Service Ltd ('CRS') engaged Wimpey to build a new office headquarters building in Roachdale. The contract was on JCT80 Private with Quantities Conditions. Hall were the electrical subcontractors for the building's generator system on DOM/1 1980 Conditions. Hall entered into a warranty with CRS and Wimpey dated 11 October 1993.

The insurance requirements of Clause 22A of the main contract were met by a joint names policy which insured CRS, Wimpey and Hall.

On 16 March 1995, before practical completion, a fire occurred at the site when the generator was being commissioned and the building was extensively damaged.

⁹⁶ (2000) 74 Con LR 12.

CRS alleged that the fire was due to negligence or breach of contract on the part of the architects and the mechanical and electrical engineers. Those parties in turn alleged that the fire was the result of breaches of the main contract by Wimpey and breaches of warranty by Hall, and sought contribution under the *Civil Liability (Contribution) Act 1978* (UK) from Wimpey and Hall.

Decision

It was held by the trial judges and the Court of Appeal, that the effect of the joint names insurance policy under the contractual arrangements between CRS, Wimpey and Hall was that Wimpey and Hall were never liable to CRS for any damage arising out of the fire.⁹⁷ It followed that Wimpey and Hall were not liable to contribute to the architects and/or the mechanical and electrical engineers. Although it was argued (and the case was ultimately decided) on the basis that Wimpey was not liable to CRS in respect of the damage in question because the parties had agreed that the damage should be covered by insurance, it was also argued that CRS's insurers were barred by the doctrine of circuity of action from suing Wimpey in CRS's name once they had indemnified CRS.

Having analysed the authorities from *Petrofina (UK) Ltd and Ors v Magnaload Ltd and Anor*⁹⁸ to the decision of Colman J in *National Oil Well v Davy Offshore Ltd*⁹⁹ and *Stone Vickers Ltd v Appledore Ferguson Shipbuilders Ltd*¹⁰⁰ Brooke LJ stated:

⁹⁷ It was held that the time for determining whether 'the other person' was liable in respect of the same damage was, at the time contribution was sought, not at the time at which damage had occurred.

⁹⁸ [1984] QB 127.

⁹⁹ [1993] 2 Lloyd's Rep 582.

¹⁰⁰ [1991] 2 Lloyd's Rep 288.

I have gone into these matters in some detail because it appears to me that Lloyd J's reference to a defence of circuity of action confuses rather than simplifies the issues we have to decide. The decision of this court in Post Office v Hampshire CC [1979] 2 All ER 818 rescued this doctrine from a comparative obscurity in which it had rested, except in the minds of those versed in shipping matters, for over 100 years . . . This doctrine had its origin in a very different world . . . this antique clearly dates from a world in which a counter claim could not be pleaded in the same action as the claim and where contributory negligence on the part of the plaintiff was usually a complete defence. The reason why I believe that reference to it will tend to confuse rather than clarify in circumstances like the present is that Lloyd J used the expression as if English Law made the parties insurers direct parties to an action when one of them wishes to exercise rights of subrogation in the name of its insured whom it has indemnified in full and to sue another party which is itself insured. As Colman J observed, it is an inappropriate plea if the insurer has provided a full indemnity to one co-insured because it will have discharged its liability under the policy in respect of the losses in question and a second co-insured cannot look to it to pay him those losses a second time. In my judgment it would be much safer to jettison the language of circuity of action and to address the question asked by Dillon LJ in the Surrey Heath case: what does the contract provide?¹⁰¹

The court ultimately determined that the trial judge was correct when he concluded that neither Wimpey nor Hall should be regarded as persons 'liable in respect of the same damage' so as to open the way to a successful claim for contribution against them. To put it quite simply, they, like CRS, had entered into contractual arrangements which meant that if a fire occurred, they should look to the joint insurance policy to provide the fund for the cost of restoring and repairing the fire damage (and for paying any consequential professional fees) and that they would bear other losses themselves (or cover them by their own separate insurance) rather than indulge in litigation with each other.

¹⁰¹ Ibid.

The court concluded that in the absence of any special contractual scheme, the doctrine of circuity of action could have no application. Noting, that in general, English Law ignores the instance of insurance, the court said that in the absence of an insurance scheme, Wimpey could have had no defence based on that doctrine to a claim brought against it by CRS.¹⁰²

Implications

The decision is, in one sense, pleasing, in that not only does it give priority to the terms of the parties' contract, it also sees a welcome retreat from an 'antique' plea which through a series of recent cases, had risen to a level of prominence arguably not warranted nor supported on a doctrinal basis.

As was identified, however, by the Queens Bench in the subsequent case of *Bovis Lend Lease Ltd (formerly Bovis Construction Ltd) v Saillard Fuller & Partners*,¹⁰³ it was not clear why the analysis adopted in earlier cases was not adopted in this case, namely that the insurer was subject to an implied term of the insurance contract that proceedings would not be brought against a co-insured and there would be no exercise of the insurer's rights of subrogation in relation to any loss covered by the joint names insurance. Such a clause would appear to be a necessary adjunct to the contractual scheme in question, including the joint names insurance provisions it contained. Such an analysis would also seem to be a necessary adjunct to the court's finding that the contractual scheme had had the effect that the contracting parties:

*had entered into contractual arrangements which meant that if a fire occurred, they should look to the joint insurance policy to provide the fund for the cost of restoring and repairing the fire damage . . . and that they would bear other losses themselves . . . rather than indulge in litigation [with] each other.*¹⁰⁴

¹⁰² See also the decision at first instance of Murray J in *Direct Engineering Services Pty Ltd v A Goninan & Co Ltd* [2006] WASC 105, in which his Honour held [at 138] that the head contractor did not oblige the Plaintiff to effect insurance for the benefit of the subcontractor and that accordingly the insurer was entitled to pursue a subrogated claim and no circuity of action resulted.

¹⁰³ (2001) 77 Con LR 134.

¹⁰⁴ (2000) 74 Con LR 12, 49.

The Court, in this later case, noted that the earlier decision '*is not free from difficulties*'. The matter went on appeal to the House of Lords which handed down its judgment on 25 April 2002. Although it was not necessary for their Lordships to address the effect of the joint names policy, they seemed content to accept that the insurer would be subject to an implied term as a satisfactory basis for the rule.

Two other recent like cases are worth noting in the context of the implications of the parties effecting joint names insurance.

The first is *John Hunt Demolition Ltd v ASME Engineering Ltd*.¹⁰⁵ In that case, there was a contractual obligation on the employer to maintain a joint names policy in respect of existing structures at the site and to recognise each of the contractors and subcontractors as an insured. There was a 'carve out' from a general indemnity given in favour of the employer by the main contractor in relation to existing structures.

Notwithstanding this, one of the main contractor's subcontractors (Hunt) settled a claim by the employer and main contractor arising out of damage to the façade (an existing structure) caused by Hunt's subcontractor's negligence, and then sought to recover from that subcontractor. In doing so, they sought to argue, in justification of the settlement with the employer and main contractor, that the contractual provisions regarding the indemnity and joint names insurance, did not preclude a duty of care arising between Hunt and the employer.

The court however rejected that argument on the basis that the parties to the main contract and subcontractors knew that if they (or other specified person) caused damage to the existing structures, the loss would be covered by the joint names insurance and it would be inconsistent with that regime to argue negligence as a basis for recovery against a subcontractor.

The other case is *Tyco Fire & Integrated Solutions (UK) Ltd v Rolls-Royce Motor Cars Ltd*.¹⁰⁶ In that case a party, who was otherwise the beneficiary of an indemnity in its favour by the designer and installer of a fire protection system, failed to take out joint names insurance as it was contractually obliged to do. Notwithstanding this, it claimed damages against the designer and installer when a leak from one of the sprinklers installed damaged other parts of the building – damage which should have been indemnified under the joint names insurance policy, had it been procured.

¹⁰⁵ [2007] EWAC 1507 (TCC).

¹⁰⁶ [2007] EWAC B7 (TCC).

The court at first instance agreed with the designer and installer that any recourse should not have been against it, but rather the insurance company. It said that the contractual obligation for the designer and installer to indemnify the defendant was predicated upon the obligation of the defendant to procure the joint names insurance and that it would clearly be unjust if the defendant's failure to take out appropriate insurance resulted in the claimant being liable under the indemnity.

On appeal,¹⁰⁷ it was submitted by the party that under the express terms of its contract, the designer and installer was obliged to indemnify it against any damage caused by that party's negligence and that the provision for joint names insurance did not expressly, and therefore could not impliedly, exclude liability that otherwise fell on the designer and installer under the contract.

It was held by the Court of Appeal that there was nothing express in the language of the contract, unless it was to be found in the mere mention of joint names insurance, to emphasise that there was a special regime in relation to the existing structures which excluded the obligations found elsewhere in the contract.

The court said that the position might possibly be different so far as damage to the works was concerned. However, even in that case it seemed that the essential structure of the contract so far as liability for negligence was concerned remained unaffected, so that in such a situation the obligation to insure in joint names only extended to the specified perils so far as loss by such perils had not been caused by negligence. In distinguishing the *Cooperative Retail Services* case, the Court of Appeal said the observations in that case to the effect that a provision for joint names insurance under a construction contract between an employer and a contractor prevented one party making claims against the other in respect of damage caused to the contract works covered by the risks against which the policy insured both parties, related to the particular contract under consideration in that case, and were not a rule of law.

¹⁰⁷ [2008] EWCA Civ 286.

Waiver of subrogation

The two authorities of *National Oil Well (UK) Ltd v Davy Offshore Ltd*¹⁰⁸ and *Woodside Petroleum Development Pty Ltd v H & RE & W Pty Ltd*¹⁰⁹ are conflicting, in relation to the effect of a 'waiver of subrogation' clause in a contractors' all risk policy of insurance.

In the *National Oilwell* case, the English Court considered that the waiver clause was confined to claims for losses which are insured for the benefit of the party claimed against. However, in the *Woodside Petroleum* case, the Full Court of the Supreme Court of Western Australia, in declining to follow *National Oilwell* on the point, held that there was no basis for limiting the ambit of the waiver clause to the cover provided, ie the court rejected the argument that the waiver was commensurate with cover.

These authorities were considered by Mackenzie J of the Queensland Supreme Court in *GPS Power Pty Ltd & Ors v Gardiner Willis Associates Pty Ltd*.¹¹⁰

In that case, his Honour concluded that he should apply *Woodside Petroleum* as representing the current state of the law on the subject. As the bulk of the claim had been pursued on the basis of a subrogated claim, his Honour concluded that such a claim was unable to be brought because of the provisions of the subrogation clause which provided that, in the event of the insurer indemnifying or making a payment to any insured(s), the insurer shall not exercise any rights of subrogation against any other insured(s).

The decision went on appeal to the Queensland Court of Appeal which handed down its judgment (by 2-1 majority) on 8 December 2000.¹¹¹

The policy of insurance

The policy in question related to work carried out on the Gladstone Power Station in relation to which the respondent had performed design and engineering functions.

¹⁰⁸ [1993] 2 Lloyds Rep 582.

¹⁰⁹ (1999) 20 WAR 380.

¹¹⁰ [2000] QSC 75.

¹¹¹ *GPS Power Pty Ltd & Ors v Gardiner Willis Associates Pty Ltd* [2001] 2 Qd R 586.

The appellant suffered loss as a result of damage to the power station, which was caused by the respondent's negligence. Most of the loss was recovered by the appellants under an insurance policy, but the respondent was sued by the appellants for the whole loss. As to that part of the loss which was covered by the insurance policy, the suit was brought by way of subrogation.

The policy contained a definition of the expression 'the Insured'. The respondent fell within that definition because it was a consultant. The definition concluded however:

This definition of 'the Insured' shall exclude consultants but only in respect of such consultant's professional duty of care to other persons and/or parties included in this definition of 'the insured'.¹¹²

The respondent contended that it was an insured because it was in certain circumstances entitled to be indemnified under the policy; whereas the appellants contended that, prima facie, under the definition of 'the Insured', the respondent was excluded and the limitation on the exclusion did not apply to it, because it was not entitled to be treated as 'the insured' in respect of its capacity as a person owing a professional duty of care to other persons included in the definition – the appellants being such persons.

The subrogation provisions in the policy of insurance denied the insurer the right to exercise *'any rights of subrogation against any other insured(s) – 'other,'* that is, than an insured which had received a payment (ie the appellants), and they provided that the insurer waive any rights arising by subrogation against *'any insured . . . described by (the) policy'*.¹¹³

As de Jersey CJ¹¹⁴ noted, the question for determination by the court was whether it should, in a sense, transpose the limitation on the insurance cover available to the respondent in that capacity as an 'Insured' party, into the operation of the subrogation provisions. As his Honour observed, the point arose because the definition of 'the insured' placed the respondent into that category only for matters other than *'in respect of (its) professional duty of care to other'* insured entities, with the payment made to the appellants having arisen from the respondents' breach of their professional duty.

¹¹² Ibid 593.

¹¹³ Ibid 592.

¹¹⁴ Ibid.

The majority judgment

Williams J, who delivered the leading majority judgment, regarded the definition of who is an 'insured' as not being concerned with the extent of the interest insured, but rather thought that as long as there was some liability insured against, the definition operated to encompass the party described as an 'insured'.

His Honour was of the view that given that the definition was one which was said to apply for the purpose of the policy, it must be adopted throughout unless the context clearly indicated otherwise. His Honour considered that if A and B were each insured under the same policy of insurance with respect to a loss, it would be meaningless for the insurer to think in terms of subrogation with respect to a claim against B consequent upon paying out a claim made by A. Accordingly, when the clause spoke of not exercising any rights of subrogation '*against any other insured*' it must realistically be referring to a situation where the 'insured' was not insured by the policy with respect to the particular loss in question. His Honour considered that the subrogation clause could only have operation where, as was the situation in that case, the respondent was caught by the expression 'the insured' but the loss in question was one in respect of which it was not covered by the policy.

Williams J noted that a lot of the difficulty in the present case may have arisen from the fact that an exclusion of losses arising '*in respect of such consultant's professional duty of care to other persons and/or parties included in this definition*'¹¹⁵ meant that much (perhaps almost all) potential liability was excluded. His Honour thought, however, that the fact that the extent of risk covered by the policy was in small compass did not mean that the party described as an 'insured' lost that character simply because liability of the insurer was so limited.

Noting that had the insurer wished the definition of 'the insured' to encompass only the parties described insofar as they were insured against the particular risk, it would have been easy for the definition to say so in express terms, Williams J held that the waiver must extend to parties described in the definition as 'insured' even though not insured against the particular loss in question. Accordingly, it followed that the insurer was not entitled to bring the action against the respondent relying on the principle of subrogation.

¹¹⁵ Ibid 598.

De Jersey CJ agreed with the reasons of Williams J, noting that the result of the case depended on the construction of the contract of insurance and that there was not any sufficient reason to depart from a literal construction. His Honour thought it was significant that the interests of certainty favour easy identification of an 'insured' entity for the purposes of the waiver of rights arising by subrogation. Like Williams J, his Honour also considered that had the parties wished to limit the provisions as the appellants contended, the parties could, with ease, have done so expressly and with complete clarity.

The dissenting judgment

Pincus JA dissented. His Honour observed that, insofar as the *Woodside Petroleum* case decided that a clause providing for waiver of subrogation rights should be given its ordinary meaning and should not be read down so as to confine its operation in the way suggested by the *National Oil Well* case, that he would, unhesitatingly, follow that view. Pincus JA also thought it sounder, as a matter of policy, to favour a construction enhancing, rather than restricting, the scope of the waiver.

His Honour was however, attracted to the argument that if one applies that part of the definition of 'the insured' which sets out the extent to which a consultant is within 'the insured', then the waiver could not cover the respondent. His Honour thought that the respondent's argument required acceptance of the view that if a party is, in any capacity or for any purpose, an insured, it is an insured for all purposes.

Pincus JA thought that if that were so, and the respondent were given temporary insurance under the policy, it being contemplated that after a period of, say, a month it would take out its own insurance, it would have the benefit of the waiver clause whenever the events giving rise to the relevant suit occurred (this, with the greatest respect, is unconvincing, as clearly a party's right to take the benefit of cover can be subject to temporal limitations). Be that as it may, his Honour, in concluding that the appeal should be allowed, saw no conceptual difficulty in the parties agreeing that a consultant should be treated as an insured under the policy for one purpose but not for another.

Implications

This case was concerned, not with the common law notion of circuity of action, but rather with the operation of an express waiver of subrogation clause. This clause did not seek to make the waiver commensurate with the cover offered under the policy, nor did it contain a proviso in relation to a particular class of insured (eg consultants). Accordingly the waiver operated to preclude recovery against any party insured under the policy.

In his judgment, Williams J noted that the result may ‘at first blush’ be thought to be rather unusual. His Honour, however, could see reasons why the large number of parties affected by a works undertaking (such as that involved in the present case) and an insurer might consider that such a position had commercial advantages. The writer would respectfully suggest that, while the commercial advantages from the consultant’s point of view are obvious, it is a little more difficult to discern the benefits to an underwriter who has paid out a significant claim, and might reasonably assume that it is entitled to seek full recovery from a party who will presumably have maintained its own professional indemnity insurance.

Notwithstanding this, the position in this country in light of both *Woodside Petroleum* and this decision seems clear. That is, if an insurer wishes the definition of an insured to encompass only the parties described insofar as they are insured against a particular risk, it must do so in the definition in express terms as opposed to simply naming and describing certain persons and parties as constituting ‘the insured’ in a policy schedule or the like.

The impact of the *GPS* case can be overcome, by seeking to have the definition of ‘Persons Insured’ encompass only those parties described insofar as they were insured against a particular risk. To prevent such a party thereafter seeking to take the benefit of the waiver of subrogation clause, this clause can be drafted to make the waiver commensurate with the cover offered under the policy, and it can further contain a proviso in relation to any particular class of insured (eg professional consultants/suppliers) in respect of which the insurer wishes to preserve its rights of recovery.

Circuitry and waiver of subrogation revisited

The case of *Larson – Juhl Australia LLC v Jaywest International Pty Ltd*¹¹⁶ concerned the purported exercise of rights of subrogation, in respect of a claim paid under the Business Interruption Section of an ISR policy. The insurer brought proceedings in the Supreme Court in the name of the plaintiff against the vendors and the guarantors of the sale of a business. The Plaintiff relied on warranties in the contract of sale and alleged misleading and deceptive conduct, contrary to the relevant sections of the *Trade Practices Act 1974* (Cth) and the *Fair Trading Act 1989* (Qld).

The defendants relied on the waiver of subrogation clause in the policy. The vendors were co-insureds under that policy in respect of their own stock in trade (which had remained on the premises) but were not otherwise covered. The policy did not cover the vendors and guarantors in respect of liabilities for breaches of warranty or for misleading and deceptive conduct.

The waiver of subrogation clause read as follows:

The insurer shall waive any rights and remedies or relief to which it is or may become entitled by Subrogation against:

1. *any Co-insured (including its directors, officers and employees);*
2. *any corporation or entity (including its directors, officers and employees) owned or controlled by any insured or against any co-owner of the property insured.*

The defendants relied upon this clause as a complete defence and this was the subject of a separate question referred to the Master who was asked to determine whether the plaintiffs were entitled to maintain proceedings against the defendants having regard to:

- the general law dealing with the right of an insurer to bring subrogated recovery proceedings against the co-insured under the policy of insurance in which the right of subrogation derives; and
- the terms and conditions of the relevant industrial special risk policy issued in favour of the plaintiff and the defendants jointly.

¹¹⁶ (2001) 11 ANZ Ins Cas 61-499.

The decision at first instance

Master Macready, in a careful judgment, upheld the defence that the insurer did not have subrogation rights in respect of the pleaded causes of action and dismissed the proceedings. The Master considered the line of both United Kingdom and Australian authorities in relation to the scope and operation of waiver clauses as well as the ability of an insurer to proceed by way of subrogated action against a co-insured in the absence of such a clause, and noted that the three principal cases, namely, *Petrofina*, *Co-operative Bulk Handling* and *Woodside Petroleum* were all cases where there was a construction project and the policies involved insurance of property.

The Master, however, found the decision in *Maxitherm Boilers Pty Ltd v Pacific Dunlop Ltd & Anor*¹¹⁷ to be instructive, as it concerned the type of policy which the court was asked to consider in the present case, by contrast with the other cases which concerned contractors' all risk insurance.

The Master observed that in the *Maxitherm* decision, the court sought to confine the notion of 'pervasive interest' to project construction insurance. Noting that the present case was not one concerned with such insurance, the Master considered there was no warrant for him applying the immunity from subrogated claims in such cases to the present matter.

Turning his attention therefore to the scope and effect of the waiver of subrogation clause, the Master considered that the effect of the decision of the Full Court of Western Australia in *Woodside*, and that of the decision of the Queensland Court in *GPS Power Pty Ltd v Gardiner Willis Associates Pty Ltd*,¹¹⁸ was that there was no doubt that in respect of cases concerning project insurance, the decision of Coleman J in *National Oilwell* should not be followed insofar as the judge in that case confined the effect of the waiver to claims for losses which were insured for the benefit of the party claimed against under the policy.

Noting that an essential part of the reasoning in *Woodside*,¹¹⁹ both at first instance and on appeal, was that co-insurance and waiver of subrogation are different concepts, the Master sought to construe the effect of the waiver clause independently from the co-insurance aspect. Accordingly, contrary to the position in relation to co-insurance, he saw no reason to confine the reasoning of the Full Court in the *Woodside* case, insofar as it related to the operation and effect of the waiver clause, to a project construction case.

¹¹⁷ [1988] 4 VR 559.

¹¹⁸ [2000] QSC 075.

¹¹⁹ *Woodside Petroleum Development Pty Ltd v H & R, E & W Pty Ltd* (1999) 20 WAR 380.

The Master considered that, logically, a restriction upon the extent of a waiver of a right of subrogation can only arise by varying the person in favour of whom there is a waiver, or the nature of the claims that are waived.

As the words of the waiver should normally be construed in accordance with their '*plain, ordinary and popular sense*', the Master thought that it was difficult to determine a mechanism for restricting the expressed waiver, posing the question:

Is it to be a limitation on the nature of the claims that are waived expressed:

- (a) *as a temporal limitation;*
- (b) *as to the nature of the cause of action; or*
- (c) *as to the facts upon which the cause of action is based?*

The Master considered that none of these limits flowed from a consideration of the terms of the policy or the circumstances of the insurance.

Although not necessary, in view of his decision, to determine the question in relation to the issue of circuity of action, the Master noted that recently in *McCamley v Harris*¹²⁰ Young J, after reference to a number of cases, set out the requirements in respect of a defence of circuity of action. These he said were:

- it must be shown that precisely the same amount of damages would be claimed in the defendant's proposed action as in the plaintiff's action;
- both the plaintiff and the defendant must be suing each other in the same right;
- both actions must be actions at law, not one in law and one in equity; and

either the cause of action must be complete, or alternatively, the defendant so obviously has an action as a result of the finding of the plaintiff that it would be scandalous to put the defendant to the trouble of starting a fresh action.

¹²⁰ *McCamley v Harris* (1997) 8 BPR 15,683.

Observing that, in the present circumstances, any claim by the defendants under the policy would relate to their loss of profits which would be in a different amount from those of the plaintiff, the Master concluded that in these circumstances the defence of circuity would fail.

The decision on appeal

In a short judgment, the Court of Appeal considered that the construction adopted by the Master of the waiver of subrogation clause of the relevant policy of insurance was correct.

As the decision of the Full Court of the Supreme Court of Western Australian in *Woodside* had since been followed by the Court of Appeal in Queensland in *GPS Power Pty Ltd v Gardiner Willis & Associates Pty Ltd*,¹²¹ the appellant's counsel did not challenge those decisions, but submitted that they were distinguishable because both were concerned with contractors' all risk policies intended to cover all relevant parties in a major construction project, which was not the case in the present appeal.

The appellant's counsel's first submission was that the clause should be construed as being coextensive with the cover provided under the policy. In rejecting this argument, the court observed that it was self defeating as it would only mean that the insurer would become entitled by subrogation to rights and remedies in respect of damage for which the policy responds. If it did not respond, then the insurer would not be liable and no question of subrogation would arise.

As to the appellant's counsel's further submission that the Master should have read down the clause in question, the court could not see how it would, on ordinary principles of construction, be entitled to make the implications sought in the appellant's submission. Observing that the duty of the court is to construe the language of the clause fairly and simply without making any extensive or extravagant implications, the court considered that there was nothing to confine the generality of the words '*shall waive any rights and remedies or relief*'.

¹²¹ [2001] 2 Qd R 586.

Implications of the decisions

- Courts of Appeal in Queensland, Western Australia and now New South Wales have emphatically rejected the position adopted by Colman J, in *National Oilwell*,¹²² to the effect that waiver clauses should be construed so as to confine their effect to claims for losses which are insured for the benefit of the party claimed against under the policy;
- In the absence of a waiver of subrogation clause, the notion of 'Pervasive interest' relied upon by the courts as a basis to defeat subrogated claims against co-insureds should be confined to project construction insurance;
- Co-insurance and waiver of subrogation are different concepts and that it should not be presumed that the parties must have intended that one be co-extensive with the other;
- Waiver clauses will be construed in accordance with their 'plain, ordinary and popular sense' and in the absence of a limitation which flows from a constriction of the terms of the policy or the circumstances of the insurance, are unlikely to be read down;
- A restriction upon the extent of a waiver of a right of subrogation can only arise by varying the person in favour of whom there is a waiver or the nature of the claims that are waived;
- An insurer appears to be entitled to subrogate to rights which are not rights arising from conduct which caused the casualty;
- The defence of circuitry of action is only likely to be available in the very limited circumstances set out in *McCamley v Harris*,¹²³ ie the defence will only be available when the rights of the competing litigants are such that the defendant would be entitled to recover back from the plaintiff the same amount which the plaintiff seeks to recover from the defendant.

Accordingly, if a waiver of subrogation clause is to be inserted into a policy of insurance, the drafter of such a clause should have regard to any matters in respect of which the underwriter wishes to preserve the right to bring recovery proceedings against a co-insured, and seek to expressly limit the scope and operation of the clause accordingly.

¹²² *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyds Rep 582.

¹²³ *McCamley v Harris* (1997) 8 BPR 15,683.

APPLICABILITY OF DUAL INSURANCE WHERE THERE IS 'PRINCIPAL CONTROLLED' COVER

Issues of dual insurance and the interaction between 'principal controlled' policies, contractors' cover (both DIC and Global) and the insurance and indemnity provisions of project documentation, continue to bedevil the industry.

It seems that as a result of a number of decisions in Australia, where there is a principal controlled policy and also a contractor's policy, there is nothing to preclude the underwriter of the principal controlled cover seeking recovery from the underwriter of the contractor's policy on the basis of dual insurance.

This is notwithstanding a clear contractual intention in the project documents that the responsibility for insuring the project lies with the principal. This is the effect of the principle of dual insurance generally, and more specifically, the impact of ss 45 and 76 of *the Insurance Contracts Act 1984* (Cth) ('ICA').

Prior to the ICA it was common for contracts of insurance to contain 'other insurance' provisions, which excluded or limited the insured's liability in the event that another insurer was liable for the same loss. The effect of s 45 of the ICA was to render 'other insurance' provisions ineffective if more than one insurance has been entered into for the same risk. The insured is entitled to recover the whole of the loss from one insurer, who is then entitled to obtain contribution from the others.

Section 45 does not, however, have an impact on situations which involve layered policies where each policy covers a discrete range of the total risk and no overlap occurs.

Section 76 of the ICA complements the operation of s 45 and provides the right of an insurer, who has been forced to pay out a claim subject to double insurance to obtain contribution from any other insurer liable in respect of the same loss.

It is beyond doubt that these sections can operate unfairly against underwriters in circumstances where there is a clear contractual intention (and expectation) that a party (be it a principal or superior contractor) is to assume responsibility for insuring the respective rights and interest of the parties to a project. Examples of such clauses encountered in other policies and which are liable to be rendered void by the operation of s 45 of the ICA, are as follows:

Where contracts works insurance is arranged on behalf of the Insured difference in conditions cover is automatically provided hereon being the difference between the policy terms and conditions arranged on behalf of the Insured and the terms and conditions of this policy. Where there is no underlying cover this policy shall remain valid. Subject to the underlying policy terms remaining in force for the duration of the contact involved.

In respect of any contracts where the principal or owner or any other party arranges insurance for any contact and/or project which involves [the named insured or any of their subsidiaries or subcontractors] this policy shall at the insured's option apply (subject to the policy's terms and conditions) only to claims not recoverable or in excess of amounts recoverable there under, ie on a difference in conditions basis.

As was noted above, the effect of s 45(1) of the ICA is to render 'other insurance' provisions ineffective if the insured has entered into more than one insurance for the same risk. Section 45(2) provides that s 45(1) does not apply in relation to a contract that provides insurance cover in respect of some or all of so much of a loss as is not covered by a contract of insurance that is specified in the first-mentioned contract.

What was unclear, however, was the degree of specificity required before s 45(2) would come into operation.

This very issue has been considered by the Supreme Court of New South Wales Court of Appeal, in the decision of *HIH Casualty and General Insurance Ltd v Plum Constructions Pty Ltd*.¹²⁴

Facts

In that case, Plum Constructions Pty Ltd ('Constructions') was doing building work at the Mingara Recreation Club. An employee of a related company also working on the site was injured and sued Constructions and another associated company, in the District Court.

¹²⁴ (2000) 11 ANZ Ins Cas 75,477.

Constructions were insured with the appellant, HIH Casualty and General Insurance Ltd ('HIH'), against public liability risk, and when Constructions' claim for indemnity under the policy was refused, it joined HIH as a third party in the proceedings. The proprietor of the Mingara club also had effected policies of public liability insurance for Constructions in respect of personal injury or death arising by accident, where the accident arose out of, or was caused by, the execution of the building works. These policies were taken out with the Commercial Union Assurance Company of Australia Ltd ('CU').

Constructions claimed indemnity under the CU policies pursuant to a third party notice. CU denied liability, relying upon various exclusions. The Judge at first instance found for CU, holding that Constructions' claim fell within one of those exclusions.

HIH argued that condition 7 of the HIH policy dealing with principal-arranged insurance, allowed it to escape liability under its own policy if CU was liable under the CU policy.

His Honour at first instance found that condition 7 was rendered void by s 45(1) of the ICA, in particular because the CU policy was not '*specified*' in the HIH policy. HIH appealed and the respondents were Constructions and CU.

On appeal it was submitted by HIH, that if the CU policy responded, there would not merely be a case of double insurance, but HIH would be exempted entirely because of condition 7 of the HIH policy which stated:

Principal-Arranged Insurance

In the event of the named Insured entering into an agreement with any other party (who for the purpose of this clause is called 'the Principal'), pursuant to which the Principal has agreed to provide a policy of insurance which is intended to indemnify the named insured for any liability arising out of the performance of the works then the company(ies) will . . . only indemnify the named insured for such liability not covered by the policy of insurance provided by the Principal.¹²⁵

On appeal, it was accepted by the parties that subsection (1) would avoid condition 7 unless subsection (2) applied. Assuming that the CU construction policy responded, the issue became one of determining whether the words '*the policy of insurance provided by the principal*' in condition 7 were sufficient to specify the CU policies within s 45(2).

¹²⁵ Ibid 75, 480.

The Court of Appeal decision

The primary Judge had held that the language of condition 7 was too general and not of sufficient specificity to satisfy s 45(2). The Court of Appeal agreed.

The Court observed that the only judicial decision on s 45(2) was the unreported decision of Judge Robin QC, DCJ of the Queensland District Court, in *Austress – PSC Pty Ltd and Carlingford Australia General Insurance Ltd v Zurich Australian Insurance Ltd*.¹²⁶ The Court of Appeal considered that decision to be a very clear one on its facts, because the relevant provision did no more than refer to *‘any other policy of indemnity or insurance in favour of, or effected by or on behalf of the insured applicable to such occurrence’*.

Nevertheless, the Court thought it pertinent that Judge Robin QC accepted the submission that s 45(2) was:

*... to be construed as requiring reference to ‘other insurance’ to be specific, as opposed to a description in general words capable of extending to other insurers, if the provision under examination is to survive being struck down by subsection (1).*¹²⁷

The Court of Appeal concluded that it was unnecessary to seek a definitive meaning of the subsection, although the policy of s 45(1) suggested to the Court that the exception in subsection (2) should be construed narrowly. The Court said that whatever the outer limits of the subsection, it could not, in any event, read condition 7 of the HIH policy as specifying ‘a’ (emphasis added) contract of insurance such as the CU construction policy.

The Court noted that here there was no identification of any particular policy with any particular insurer. The type of insurance which the proprietor was obliged to take out was described in the building contract in terms of the broadest generality and with no reference to conditions or exclusions. The Court further noted that the HIH policy was not in form or substance a type of layered insurance or excess insurance.

That the *‘insurance’* would be *‘principal-arranged’*, only emphasised its futurity, contingency and lack of relevant specificity. In the context of condition 7 the court considered that a *‘policy of insurance’* means any policy of insurance. The court thought this was the antithesis of a *‘specified contract’* within s 45(2).

¹²⁶ *Austress-PSC Pty Ltd v Zurich Australian Insurance Ltd* (Unreported, Queensland District Court, Robin J, 1 May 1992).

¹²⁷ *Ibid* 6.

The judgment went on to note that it may be that a contract of insurance need not actually have been formed and/or commenced before it is capable of being specified within s 45(2). It was thought possible that a clearly defined class of insurance such as 'X's *standard Construction Policy with an excess of Y*' would suffice. The court, however, reserved its position on these possibilities.

Recent authorities

Reference should also be made to a decision of her Honour, Johnson J in the Supreme Court of Western Australia, in March 2007 in *Zurich Australian Insurance Ltd v Metals & Minerals Insurance Pty Ltd*.¹²⁸ In that case, Zurich contended that there was no difference in substance between the clause under consideration and the clause relied on in the HIH case.

On the other hand MMI's main contention was that s 45(1) did not make void other insurance provisions where [as was the case] the insured was entitled to the benefit of a policy 'entered into' by another.

MMI also argued for a 'distributive' approach (so that s 45(1) might have the effect of rendering the provision void in one of its applications but not in another eg – where the insured has the benefit of another contract of insurance taken out by a third party which covers the same risk). Zurich rejected the distributive approach on the basis that s 45 was intended to render void all 'other insurance' clauses.

Her Honour said that in either case 'the underlying insurance clause . . . clearly has the effect of limiting or excluding the liability of the insurer under the contract', continued; '. . . such a provision is void only where the insured has 'entered into' the underlying insurance policy . . . nevertheless, in my view, the only way in which to achieve that result is to give to the expression 'the insured has entered into' . . . meaning they simply do not have . . . essentially I believe that s 45(1) requires amendment to achieve the purpose which I accept was intended by the legislature . . .'.¹²⁹

Having seemingly determined thus, her Honour went on to say:

*The question for the Court is whether or not the Zurich policy is specified in the sense required by s 45(2).*¹³⁰

¹²⁸ (2007) 209 FLR 247.

¹²⁹ Ibid 280.

¹³⁰ Ibid.

Having determined that it was not, Johnson J concluded:

For the reasons I have outlined, I am satisfied that the underlying insurance clause in the Hamersley Policy is in breach of s 45(1) and is not saved by s 45(2). On that basis, the clause is void and MMI cannot rely on it to allege that its liability is not co-ordinated with that of Zurich.¹³¹

The reasoning for this finding was with respect, accordingly difficult to follow and perhaps unsurprisingly an appeal from the decision was lodged.¹³² What the judgment does reinforce however, is the degree of specificity which will be required in order to enliven the operation of s 45(2).

The underlying insurance clause in the Hamersley policy was in the following terms:

Underlying Insurance

Underwriters acknowledge that it is customary for the insured to effect, or for other parties including joint venture partners, contractors and the like) to effect, on behalf of the Insured, insurance coverage specific to a particular project, agreement or risk.

In the event of the Insured being indemnified under such other Insurance effected by or on behalf of the Insured (not being an Insurance specifically effected as Insurance excess of this Policy) in respect of a Claim for which Indemnity is available under this Policy, such other Insurance hereinafter referred to as Underlying Insurance, the Insurance afforded by this Policy shall be Excess Insurance over the applicable Limit of Indemnity of the Underlying Insurance, but subject always to the terms and conditions of this Policy.

¹³¹ Ibid 285.

¹³² On Appeal [2009] WASCA 31, it became apparent that it was her Honour's finding that s 45 rendered the whole of the underlying insurance clause void, that was critical. It was held by the Court of Appeal that s 45 could not be read as excluding severance, and this was confirmed on appeal to the High Court in *Zurich Australian Insurance Ltd v Metals & Minerals Insurance Pte Ltd* [2009] HCA 50, which also concluded that s 45 did not allow room for a construction which would include a non-party insured among the ranks of those who have 'entered into' the relevant contract.

For an even more recent example of the manner in which s 45(1) can operate, see the decision of *Australasian Medical Insurance Ltd & Anor v CGU Insurance Ltd* [2010] QCA 189 [32] – [36].

In the event of cancellation of the Underlying Insurance or reduction or exhaustion of the Limits of Indemnity thereunder, this Policy shall:

- (i) in the event of reduction pay the excess of the reduced underlying limit*
- (ii) in the event of cancellation or exhaustion continue in force as underlying insurance*

but subject always to the terms and conditions of this Policy.

In finding that the clause was not ‘saved’ by s 45(2), Johnson J said:

Having considered the purpose of s 45(2) and keeping in mind that the requirement that the other insurance policy be specified is designed to ensure that the relevant clause is a true ‘excess’ clause, I have formed the view that the underlying insurance clause in the Hamersley Policy insufficiently specifies the other insurance contract for it to be ‘saved’ by s 45(2). In particular, I share the opinion of Mason P in HIH Casualty & General Insurance Ltd (above) that broad wording of this type is inadequate . . . Whilst I accept MMI’s submission that it is possible and indeed, in relation to contracts entered into subsequently, necessary to identify the other policy by class, I mean by that that it is not necessary to identify a particular policy. However, it remains necessary to provide sufficient information concerning the class to be able to identify the policies within that class as providing the primary cover, with the policy with the ‘excess’ clause providing cover for loss over and above the limit of the other policy.¹³³

Her Honour observed that she was not required to identify the way in which an arrangement of the type entered into between Hamersley and Speno should properly be specified in order to fall within s 45(2), but in the circumstances of the case would not have thought it was particularly difficult to consider the various classes of contracts requiring the other party to obtain insurance to Hamersley’s benefit, to ascertain the identifying criteria in relation to each class of contract.

The Western Australia Court of Appeal delivered its judgment on 6 February 2009.¹³⁴

¹³³ Ibid 284.

¹³⁴ *Speno Rail Maintenance Australia Pty Ltd v Metals & Minerals Insurance Pty Ltd* [2009] WASCA 3.

Relevantly, in relation to the requirement for there to be specificity under s 45(2) the Court of Appeal noted that there was force in Zurich's submission that the fact that in particular circumstances it may be onerous or impossible for greater specificity to be given in an other insurance clause is not a ground for watering down the requirement or specification. In order that an excess policy be 'specified' for the purpose of s 45(2), the specification must have contained sufficient information to enable the identification of a specific primary policy to which the excess policy was intended to be secondary.

The court concluded:

'... if the insurance is not sufficiently specifically identified, the Policy will not be a true excess policy... An inability or failure to adequately specify a policy for the purpose of s 45(2) means the general rule in s 45(1) will apply. That will result in both insurers being liable to the insured, for whose benefit s 45 was inserted, with certainty and security. The insurer who indemnifies will be able to claim contribution from the other insurer'.¹³⁵

Finally, in relation to s 76 and dual insurance, mention should also be made of the recent Victorian Court of Appeal decision in *QBE Insurance (Australia) Limited v Lumley General Insurance Limited*.¹³⁶

The Court of Appeal held that the correct principles, in so far as they were applicable to the case [the facts of which are not herein particularly relevant] were as follows:

- (a) *An insurer (first insurer) is entitled to contribution from another insurer (second insurer) if the following requirements are met:*
 - (i) *both insurers insure a common insured*
 - (ii) *the common insured has suffered a loss or incurred a liability that is covered by both policies in whole or in part*
 - (iii) *the first insurer has indemnified the common insured in respect of the loss or liability in whole or in part, in accordance with its obligations under its policy*
 - (iv) *the second insurer has not indemnified the common insured in respect of the loss or liability in whole or in part, in accordance with its obligations under its policy.*

¹³⁵ Ibid [30]. It should be noted that the issue of the specificity required was not the subject of the Appeal to the High Court.

¹³⁶ (2009) 256 ALR 574.

- (b) Ordinarily, the question whether the loss or liability is covered by both policies is determined at the time of the insuring clause event. The fact that, subsequently, the second insurer ceases to be liable under its policy because the common insured has been indemnified by the first insurer under its policy does not extinguish the first insurer's right to contribution.¹³⁷
- (c) Where the loss or liability falls within an exclusion in the second policy, the first insurer is not entitled to contribution from the second insurer.

Relevantly, the Court of Appeal also confirmed the finding of the Judge at first instance that although a party, *Commercial Interiors*, was not a party to the Lumley policy, it came within the definition of Insured under the policy and, in accordance with s 48 of the Insurance Contracts Act, it had a right to be indemnified under that policy. Neither s 48 nor the Lumley policy made that right contingent on the making of a claim.¹³⁸

Devices to limit recovery

While the most recent authorities suggest that it may not be necessary to identify by reference to a policy number, for example, a specific 'other' contract of insurance, the cases highlight the high degree of specificity which will be required before the courts will give effect to the operation of s 45(2) and relieve an insurer of the effect of s 45(1). Some suggested devices to limit the potential for this type of recovery are as follows:

- Provide no cover for certain events where it may be expected that other insurance is held.
- Have in place a true 'layered policy' situation, to the extent that the cover provided covers separate and distinct losses.

¹³⁷ The situation can be contrasted with that which arose for consideration in *Collyear v CGU Insurance Ltd* (2008) 15 ANZ Ins Cas 61-760, where the damage had been remedied pursuant to an indemnity provided by someone other than the insured and outside of the insurance cover.

¹³⁸ Because the policy contained a provision that any notice of claim given by one insured party would be treated as a notice of claim by all insured parties, but in any event, the insured's omission to give notice would be remedied by s 54 of the *Insurance Contracts Act 1984* (Cth).

- Specifically identify the policy taken out as project insurance, making it clear that in effect the subject policy will only operate on a DIC basis to that policy. (A point of construction arises as to what is to be specified: is it the contract of insurance or is it the loss that is not covered? Although it has been suggested that it is the loss not covered that needs to be specified and not the particular contract, this is doubtful and ideally both should be specified to put the matter beyond doubt).
- Insert a substantial deductible in respect of claims made other than through the named insured to prevent parties further down the contractual chain from claiming against the policy where there is other 'more appropriate' insurance. Another mechanism which may be utilised in this scenario is a 'provisions to the contrary clause' coupled with limiting provisions in the contract documents (refer *Woodside Petroleum*).¹³⁹
- Where there is principal controlled CAR in place, delete (if possible) the reference to principal as an 'insured' in the contractor's policy. This is because the definition of 'insured' under the principal controlled policy may be read 'distributively', so that it will not be the 'same insured' covered in respect of the same risk (subject to who makes the claim under the principal controlled CAR insurance).
- Finally, as a matter of claims management, it is obviously preferable that any claim which arises on a project which has principal controlled CAR cover, be referred to that insurer at first instance. Although it will not preclude that insurer from seeking contribution against other appropriate insurance held by the parties to the project, it is a matter for that insurer to ascertain the existence of those policies and then to seek recovery.

¹³⁹ *Woodside Petroleum Development Pty Ltd v H & RE & W Pty Ltd* (1999) 20 WAR 380.

DAMAGES FOR BREACH OF CONTRACT FOR FAILING TO NOTE OTHER PARTIES INTERESTS

Background

A situation commonly encountered in construction claims, both in relation to property damage and injury to workers on site, is where parties have failed to comply with the requirements of their contracts and subcontracts, to note the interests of other parties in the project as an insured. Often, however, the parties whose interests were not noted have their own 'floater' or other policy of insurance, which covers them in respect of that relevant risk.

Until recently, it was often thought to be futile to bring an action against a co-defendant for breach of contract for failing to insure the other defendant's interests, as the other defendant had suffered no 'loss', having the benefit of indemnity under its own policy of insurance. Arguably, the only party to have suffered any 'loss' is the underwriter of the 'floater' policy which then finds itself without the ability to even claim contribution on the basis of dual insurance from the other defendant's insurer.

It had been thought possible that, in such a case, it was only where the defendant had a substantial deductible under its 'floater' policy, that there was any loss suffered that would be compensable as damages for breach of contract and that otherwise damages would be nominal. This arose from the fact that the defendant's underwriter, while indemnifying the defendant, was not itself a party to the litigation nor to the contract between the defendant and the party in breach. If the underwriter was only able to subrogate itself to rights arising out of the claim which gave rise to the obligation to indemnify (and this proposition now seems doubtful in light of the *Jaywest*¹⁴⁰ decision referred to earlier) it was unable to recover its own 'loss' as this arose from the other party's failure to insure the defendant's interests.

¹⁴⁰ *Larson-Juhl Australia LLC v Jaywest International Pty Ltd* (2001) 11 ANZ Ins Cas 61-499.

Recent case

This situation has been considered by the Full Court of the Supreme Court of Western Australia in the case of *Thiess Contractors Pty Ltd v Norcon Pty Ltd*.¹⁴¹ In that case the respondent was alleged to be in breach of a contractual term to procure and maintain an insurance policy on behalf of the appellant and respondent. The question for the court was whether the fact that the appellant had taken out public liability insurance on its own behalf precluded recovery of damages from the respondent for breach of contract.

Facts

Importantly, for present purposes, the appellant alleged in its statement of claim that it was a term of the subcontract between it and the respondent that the respondent would, at its own expense, ‘*procure and maintain*’ an insurance policy in the joint names of the appellant and the respondent and others, ‘*covering liability in respect of . . . personal injury to any person . . . where the injury arises out of or is caused by the execution of a subcontractor’s works*’,¹⁴² and that the respondent was in breach of that term in that it failed to procure the proposed policy.

The respondent pleaded in part of its defence the following:

5. Further or alternatively, if the second third party [the respondent] breached [18.04] of the . . . subcontract as alleged or at all, which is not admitted, then:
 - (a) at all material times the first third party [the appellant] had taken out its own public liability policy of insurance (‘the policy’), the further particulars of which the second third party is not presently aware;
 - (b) the first third party has made a claim, or is entitled to make a claim, pursuant to the policy with respect to any liability that it has in these proceedings;
 - (c) further or alternatively to subparagraph (b) above, the first third party has been granted indemnity pursuant to, or is entitled to be granted indemnity pursuant to, the policy;
 - (d) by reason of the matters pleaded above, there is no loss or liability in respect of which the first third party is entitled to claim indemnity pursuant to any other policy of insurance;

¹⁴¹ (2001) 11 ANZ Ins Cas 61-509.

¹⁴² *Ibid* 75, 912.

- (e) the insurer or insurers on the policy are not entitled to exercise a right of subrogation so as to claim pursuant to another policy of insurance on behalf of the first third party;
- (f) the first third party has suffered no loss by reason of any breach by the second third party of [18.04] of the . . . subcontract.

The appellant brought an application to strike out paragraph 5 of the respondent's defence, contending that the fact it had taken out its own public liability policy of insurance, in terms wide enough to cover the claim brought by the plaintiff against it, was irrelevant to its claim against the respondent. After a ruling by a lower court judge that paragraph 5 of the respondent's defence should stand, the appellant appealed to the Full Court, its sole contention being that the judge below erred in holding that paragraph 5 of the respondent's defence to the appellant's claim disclosed an arguable defence.

Decision

Steytler J, delivered the leading judgment with which Murray J and Templeman J agreed.

His Honour referred to the unreported judgment of the Full Court of the Supreme Court of Western Australia in *Hacai Pty Ltd v Rigil Kent Pty Ltd*,¹⁴³ in which the court stated as follows:

'In essence, the proposition argued is that the loss which the respondents' claim to be able to set-off against the appellant's claim for a contribution is the loss of insurance cover in respect of that claim which should have been provided at the expense of the appellant for the benefit of the respondents. The appellant argues that the respondents, however, may be seen to have suffered no such loss if they have precisely the same type of insurance cover albeit obtained at their own expense'.

The court in that case went on to state:

¹⁴³ *Hacai Pty Ltd v Rigil Kent Pty Ltd* (Unreported, Western Australia Full Court, Malcolm, Murray and Owen JJ, 16 August 1996).

'The intention of the parties appears to have been that the insurance against any such claim for damages as that made by . . . [the plaintiff], which might be brought directly or by way of a claim for contribution against either the appellant or the respondents, was to be effected at the expense of the appellant. It seems clear to me that the respondents have lost the capacity to meet the appellant's claim for a contribution by making a claim upon such a policy of insurance. The fact that they might otherwise defray the expense of meeting the appellant's claim seems to me to be irrelevant'.

Steytler J considered it to be consequently well established that, where a plaintiff suffers a loss as a result of a defendant's negligence but is the beneficiary of an insurance policy covering that loss, the sum received by the plaintiff from the insurer is not taken into account in reduction of the damages. His Honour went on to pose the question:

But what should be the situation where the plaintiff is entitled to recover damages from the defendant for breach of a contract to take out insurance on the plaintiff's behalf, but has taken out its own insurance to cover the same event or events?

His Honour noted that that question was considered in *Western Sydney Regional Organisation of Councils Group Apprentices v Statrona Pty Ltd*, unreported judgment of the Supreme Court of New South Wales.¹⁴⁴ There, Sheller JA, with whom Meagher JA was in agreement, said:

. . . the plaintiff's entitlement under a different contract for indemnity on the contingency of its becoming legally liable to pay compensation to the worker does not reduce the damages recoverable for breach of contract. The plaintiff is not indemnified by the second contract of insurance for breach of the first contract but because it has made a contract for a contingency upon the happening of which it became entitled to indemnity. If . . . [the plaintiff] claims against an insurer to be indemnified it must account to the insurer for any benefit which reduces the loss or liability insured against . . .

¹⁴⁴ (2002) 12 ANZ Ins Cas 61-530.

His Honour also considered an unreported decision of the Federal Court of Australia in *Besselink Bros Pty Ltd v Citra Constructions Pty Ltd*¹⁴⁵ in which the court (Smithers, Northrop and Gallop JJ) were confronted with a similar situation to that which arose in the present case. The appellant in that case had failed to obtain insurance which it was contractually obliged to effect. One of the contentions which was mounted by the appellant in answer to the respondent's claim against it was that the respondent had a right to indemnity from its own insurer in respect of its liability to the plaintiff and had consequently suffered no loss through the appellant's failure to obtain the insurance. His Honour noted that the court held that this submission was not sustainable and that, so far as the appellant was concerned, the fact that the respondent had effected a policy of the nature mentioned was 'purely fortuitous' and noted that there was no duty on the respondent to even make a claim under that policy.

His Honour considered that the cases referred to above provided an 'insuperable stumbling block' to a defence of the kind sought to be mounted by the respondent in paragraph 5 of its defence to the appellant's claim against it. His Honour concluded that the fact was that the appellant had lost the benefit of the proposed policy and thought it was irrelevant that it might, by resort to the policy which it had taken out, recover or avoid any expense which would otherwise have followed from the loss of the benefit of the proposed policy.

His Honour similarly rejected the contention by the respondent's counsel who sought to distinguish the cases relied upon on the basis that in the present case, there was a plea, in the alternative, that the appellant had already been granted an indemnity under the policy taken out by it. His Honour thought that even if the fact of an existing grant of indemnity was a sufficient distinction, it could not apply in the present case as the issues raised by the plaintiff against the appellant, and those between the appellant and the respondent, had yet to be tried.

¹⁴⁵ *Besselink Bros Pty Ltd v Citra Constructions Pty Ltd* (Unreported, FCA, Smithers, Northrop, and Gallop JJ, 31 October 1984).

Implications

The decision is an important one, particularly for underwriters involved in insuring the interests of parties engaged in construction projects and for contractors who are obliged to effect such insurance.

While the decision provides little guidance as to how the courts would assess damages for breach of the failure to note a party's interests, that may well equate to the full value of the indemnity which would otherwise have been available to that party had the notation been effected.

If that is the case, a defendant who has failed to procure the relevant insurance may find itself exposed to a claim for breach of contract in respect of which it is not entitled to be indemnified under its policy. By contrast, had it procured insurance as it was contractually obliged to, not only would it avoid potential exposure to an uninsured claim for damages, but its underwriter would be able to claim against the other party's insurer and seek contribution on the basis of dual insurance.¹⁴⁶

¹⁴⁶ In terms of whether or not a party is in fact in breach of an obligation to procure insurance, reference should be made to the decision of the New South Wales Court of Appeal in *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* [2008] NSWCA 114. In that case it was held that Australand's 'rights and interests' referred to were those provided by the indemnity clause. There being no right in Australand to recover from *Erect Safe* in respect of damage occasioned by its own negligence, there was no obligation on *Erect Safe* to obtain insurance to support Australand's direct liability to another, caused by the negligent act of Australand.

CONSTRUCTION LIABILITY POLICIES

Generally the initial policy triggers will, under a construction liability policy, be that there is:

1. A legal liability to pay 'Compensation';
2. In respect of personal injury or 'Property Damage';
3. As a result of an 'Occurrence'.

Ordinarily 'Compensation', 'Property Damage' and 'Occurrence' will be defined terms within the Policy as follows:¹⁴⁷

'Compensation' means monies paid or agreed to be paid by judgment or settlement.

'Property Damage' [the meaning of which will be considered from page 84 of this publication in the context of Contract Works insurance] includes:

Physical injury to a loss of or destruction of tangible property (often with a loss of use component).

'Occurrence' is an event (including continuous or repeated exposure to substantially the same general conditions) which results during the period of insurance in (personal injury) or Property Damage.

Compensation

It is clear that the liability must be an existing legal liability. It is now clear however that the obligation to pay 'Compensation' does not have to be one that arises from a tortious liability but can arise from breach of a statutory obligation or by way of damages for breach of contract.

In *Yorkshire Water Services v Sun Alliance & London Insurance PLCC* it was said:¹⁴⁸

¹⁴⁷ The precise wording of the definition will vary from policy to policy.

¹⁴⁸ [1997] 2 Lloyds Law Rep 21, 28-29.

In my judgment Mr Crowther's analysis is correct when he submits that there are four steps leading to a claim under the prudential policy. 1. the original cause; 2. an occurrence arising from the original cause, which is relevant to the limits of liability; 3. claims made by third parties in respect of damage to property; 4. the establishment of legal liability to pay damages or compensation in respect of such sums.

Or to put it another way there are four relevant requirements before an indemnity can be obtained under the policy. 1. Sums 2. which the insured shall become legally liable to pay 3. as damages or compensation 4. in respect of loss or damage to property.

*In this context 'sums' must mean sums paid or payable to third party claimants. No such sum arises in relation to the flood alleviation works. 'Legally liable to pay' must obviously involve payment to a third party claimant and not expenses incurred by the insured in carrying out works on his land or paying contractors to do so. And the liability must be to pay damages or compensation. 'Damages' means sums which fall to be paid by reason of some breach of duty or obligation, see *Hall Brothers Steamship Co. Ltd v Young*.¹⁴⁹ 'Loss or damage to property' is a reference to the property of the third party claimant and not that of the insured.*

*Mr Crowther relied on the cases of *Post Office v Norwich Union Fire Insurance Society*, and *Bradley v Eagle Star Insurance Co Ltd*¹⁵⁰ in which the *Post Office* case was affirmed. Both cases were concerned with claims where the plaintiff was suing the tortfeasor's insurer direct under the Third Parties (Rights against Insurers) Act 1930 and involved the question of what had to be established before the insured tortfeasor had a right to sue the insurer.*

Lord Denning M.R. in the *Post Office* case said:¹⁵¹

¹⁴⁹ [1939] 63 LIL. Rep. 143,145.

¹⁵⁰ [1967] 1 Lloyd's Rep. 216; see also *Bradley v Eagle Star Insurance Co Ltd* [1989] 1 Lloyd's Rep. 465.

¹⁵¹ *Ibid.*

... so far as the 'liability' of the insured person is concerned, there is no doubt that his liability to the injured person arises at the time of the accident, when negligence and damage coincide. But the 'rights' of the insured person against the insurers do not arise at that time. The policy says that 'the company will indemnify the insured against all sums which the insured shall become legally liable to pay as compensation in respect of loss of or damage to property'. It seems to me that the insured only acquires a right to sue for the money when his liability to the injured person has been established so as to give rise to a right of indemnity. His liability to the injured person must be ascertained and determined to exist, either by judgment of the court or by an award in arbitration or by agreement. Until that is done, the right to an indemnity does not arise. I agree with the statement by Devlin J. in *West Wake Price & Co. v Ching*¹⁵²

... the assured cannot recover anything under the main clause or make claim against the underwriters until they have been found liable and so sustained a loss . . .

This passage was expressly approved in the House of Lords in *Bradley's* case. It is subject to the gloss that the insured is entitled to sue for a declaration that the insurer will be liable to indemnify him, if this is disputed, before payment is actually made. And the contract can be specifically enforced so that the insurer can be obliged to pay, (unless there is a 'Pay to be paid' clause) without the insured actually having to pay first; but the liability to pay quantified sum must be established. See per Lord Goff of Chieveley in *Firma C-Trade Ltd v Newcastle Protection and Indemnity Association Ltd*.¹⁵³

The conclusion detailed by those authorities is that the insured has no entitlement to indemnity prior to the legal liability to a third party being established.

Scope for implication of a term

Policies often contain a mitigation clause requiring a party to take steps to avert or minimise the possibility of further loss. Often this obligation is one imposed as a purported precondition to policy coverage and is in rare circumstances there may in fact be an express right given to the insured to recover from the insurer amounts expended in mitigating its exposure.¹⁵⁴

¹⁵² [1956] 2 Lloyd's Rep 618.

¹⁵³ [1990] 2 Lloyd's Rep 191, 202.

¹⁵⁴ In the absence of an express right to payment, the mere fact that an obligation is imposed on one party to a contract for the benefit of the other does not of itself carry an implied term that there is an entitlement to reimbursement of the costs incurred: *Royal Sun Alliance Insurance (Australia) Ltd v Mihailoff* [2002] SASC 32.

An issue that sometimes arises is whether, in the absence of a 'mitigation' clause, it is open for an insured which has incurred expenditure in order to mitigate a liability to a third party (which would otherwise have been covered under a policy) to claim their costs directly against the insurer on the basis of an implied term in the policy.

In the case of *Yorkshire Water Services Ltd v Sun Alliance & London Insurance PLC*,¹⁵⁵ a unanimous decision of the Court of Appeal, the trial judge and Court of Appeal rejected the claim for the implication of such a term. Stuart-Smith LJ stated that one of the reasons for rejecting such an implication was that it was not necessary to imply any such term to give business efficacy to the liability policy in that case.¹⁵⁶

In *Yorkshire Water*, the insured operated a sewage sludge waste tip on the banks of the river Colne. There was an accidental failure of the tip, causing a vast quantity of sewage to be deposited in the river and into the sewage works. In order to avert further damage to the property of others and to prevent or reduce the possibility of claims similar to those made against the insured by a third party the plaintiff spent a large sum of money doing urgent flood alleviation works on its property. The plaintiff claimed the cost of the remedial works under liability policies under which it was an insured. It asserted an implied term that:

- (a) *Every contract of insurance carries an implied term that the insured will make reasonable efforts to prevent or minimise loss which may fall to the insurer. If such precaution of mitigation involves the insured in expenditure, it is an implied term . . . that the insured is entitled to be indemnified in respect of that expenditure'; or*
- (b) *'The insured is entitled to be indemnified (up to the limit of the policies) in respect of expenditure reasonably incurred to prevent or minimise further loss which may otherwise fall to the insurer consequent on the occurrence or event.*

The trial judge and the Court of Appeal rejected the claim.

¹⁵⁵ [1997] 2 Lloyd's Rep 21.

¹⁵⁶ *Ibid* 30.

Reference should also be made to *Guardian Assurance Co Ltd v Underwood Constructions Pty Ltd*.¹⁵⁷ In that case the High Court allowed recovery under a policy of insurance for the insured's costs of repairing uninsured items outside of an excavation which had been damaged. The court held that in circumstances where the insured's excavation had been damaged and the repair of those uninsured items was necessary to restore the insured excavation to its undamaged condition, that those costs should be recoverable as loss or damage to the insured excavation. The evidence in that case established that the damage to the office block disturbed the physical integrity and enduring quality of the excavation itself, which in the absence of repairs undertaken were susceptible to further collapse. The High Court however decided the case solely on the ground that the costs were recoverable because they were incurred to restore the already damaged insured excavation.

*Re Mining Technologies Australia Pty Ltd*¹⁵⁸ concerned a property damage policy, under which the insurer agreed to indemnify a mining company against accidental 'loss, damage or liability to' its underground mining equipment. That equipment was buried by a roof fall, as a result of which some of it was permanently lost. Some equipment was recovered by the insured. The insured's expenses of the successful recovery were far less than the insured value of the equipment. It was held by majority (Davies JA and McPherson JA, Pincus JA dissenting) that the insured was entitled to indemnity against those expenses.

The decision was concisely summarised by de Jersey CJ (Jerrard JA and White J agreeing) in *PMB Australia Ltd v MMI General Insurance Ltd*¹⁵⁹ in the following terms:

'... a condition of the contract of insurance . . . obliged the appellant to "take all reasonable precautions to prevent loss, destruction or damage to the property insured by (the) policy" . . . While not in terms apt to deal with the extended risk, the provision is not dissimilar from that from which Davies JA, in Mining Technologies, was prepared to imply the requisite term. . . . Davies JA was the only member of the Court prepared to do so. That said, the verbiage of the term Davies JA proposed itself indicates the inappropriateness of making such an implication here. The term his Honour proposed reads (p 72):

¹⁵⁷ (1974) 48 ALJR 307.

¹⁵⁸ [1999] 1 QdR 60.

¹⁵⁹ (2002) 12 ANZ Ins Cas 61–537.

'Where loss, damage or liability, which would otherwise have occurred, is avoided by the exercise of reasonable care, including the reasonable expenditure of money or performance of work, on the part of the insured or any person acting on the insured's behalf, that expenditure or the value of that work . . .'

The loss or damage sought to be avoided by the 'new awareness' based expenditure here was not in that sense certain to occur.

Insofar as the other members of the court touched on the issue, McPherson JA referred (p 88) to 'authority that expenses incurred in averting or warding off the imminent happening of the insured risk or peril are capable of being considered within the indemnity of the cover afforded against the loss itself', and Pincus JA was (p 67) prepared to contemplate an implication to cover 'extraordinary' expenditure to avoid 'imminent damage'. Those featured to not characterise this case.

The effect of the majority judgments is uncertain because the Judges in the majority gave different rationales for the result.

McPherson JA [84]¹⁶⁰ relied upon the conclusion that it

was not a case where the loss was merely apprehended or the peril had not yet begun to operate. The equipment was already trapped or stranded in the tunnel by the collapse of the roof before the expense was incurred. The expenditure . . . was necessary in order to retrieve (the equipment) from an event or loss which had already happened.

McPherson JA also relied upon *Guardian Assurance Co Ltd v Underwood Constructions Pty Ltd*.¹⁶¹

His Honour's reasons were not however adopted by Davies JA – nor was his Honour referred to the *Yorkshire Water Services Case*.¹⁶² Ultimately his Honour concluded that the process of retrieving the trapped equipment was one of 'repair' within the partial loss provisions of the Policy.

¹⁶⁰ *In Re Mining Technologies Australia Pty Ltd* [1999] 1 QdR 60, 65, 66.

¹⁶¹ (1974) 48 ALJR 307.

¹⁶² See also Pincus JA's analysis of *Guardian in Re Mining Technologies Australia Pty Ltd* [1999] 1 QdR 60, 65, 66.

Davies JA's finding of an implied term in *Re Mining Technologies* turned upon the nature of the policy and the facts of that case. His Honour found that retrieval of the equipment did not constitute repair, but his Honour was prepared to imply a term that provided for indemnity only in respect of expenditure incurred which avoided the occurrence of loss or damage.

Occurrence

A critical issue in determining policy response is the requirement that there be a relevant 'Occurrence' during the period of insurance. When an 'Occurrence' is said to arise in the context of a liability policy – specifically whether a relevant 'Occurrence' took place prior to the expiration of a maintenance/defects liability period (the relevant period of cover) under a policy of insurance, was considered in the matter before the Queensland Court of Appeal in *Windsurf Pty Ltd v HIH Casualty and General Insurance Ltd*.¹⁶³

In that case, the appellant was the developer of units at Runaway Bay and claimed to be entitled to be indemnified under its insurance contract with the respondent which had refused to indemnify it. The plaintiff had purchased one of the units and it was found that the carpet on the set of stairs had been negligently laid. In June 1993, the carpet moved, causing the plaintiff to fall and break her ankle.

The contract of insurance entitled the appellant to indemnity for sums payable *'in respect of or arising out of or by reason of . . . personal injury . . . happening as the result of an occurrence . . .'*¹⁶⁴ The period of that cover was expressed to operate *'in full force and effect'* until completion of the maintenance/defects liability period, which concluded at the end of March 1993. The carpet was negligently laid prior to that, but the plaintiff's fall occurred subsequently. The question for the court was – what was the 'occurrence' which led to the plaintiff's injury? de Jersey CJ delivered the unanimous judgment of the Court of Appeal. The Chief Justice stated:

*... The contract defines the word 'occurrence' to mean 'the event (including a continuous or repeated exposure to substantially the same general conditions) from which a loss or series of losses may emanate.'*¹⁶⁵

¹⁶³ (1999) 10 ANZ Ins Cas 61-447.

¹⁶⁴ Ibid 75,122.

¹⁶⁵ Ibid 75,123.

The learned judge referred to the ordinary conception of ‘event’, as being

‘something that happened at a particular time, at a particular place, in a particular way . . . an occurrence or an incident’, and took the view that the ‘event’ here was ‘the shifting of the carpet as [the plaintiff] walked upon it rather than the negligent laying of the carpet or the negligent inspection of the carpet as laid.’ The appellant contends that the relevant ‘occurrence’, the ‘event’, was the negligent laying of the carpet and the related inspection . . .

The Chief Justice went on to conclude:

*The use of the word ‘event’ would ordinarily invite one to focus on the proximate or immediate incident leading to the injury, here the shifting of the carpet, which occurred outside the period of insurance . . . What, in ordinary parlance, was the ‘event’, the happening or incident, for which [the plaintiff’s] injury flowed? Surely the shifting of the carpet and her fall . . .*¹⁶⁶

Accordingly, this suggests that in determining whether something is an ‘Occurrence’ within a construction liability policy, it will often be the ‘incident’ which gives rise to the damage, rather than the work during the construction period which will be determinative of policy response. This highlights the need for Contractors to maintain a ‘floater’ policy or procure ‘Completed Operations’ cover.

Against the proposition advanced above is a New Zealand authority – *Bridgeman v Allied Mutual Insurance*¹⁶⁷ in which it was found that farming operations represented by certain contracting work was the real cause of damage to a road in consequence of a land slip. In that case Nicholson J said that the doctrine of proximate cause was based on the presumed intention of the parties as expressed in the contracts which they had made. It must be applied with good sense so as to give effect to, and not defeat, that intention.

¹⁶⁶ Ibid.

¹⁶⁷ [2000] 1 NZLR 433.

One or more deductibles?

The focus on the 'event' in the decisions referred to above, raises another issue, being the possible imposition of multiple deductibles.

In the decision of *Seele Austria GMBH Co v Tokio Marine Europe Insurance Limited*¹⁶⁸ (a case concerned with contract works rather than liability insurance) the England and Wales High Court (Technology and Construction Court) noted that the Court of Appeal had held that workmanship deficiencies to each window represented a separate occurrence/event, and thus permit the defendant to apply the retained liability (or deductible as it was called) of £10,000 to each repaired window. It noted that if, on the other hand, the defects to the repaired windows were due to design errors, it had long been accepted by the defendant that such defects, repeated throughout the glazing works would constitute only one event or occurrence under the policy, and therefore give rise to one deductible of £10,000 in respect of all the windows.

The judgment of the Court of Appeal majority Moore-Bick LJ with whom Richards LJ agreed, was not disturbed by the High Court. Moore-Bick LJ concluded that:

'The workmanship deficiencies to each window represent a separate occurrence; there was a series of occurrences, but they did not arise out of one event.'

The learned Judge stated:¹⁶⁹

¹⁶⁸ [2008] EWCA Civ 441.

¹⁶⁹ *Ibid* [56].

‘... I do not think that the installation of defective windows can be regarded as an event for these purposes either, however, if they had all suffered from a common defect in design and manufacture which lay at the root of the problem, it might have been possible to argue, despite the number of separate units involved, that the installation of windows with a common defect was an event for these purposes, but as I understand the Judge’s findings, that is not really the case . . . Rather the impression one obtains from the findings in paragraph 5 of the judgment . . . is that poor workmanship was really to blame. It seems fairly clear that similar short comings in workmanship affected all the windows and I am prepared to assume for present purposes that in each case the same mistakes were made. However, there is no evidence that those mistakes were attributable to a single event, such as giving the workmen wrong instructions which they then conscientiously followed so as to produce a series of similar defects. Again, had that been the case, it may have been possible to argue that giving faulty instructions was the unifying event, but the Judge’s findings point to the conclusion that the defects were simply the result of poor workmanship repeated over and over again.’¹⁷⁰

Prior to making those findings, the Court had considered the ‘best test’ of the existence of a single event, being to ask whether there is a unity of cause, intention, location and time.¹⁷¹ The Court also noted that it was not altogether easy to say precisely what constitutes an ‘event’, but noted that in *Axa Reinsurance (UK) PLC v Field*,¹⁷² Lord Mustill (with whom the other members of the appellant committee agreed) suggested that in ordinary speak, an event is something that happens at a particular time, at a particular place, in a particular way.¹⁷³

¹⁷⁰ The decision in this case can be contrasted with an earlier decision of the Court of Appeal in *Mitsubishi Electric UK Ltd v Royal London Insurance Ltd and Others (UK)* [1994] 2 Lloyd’s Rep 249, in which Bingham MR effectively reduced the trial Judge’s finding of 94 deductibles down to a single deductible.

¹⁷¹ *Kuwait Airways Corporation v Kuwait Insurance Co SAK* [1996] 1 Lloyd’s Rep 664, 686 per Rix J.

¹⁷² [1996] 1 WLR 1026.

¹⁷³ *Ibid* 1035.

'AN(Y) INSURED' OR 'THE INSURED': RECENT DEVELOPMENTS IN THE INTERPRETATION OF CROSS LIABILITY CLAUSES AND 'WORKER TO WORKER' EXCLUSIONS'¹⁷⁴

The first step when receiving a claim for property damage or personal injuries is to determine whether a loss claimed is insured by the operation of the insurance policy and to what extent that loss (or a portion of it) is excluded. Sometimes this task is made difficult by imprecise contractual terms and indemnities and the failure of contracting parties to effect insurance for the benefit of other parties. Problems can also arise when determining the scope of indemnity where parties have effected insurance for the benefit of other construction participants who have suffered loss or injury.

This latter problem is demonstrated by two competing authorities of the Supreme Court of Queensland and a more recent Authority of the New South Wales Court of Appeal regarding the interpretation of the term 'the Insured' where a policy of insurance extends cover to more than one insured.¹⁷⁵ The issue in contention is whether the term should be interpreted to refer to each insured separately or to include 'any insured' or 'all insureds' for the purposes of interpreting insuring and exclusion clauses.

Re FAI General Insurance Co Ltd & Fletcher

The issue was considered by White J in the *Re FAI General Insurance Co Ltd & Fletcher*,¹⁷⁶ WorkCover Queensland sought a declaration that WorkCover and Fletcher's public liability insurer were each equally obliged to indemnify Fletcher for an injured worker's claim. The injured worker was employed by Fletcher's subcontractor and pursuant to the now inoperative *Worker Compensation Act 1990* (Qld) (the Act), Fletcher was entitled to indemnity from WorkCover.

The Public liability insurer relied on an exclusion clause, which excluded liability 'for bodily injury sustained by any person arising out of and in the course of such person's employment by *the insured*' (writer's emphasis).

¹⁷⁴ The author acknowledges the contribution of David Rodighiero, Partner Carter Newell Lawyers.

¹⁷⁵ *Re FAI General Insurance Co Ltd & Fletcher* (1998) 10 ANZ Ins Cas 61-403 and *WorkCover Queensland v Royal & Sun Alliance Insurance Australia Ltd* (2001) 11 ANZ Ins Cas 61-489.

¹⁷⁶ [1998] 10 ANZ Ins Cas 61-403.

WorkCover in response argued that the employee exclusion did not apply where the claim had been made by an insured who was not actually the employer, but was only 'deemed' to be an employer by operation of s46.1 of the Act.

Her Honour held that the words in the definition of the insured 'for their respective rights and interests', meant that it was necessary to consider the exclusion in the context of the insured who was making the claim for indemnity. Because the insured in that case (who was the principal) did not actually employ the worker, the exclusion did not apply. The public liability insurer was therefore liable to indemnify the principal for the worker's claim and dual insurance with WorkCover applied.

White J's decision and reasoning were unanimously approved by the Full Court of the Supreme Court of Western Australia in *Speno Rail Maintenance Australia Pty Ltd v Hamersley Iron Pty Ltd; Zurich Australian Insurance v Hamersley Iron Pty Ltd*.¹⁷⁷ The brief facts of that case were that an employee of Speno was injured while carrying out work on Hamersley's railway line. Speno had arranged insurance which extended cover to Hamersley. The policy, however, contained an employer's liability exclusion clause excluding liability 'arising out of or in the course of the employment of such person in the service of *the insured*'.

It was agreed that Speno's claim was expressly excluded under the exclusion. In determining this issue with respect to Hamersley, the Full Court considered the effect of the cross-liability clause in the policy which provided that each party comprising the insured shall be considered a separate legal entity and the word 'insured' applies to each party as if a separate policy had been issued to each party. The Court unanimously agreed that the clause be given its natural meaning in relation to each clause of the contract, except where the context required otherwise.¹⁷⁸ The Full Court also unanimously held that as the exclusion clause was intended to operate in respect of employer's liability, Hamersley was entitled to indemnity in respect of its liability to the worker, because it was not the worker's employer.

¹⁷⁷ (2000) 23 WAR 291.

¹⁷⁸ *Weightman v Noosa Shire Council* [1999] QSC 368.

WorkCover Queensland v Royal & Sun Alliance Insurance Australia Ltd

As a result of *FAI General Insurance* and *Speno*, it was considered that where a policy included similar clauses as found in those cases, each party comprising the insured would be considered a separate legal entity and the word ‘the Insured’ would apply to each party as if a separate policy had been issued to each. However, Wilson J of the Supreme Court of Queensland in *WorkCover Queensland v Royal & Sun Alliance Insurance Australia Ltd*,¹⁷⁹ in considering a cross-liability clause (which was substantially the same as that in *Speno*’s case), reached a conclusion which appeared contrary to that of the Full Court in *Speno*.

Further, Wilson J rejected the reasoning of White J in *FAI General Insurance* and said that an exclusion clause (similar to that in *FAI General Insurance*) ‘should be construed as excluding liability for injury in the course of employment by *any one of* the insured’ (including the subcontractor). Accordingly, her Honour concluded that the effect of the exclusion was that the insurers were not liable to indemnify the principal for its liability to a contractor’s employee.

Recent authority

Recently these issues were again considered at first instance by McClellan J of the Supreme Court of New South Wales in the matter of *Transfield Pty Ltd v National Vulcan Engineering Insurance Group Ltd*.¹⁸⁰

At first instance

Transfield was the principal contractor for the construction of a section of the New Southern Railway, being 158m of reinforced concrete tunnel. For the purpose of the project, Transfield engaged four subcontractors. On two separate occasions, sections of the works collapsed causing damage to plant and equipment belonging to two of the subcontractors. As a result, proceedings were brought by the two subcontractors. Transfield also commenced proceedings against the two subcontractors for property damage it had suffered.

¹⁷⁹ (2001) 11 ANZ Ins Cas 61-489.

¹⁸⁰ (2003) 12 ANZ Ins Cas 61-547.

Prior to the incidents, Transfield had taken out a Contractor's Floaters policy. The policy extended cover to Transfield, 'and their subcontractors and all principals as they may appear and all other interested parties as may be required, for their respective rights, interests and liabilities'. The policy was, however, subject to an exclusion 'for damage to property owned by **the Insured**'. (writer's emphasis)

The primary issue was whether the policy responded to indemnify the subcontractors against the claim made by Transfield, all of whom were insureds under the policy. This involved the determination of whether the meaning to be given to the term 'the Insured' in the exclusion clause was a reference to *any insured* or to the *separate insured* seeking policy indemnity in respect of the claim made against it.

Similar to the clauses in *WorkCover Queensland's* case the policy included a clause deeming subcontractors to be included in the name of the insured, waiver of subrogation and particularly a cross-liability clause that provided:

*Each of the persons comprising the Insured shall for the purposes of this policy be considered as a separate and distinct unit and the words 'the Insured' shall be considered as applying to each of such persons in the same manner as if a separate policy had been issued to each of them in his name alone . . .*¹⁸¹

The insurer argued that the property that failed was owned by Transfield and the policy does not respond to liability 'for damage to property owned by the Insured'. Furthermore, the insurer submitted that the expression 'the Insured' as identified in the deeming provision – 'In respect of operations performed by subcontractors . . . such subcontractors shall be deemed to be included in the name of Insured' – when used in the exclusion was to be construed as meaning *all* of the insureds under the policy.

In rejecting the insurer's arguments, McClellan J found that the policy was clearly intended to insure each insured (including subcontractors as deemed insureds) for their respective rights, interests and liabilities. Informed by the cross-liability clause, each party was to be considered a separate entity 'in the same manner as if a separate policy had been issued to each of them'.

Accordingly, the exclusions needed to be interpreted in the same light.

¹⁸¹ (2001) 11 ANZ Ins Cas 61-489, 75, 657.

Therefore as the claim for indemnity by the subcontractors relating to their liability for damage to Transfield's property was not for damage to their property, the exclusion was inapplicable and indemnity appropriate.

On appeal

The case went on appeal to the New South Wales Court of Appeal.¹⁸² The central question was whether the policy responded to a claim by one insured in respect of property damage it had sustained as the result of the assumed negligence of another, or whether the exclusion applied.

The critical part of Santow JA's reasoning (with whom Ipp JA and Young CF agreed) was—

42. . . . *When in clause 1 of section C the insurers commit 'to pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay' as well as defending any claim or suit against the Insured to recover damage, one would expect the words 'the Insured' to have the same meaning in section C when it comes to stating exclusions, namely the Insured who claims under the policy. Indeed clause 3(a) also logically must operate on that basis when it excluded 'bodily or personal injuries sustained by any person . . . in the course of his employment by the Insured'. Here, there is no need for any stretch of the imagination to envisage circumstances where employees of the Insured would claim under the policy but for the exclusion in clause 3(a).*
43. *Thus as each of the exclusions 3(a) and (b) operate as an exception to the cover provided by section C, each must be construed in the same manner. . . .*
44. *Similarly, the 'liability' in relation to which exclusions 3(a) and 3(b) operates is and can only be the liability of the particular insured entity which makes a claim under section C.*
45. *Further, to construe 'the Insured' in Exclusion 3 (b) as meaning 'any of the insured entities' is inconsistent with:*
 - (a) *the use of the definite article;*
 - (b) *the use elsewhere in the policy of different language where it is intended to refer to insured entities generally or any one or all insured entities. . . .*

¹⁸² *National Vulcan Engineering Insurance Group Ltd & Ors v Transfield Pty Ltd* (2003) 59 NSWLR 119.

49. *Furthermore, construing Exclusion 3(b) as referring only to the insured entity which makes the particular claim is expressly reinforced by [the cross-liability clause].*¹⁸³

His Honour rejected a submission by the insurer that his interpretation would render the exclusion redundant. He pointed out that it would apply to claims in respect of property in which a third party had a partial proprietary interest, and so exclude claims by one joint owner against another, or a mortgagee or lessee against an owner.

While the Policy considered in *National Vulcan*, expressly insured the parties ‘for their respective rights, interests and liabilities’ and it contained a cross-liability clause, those features did not appear to be essential to Santow JA’s reasoning.¹⁸⁴ Santow JA considered that the exclusion in *National Vulcan* could operate logically only if ‘the insured’ referred to was the insured making the claim. Although a contrary conclusion had been reached by Wilson J of the Supreme Court of Queensland in *WorkCover Queensland v Royal & Sun Alliance Insurance Australia Ltd*,¹⁸⁵ Santow JA specifically declined to follow Wilson J.¹⁸⁶

Conclusion

While the reasoning of the Court in *WorkCover Queensland* was expressly rejected in *Transfield*, it is submitted that the end result in *WorkCover Queensland* was correct, based on other aspects of the reasoning that the extension for the subcontractor only operated to the extent there was no other insurance. Ordinarily, such a provision would be void pursuant to s 45 of the *Insurance Contracts Act 1984* (Cth), except in the case of a contract of insurance required by law (for example, workers’ compensation insurance).

Regarding the interpretation of the term ‘the Insured’, the significance of the decisions in *Transfield* and *Speno* is that, while not authoritative in Queensland, they provide support for the decision and reasoning of *FAI General Insurance* to be preferred over that of *WorkCover Queensland*.

¹⁸³ *Ibid* ANZ Ins Cas 77,074-5.

¹⁸⁴ *Ibid* [42] – [45].

¹⁸⁵ (2001) 11 ANZ Ins Cas 61-489.

¹⁸⁶ *National Vulcan Engineering Insurance Group Ltd v Transfield Pty Ltd* (2003) 59 NSWLR 119.

Therefore, where a policy contains a cross-liability clause the meaning of 'the Insured', subject to an express intention to the contrary, should be considered in the context of the insured that is seeking coverage under the policy for the particular claim, which may extend to claims between insureds. For the exclusion to have operated as suggested by the insurer in *Transfield*, the policy wording ought to adopt language clearly reflecting the intent. McClellan J suggested that to achieve this intention, the exclusion would have to read either 'any insured' or 'an insured' rather than 'the Insured'.¹⁸⁷

¹⁸⁷ The principle that the expression 'the Insured' should ordinarily be construed as referring to the party insured seeking indemnity in respect of a particular claim, was confirmed by Pagone J at first instance in *Lumley General Insurance Ltd v QBE Insurance (Aust) Ltd* (2008) 15 ANZ Ins Cas 61-766, although the submission did not assist the insurer raising the argument. This was because his Honour noted that the notice could be given to the insurer by 'any party' insured under the policy and accepted as notice on behalf of all other parties insured. For a [obiter] discussion of the effect of a cross-liability clause, see *Speno Rail Maintenance Australia Pty Ltd v Metals & Minerals Insurance Pte Ltd* [2009] 15 ANZ Ins Cas 61-793,145-149.

CONTRACT WORKS POLICIES – ‘DAMAGE’ AND POLICY EXCLUSIONS WITH RESPECT TO DEFECTS IN DESIGN, MATERIALS AND WORKMANSHIP

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. While each case will be determined by reference to the particular policy wording, the following authorities are instructive, when assessing the likely attitude of the courts to such claims.

Two areas in particular are, the questions of what constitutes ‘*damage*’ or ‘*physical damage*’ under the policy and what portion of that damage can be said to fall within a common proviso to the defective workmanship/design exclusion seeking to limit the exclusion to that part of the works ‘*immediately affected*’.

The meaning of ‘Damage’

In *Graham Evans and Co (Qld) Pty Ltd v Vanguard Insurance Company Limited*,¹⁸⁸ Dowsett J held that mere unsuitability for purpose of works was not damage. That was however predicted on a policy which did not cover the works, but covered only the contractor’s plant.

By contrast, the rendering useless of a coat of paint was regarded as damage by Forster J in *Graham Evans and Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd*.¹⁸⁹

The English Court of Appeal case of *Promet Engineering v Sturge*¹⁹⁰ suggests that the term ‘damage’ should be given its ordinary meaning. In that case, a claim was made on an insurance policy in relation to damage to an offshore accommodation platform. Fatigue cracking was discovered in the platform which had started within welds which were found to be defective.

The Court of Appeal decided that there was damage within the meaning of the extension of the insurance cover (‘any defective part which has caused loss or damage to the [platform]’). Hobhouse LJ said:

¹⁸⁸ (1987) 4 ANZ Ins Cas 60-772.

¹⁸⁹ (1986) 4 ANZ Ins Cas 60-689, 74.

¹⁹⁰ [1997] 2 Lloyd’s Rep 146.

*... on any ordinary use of language they [legs and spud cans] were damaged. They were damaged by being subjected to stresses which they were unable to resist due to the latent defects, that is to say the wrongly profiled welds.*¹⁹¹

In *Prime Infrastructure (DBCT) Management Pty Ltd v Vero Insurance Ltd*,¹⁹² the appellants contended that the 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 court 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.

The Australian case of *Ranicar v Frigmobile*¹⁹³ also saw the court adopt (per Green CJ) the 'ordinary meaning of the word damage'. The Chief Justice said that damage required:

*A physical alteration or change, not necessarily permanent or irreparable, which impairs the value or usefulness of the thing said to have been damaged.*¹⁹⁴

That case in fact involved scallops which, due to being stored at a higher temperature than prescribed by export regulations could not be exported notwithstanding the fact that they could still be eaten. The court said that the alteration in temperature had

*undeniably involved a physical change to a substance and that change had the effect of removing one of the primary qualities which the scallops had – their exportability.*¹⁹⁵

¹⁹¹ Ibid 156 per Hobhouse LJ.

¹⁹² (2005) 13 ANZ Inc Cas 61-661.

¹⁹³ (1983) 2 ANZ Ins Cas 60-525.

¹⁹⁴ Ibid 78 per Green CJ.

¹⁹⁵ Ibid.

The requirement that there be a physical alteration or change is illustrated in two subsequent UK decisions.¹⁹⁶ The first is in the case of *Bacardi v Thomas Hardy Packaging*.¹⁹⁷ That case concerned the manufacture and bottling of Bacardi Breezers. The Court of Appeal decided that the addition of contaminated carbon dioxide did not constitute damage. The Court held that the new product was not damaged, but merely defective at the moment of its creation.¹⁹⁸ The distinction was confirmed in a construction context by the English Court of Appeal in *Skanska Construction UK Ltd v Egger*.¹⁹⁹

The second case is *Pilkington v CGU Insurance*²⁰⁰ in which the Court of Appeal held that the incorporation of defective glass into a rail station could not be considered as damage to that other property. Potter LJ said:

*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.*²⁰¹

The case can be contrasted with that in *Austral Plywoods v FAI General Insurance Co Ltd*.²⁰² In that case, the question was whether there had been ‘property damage’ which was defined as ‘physical injury to tangible property’. The Court of Appeal in Queensland decided that the affixation of defective plywood to a hull by means of screws and glue caused physical injury to the hull. It was held that the hull was damaged by this affixation, because it was not only physically injured by the screw holes and glue, but was rendered unsuitable or less suitable for the purpose for which it was constructed.

In terms of the requirement that the physical alteration must impair the value or use of the property, reference is made to two United Kingdom decisions.

¹⁹⁶ As identified in a presentation by Nicholas Longley: ‘What is ‘Damage’ in Contract Work Claims’; Society of Construction Law Seminar, Hong Kong, 28 September 2005.

¹⁹⁷ [2002] 2 Lloyd’s Rep 379; *Bacardi-Martini Beverages Ltd v Thomas Hardy Packaging Ltd & Ors* [2002] EWCA Civ 549.

¹⁹⁸ *Ibid* 386 per Manse LJ.

¹⁹⁹ [2002] BLR 236.

²⁰⁰ [2004] BLR 97.

²⁰¹ *Ibid* 107.

²⁰² (1992) 7 ANZ Inc Cas 61-110.

In *Hunter v Canary Wharf*,²⁰³ the Court of Appeal considered whether the deposit of dust could constitute damage for the purpose of a nuisance claim. Pill LJ, with whom the two other judges agreed, said:

*Damage is in the physical change which renders the article less useful or less valuable.*²⁰⁴

In the decision of *The Orduja*²⁰⁵ the English Court of Appeal considered that the fact that the property in question required the expenditure of money to restore it to its former useable condition was a relevant consideration in determining whether or not the property had been ‘damaged’.

‘Physical damage’

There also may be a distinction between the requirement for there to be ‘damage’ as opposed to ‘physical damage’.

In the case of *Lewis Emanuel and Son Ltd & Anor v Hepburn*²⁰⁶ the Court considered the interpretation of the phrase ‘physical loss or damage or deterioration’. The Court concluded that it was necessary to apply the natural and ordinary meaning to those words but of most interest, the judge, Mr Justice Pearson, concluded that the word ‘physical’ qualified, not only ‘loss’ but also ‘damage’ and ‘deterioration’.

In *British Celanese Limited v A.H. Hunt (Capacitors) Limited*²⁰⁷ the Court once again underlined the importance of the ordinary use of words. This case involved a claim in which machinery became clogged with solidified material that had to be cleaned before the machinery could again be used. The judge in that case found that the clogging did constitute physical injury.

The case of *S.C.M. (United Kingdom) Limited v W.J. Whittall & Son Limited*²⁰⁸ affirmed that decision, and held in that case that the blockage of pipes with material that had solidified in them as a result of a power failure, constituted physical damage.

²⁰³ [1996] 1 ALL ER 482.

²⁰⁴ *Ibid* 499.

²⁰⁵ [1995] 2 Lloyd’s Rep 395.

²⁰⁶ [1960] 1 Lloyd’s Rep 304.

²⁰⁷ [1969] 2 ALL ER 1252.

²⁰⁸ [1971] 1 QB 337.

The case of *Hunter & Ors v Canary Wharf & London Docklands Development Corporation*²⁰⁹ suggested that the deposit of dust was capable of constituting physical damage. However, LJ Pill went on to say:

*... the fact it costs money or labour to remove a deposit of material on property does not necessarily involve a finding that the property has been damaged.*²¹⁰

Finally, reference should be made to the Canadian case of *Canadian Equipment Sales & Service Co Ltd v Continental Insurance Co*²¹¹ in which expense was incurred in removing from a pipe a piece of equipment and coverage was triggered by ‘injury’ to property (‘injury’ often being equated with ‘damage’). It was held that the presence of a piece of pipe in a pipeline constituted an ‘injury’ to the pipeline because the material in the pipeline made it an ‘imperfect or impaired’ pipeline.²¹²

The issue of what constitutes ‘physical damage’ was considered by the New South Wales Court of Appeal in *Transfield Constructions Pty Limited v GIO Australia Holdings Pty Limited*.²¹³ In that case, the appellant (insured) had contracted to construct certain grain silos. The respondent (insurer) had insured the works against physical loss or damage, which included destruction.

Owing to a defect, the fumigation pipes in each silo became blocked by grain. The insured was required to remove the grain to carry out repairs. The question was whether the blockage of the fumigation pipes by grain constituted physical loss or damage.

At first instance, Rolfe J held that it did not. The insured appealed to the New South Wales Court of Appeal and contended that the fact that the pipes were rendered useless constituted physical damage within the meaning of the policy.

Meagher JA (with whom Clarke and Sheller JA agreed) put the position as follows:

²⁰⁹ [1997] AC 655.

²¹⁰ *Ibid* 676.

²¹¹ [1975] 59 DLR (3d) 333.

²¹² This case and the four preceding are referred to in a paper delivered by Michael D. Harvey ‘A tale of blocked pipes, fly tipping, acid, Degas and an alcoholic beverage’, delivered on Thursday 11 May 2005 at the general meeting of the Association of Average Adjusters.

²¹³ (1997) 9 ANZ Ins Cas 61-336.

*No pipes were lost, no pipes were destroyed, no pipes were damaged. It is not contested that to remove the pipes and re-install them would have caused a financial loss to the plaintiff/appellant. That again is beside the point. Mr Maconachie . . . said 'the fact that the pipes were rendered useless constituted physical damage within the meaning of the policy'. I do not think so. Loss of usefulness might in some context amount to damage, though even that is not beyond dispute, but in my view it cannot amount to physical damage. Functional in (sic) utility is different from physical damage. For these reasons . . . I think the appeal should be dismissed.*²¹⁴

Was the Damage 'Unforeseen'?

A question which often arises in relation to a requirement commonly contained in contract works policies, is whether the physical loss or damage to the contract works could be said to be 'unforeseen'.

In a case of *CA Blackwell (Contractors) Ltd v Gerling Allgeneine Verischerungs AG*,²¹⁵ a good deal of evidence was given at trial as to how the contractor had protected (in that case) its earthworks from water damage during the course of the works.

Although it had been contended by one of the parties in that case that 'disaster was inevitable with work continuing [through a period of predicted wet weather]', the Court found that 'proactive' measures taken by the insured to seek to protect the works from water damage, were such that there was no suggestion that the policy would not otherwise respond (other than with respect to any loss that was excluded due to the defective workmanship exclusion).

Attention is also drawn to comments in a decision in *L'Union Des Assurances De Paris IARD v Sun Alliance Insurance Ltd*,²¹⁶ in which the New South Wales Court of Appeal noted that 'unforeseen' does not mean 'unforeseeable' either as a matter of language or law. The Court of Appeal concluded that the former is subjective and speaks of the mind of the insured. The latter is objective and speaks of the object of perception or thought. In that case, the court observed that before the event, nobody at the insured, knew that the damage which resulted from [in that case, contamination] would occur. Therefore it was 'unforeseen'.

²¹⁴ Ibid 76,716.

²¹⁵ [2008] 1 All ER (Comm) 885.

²¹⁶ [1994] NSWCA 173.

Similarly, in a case at first instance of *Rickard Constructions v Rickard Hails Moretti*²¹⁷ the insurer submitted that as there were design defects, and that the failure was a result of those defects, it could not be said that the damage was either sudden or unforeseen. Alternatively, the insurer submitted, that the failure could not be characterised as unforeseen, because the insured, (or a reasonable and competent civil engineering contractor in its place) should have known or understood or foreseen that the failure was a likely consequence of the practices [which the Court had identified as amounting to defective workmanship].

On appeal, the New South Wales Court of Appeal concluded,²¹⁸

'I do not think that this is what 'unforeseen' means in the context of the policy. To construe that word [unforeseen] as [the insurer] submits would be, in effect, to limit the insuring clause in the same way that [the insurer] says its obligations are limited by [another unrelated clause] of the exclusions . . . if foreseeability of loss is an essential element of liability in negligence, then [the insurer's] construction of the word 'unforeseen' would mean that the Policy could never indemnify [the insured] for the negligent performance of its obligations as a civil engineering contractor'.

Policy exclusions

In the case of *Chalmers Leask Underwriting Agencies v Mayne Nickless Ltd*,²¹⁹ a clause in the policy of insurance excluded from cover:

loss or damage directly caused by defective workmanship, material or design or wear and tear, or mechanical breakdown or normal upkeep or normal making good but so that this exclusion shall be limited to the part immediately affected and shall not apply to any other part or parts lost or damaged in consequence thereof.

A claim was made under the policy in respect of damage caused to flood mitigation works through the breaching by flood waters of a coffer dam that had been impacted by vehicles passing over its top. No claim was made for damage to the dam itself. The construction of the limiting words of the exclusion clause was raised, for the first time, in the High Court.

²¹⁷ [2004] 220 ALR 267

²¹⁸ [2006] NSWCA 356 [209]

²¹⁹ (1983) 155 CLR 279.

It was held:

*that this exclusion referred to a single overall exclusion of loss or damage of the type described in the clause and not to one or other of the possible causes of exclusion. Accordingly, the limitation applied only to the coffer dam as 'the part immediately affected'. The consequentially damaged works were covered by the policy.*²²⁰

The Cofferdam and Bank

In that case, no claim was made in respect of the coffer dam or bank for its rectification. However, in the case of *Walker Civil Engineering v Sun Alliance & London Insurance PLC*,²²¹ Rolfe J considered that there were strong indications in the judgments in *Chalmers Leask* that had a claim been made for its rectification it would have been rejected. His Honour in that case, noting that there was no binding authority directly on the point, considered that the decision provided persuasive support for the proposition that reinstatement work of the defective work was not recoverable under the policy before him for consideration. The basis for his Honour so concluding was that the loss or damage resulting from the necessity to carry out such rectification work was directly caused by defective workmanship, material or design.

Three Coats of Paint

Another case of interest in this regard is *Graham Evans & Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd*.²²² In that case, a building required three coats of paint and, after a substantial part of its exterior had been painted with three coats, the paintwork began to flake from it.

The plaintiff, as the responsible building company, had to strip a considerable amount of the paintwork with a view to large areas being repainted. The evidence establishes 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 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, which was in essentially the same terms and having essentially the same exclusion as the one considered in *Chalmers Leask*.

²²⁰ *Ibid.*

²²¹ (1996) 9 ANZ Ins Cas 61-311.

²²² (1986) 4 ANZ Ins Cas 60-869.

In this case, noting that the impugned workmanship could relate only 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.

By contrast, in the UK case of *Skanska v Egger*,²²³ Mance LJ dismissed out of hand any attempt to claim that a defective sub-base to the flooring could be considered to have caused damage to the floor above. Mance L J said:

*That argument 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.*²²⁴

In *Walker Civil Engineering v Sun Alliance & London Insurance PLC*,²²⁵ 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.

In *Walker*, Rolfe J also disagreed with Foster J's finding that the causal connection was indirect rather than direct, finding it impossible to conclude that the damage to the second and third coats did not arise directly from the failure of the first coat.

²²³ 83 Con L.R. 132.

²²⁴ *Ibid* 143.

²²⁵ (1996) 9 ANZ Ins Cas 61-311.

Sewerage Tanks

In *Walker's* case, the contract works policy excluded cover for loss or damage directly caused by defective workmanship, construction or design. A proviso to the exclusion, however, stated that the exclusion applied only to the defective part, and any other part or parts lost or damaged in consequence of the direct loss or damage did not fall within the exclusion and were covered by the policy.

As part of the contract works, the plaintiff had installed in-ground fibreglass sewerage tanks on the site. One of the problems which had arisen with the fibreglass tanks was that, when empty, the tanks would be 'popped' out of the ground by hydrostatic ground water pressure. To counter this, concrete had been poured over each tank in order to stabilise it in position. The tanks were then found to be defective and had to be replaced. In order to remove them from their position, the plaintiff had needed to break and remove the concrete.

The plaintiff accepted that the fibreglass tanks were not covered by the policy because of the exclusion. It, however, made a claim under the proviso for indemnity in respect of the costs of removing the concrete as being loss or damage flowing from the necessity to carry out rectification work.

Rolfe J, in finding for the insurer which had denied indemnity under the policy, considered that re-instatement of the defective work was not recoverable under the policy, the reason being that the loss or damage resulting from the necessity to carry out such rectification work was directly caused by defective workmanship, material or design.

His Honour considered that if fibreglass tanks had not been used, then there would be no need to use the concrete or, put another way, the concrete played no part other than to stabilise the tanks. Thus the concrete was an integral part of the tank construction.

His Honour considered the secondary submission of the insurer, whereby it was contended that to the extent that the loss was not excluded, it was not an 'occurrence' under the policy because the policy defined occurrence as an act which was not intended or expected by the plaintiff, whereas the removal of the concrete was intended by the plaintiff.

The court, in rejecting this submission, held that the word ‘intended’ was to be limited to exclude from the policy an intended act giving rise to the initial loss or damage and ‘expected’ should be construed in the same way. Accordingly, if the court’s view on the primary submission was not correct, the plaintiff was entitled to recover the costs of removing the concrete under the policy.

The case went to appeal before the New South Wales Court of Appeal (Mason P, Sheller JA and Sheppard AJA).²²⁶ The court unanimously held that the appeal should be dismissed. Sheller JA (with whom Mason P agreed) said:

*In my opinion, the appellant’s claim is properly characterised as a claim to be indemnified under the policy for the cost of reinstating the defective part, namely the fibreglass tanks. So characterised, it was not a claim in respect of any other part or parts lost or damaged in consequence of defective workmanship, construction or design, any more than would be a claim for the cost of stripping off of the second and third coats of paint in Graham Evans if they had remained in tact and undamaged but had to be removed in order to reinstate the primer coat.*²²⁷

Sheppard AJA, who delivered the leading judgment said as follows:

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.

²²⁶ (1998) 10 ANZ Ins Cas 61-418.

²²⁷ Ibid 74,684.

Sheppard AJA went on to say:

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.²²⁸

Sheppard AJA concluded thus:

Here the part of the works which was defective was the tanks and all that was installed within them, the latter not because there was any defect in the equipment which was housed in the tanks but because the equipment was of no use unless it was housed in tanks which were free from defects. It is not appropriate, in my opinion, to look separately at the tanks, so as to consider them alone and treat the need to remove the equipment inside them as a separate and distinct item of loss. One has to look at the tanks, really the sewerage pumping stations, as a whole. When this is done it becomes clear that the exclusion clause, notwithstanding the limitation to it, operates to exclude the claim which is here made, the relevant part of the works being defective.²²⁹

The case can be contrasted with that of *Promet Engineering*²³⁰ in which the Court was requested to consider whether a defective part, in that case the weld, had caused damage. Hobhouse LJ said:

The 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 . . .²³¹

²²⁸ Ibid 74,693.

²²⁹ Ibid 74,694.

²³⁰ [1997] 2 Lloyd's Rep 146.

²³¹ Ibid 156.

Compacted Earth Mounds

A similar argument to that advanced in Walker's case was raised and rejected by the Full Court of the Supreme Court of Victoria in *Prentice Buildings Ltd v Carlingford Australia General Insurance Ltd*.²³²

In that case, the appellant had subcontracted the work of building compacted earth mounds and sheds. The mounds had originally been completed to the satisfaction of that subcontractor's foreman, however, a new foreman was brought to the site and he instructed the subcontractor's workmen to begin removing the top of the mounds for the purposes of reshaping them.

Subsequently, the head contractor's representative stated that the work in question was unnecessary and demanded that the subcontractor rectify the mounds. When it failed to do so, and left the site, the mounds were rectified at considerable expense. It was contended by the subcontractor's counsel, that as the costs and expenses incurred by the appellant necessarily included the cost of demolishing the non-defective parts of the mounds, and expenses to which the appellant was put by reason of having to carry out additional work on the mounds, the case, or part of it, fell within the exception to the exclusion in the policy. In that case, the proviso limited the exclusion to *'the part which is defective and shall not apply to any other part or parts lost or damaged in consequence thereof.'*

In rejecting this submission the court said:

In my opinion, the sort of thing covered by what might be called the proviso to the exception is exemplified by the water damage suffered in the valley in the case of Chalmers Leask Underwriting Agencies v Mayne Nickless Ltd, as distinct from the cost there of rectifying the defective design of the dam plus roadway. If, for example, the mound in the present case had been a brick wall made with poor workmanship and as a result part of it fell and damaged some machinery, the proviso to the exclusion would apply to leave recoverable under the policy the loss suffered by reason of the fall and the damage to the machinery. But, in my opinion, in the present case there is no difference in character between . . . rectification of non-defective parts and . . . rectification of defective parts because both parts merely are constituents of a defective whole, or a whole that embodies, as a whole, defective workmanship.

²³² (1990) 6 ANZ Ins Cas 60-951.

What is meant by ‘defective design’ and ‘defective building work’?

The Courts have looked at concepts such as ‘faulty workmanship’, ‘faulty design’ and ‘negligent design’ when considering clauses in construction contracts and insurance policies.

In the case of *Chalmers Leask Underwriting Agencies v Mayne Nickless Ltd* (1983) 155 CLR 279, a clause in the policy of insurance excluded from cover:

‘. . . loss or damage directly caused by defective workmanship, material or design or wear and tear, or mechanical breakdown or normal upkeep or normal making good but so that this exclusion shall be limited to the part immediately affected and shall not apply to any other part or parts lost or damaged in consequence thereof’.

A claim was made under the policy in respect of damage caused to flood mitigation works through the breaching by flood waters of a coffer dam that had been impacted by vehicles passing over its top. Now claim was made for damage to the dam itself.

The case is most commonly cited as an authority in relation to what is meant by *‘the part immediately affected’*. It is, however, sometimes invoked as an authority as to the operation of defective design exclusions, in similar terms. This is because Hunt J, in the The Supreme Court of New South Wales at first instance, upheld the insured’s contention that there had been no relevant defective workmanship or design.

What is sometimes overlooked is that on appeal to the New South Wales Court of Appeal,²³³ Hutley, Glass and Mahoney JJA disagreed with Hunt J’s construction of Cl (iii) which had provided the basis of his Honour’s finding that there had been no relevant defective workmanship or design.

When the matter went to the High Court the court stated.²³⁴

‘However, we do not find it necessary to consider whether there was any relevant defective workmanship or design and whether, if there was, the disputed loss and damage flowed from it.’

It is clear that an insurer will not have to establish negligence on the part of an insured if a ‘design’ (being an inanimate object) is described as faulty or defective.

²³³ *Chalmers Leask Underwriting Agencies v Mayne Nickless Limited* (1982) 2 ANZ Ins Cas 60-463.

²³⁴ *Ibid* [30].

The meaning of ‘faulty design’ came under judicial scrutiny in the case of *Manufacturers Mutual Insurance Ltd v Queensland Government Railways*,²³⁵ before the High Court of Australia. The High Court in that case held that ‘faulty’, by reference to a thing, such as a design, meant a design that was not fit for its intended purpose: an objective test.

To quote Barwick CJ:

‘We have not found sufficient ground for reading the exclusion in this policy as not covering loss from faulty design when as here, the piers fell because their design was defective although not negligent. The exclusion is not against loss from negligent designing; it is against loss from faulty design and the latter is more comprehensive than the former.’

Queensland Railways has been considered and approved (by reference to a defective rather than faulty design) in *Hitchens (Hatfield) Ltd v Prudential Assurance Co.*²³⁶ The court in that case held that the insurer did not have to establish negligence in order to rely on the exclusion if the exclusion referred to there being a defect in design of the damaged item.

Most recently, the Supreme Court of Canada has narrowed the operation of a faulty design exclusion in a builder’s risk insurance policy.²³⁷ As a result of the decision, the law in Canada seems to be that a design will not be considered faulty simply because it failed to work for the intended purpose or because it failed to withstand all foreseeable risks. A design will only be considered faulty if it did not meet the standard which reflected the ‘state of the art’ at the time of its formulation.

As to the issue of what constitutes a ‘design’, reference is made to the comments of Bull J from the Court of Appeal in *Pentagon Construction Co Ltd v United States Fidelity and Guarantee Company*²³⁸ in which the judge stated:

‘In sophisticated contracts, the design includes the specifications as well as the drawings.’

²³⁵ [1968] 118 CLR 314.

²³⁶ [1991] 2 Lloyd’s Rep 580.

²³⁷ *Canadian National Railway Co v Royal and Sun Alliance Insurance Co. of Canada* [2008] SCC 66.

²³⁸ [1978] 1 Lloyd’s Rep 93.

The judge went on to say:

'Likewise 'faulty or improper design' must have reference to design as contemplated by the construction contract in the sense of including all the details covered by the drawings and specifications which that contract required to be followed.'

A New Zealand case of relevance in this context is *Lester v White*.²³⁹ The relevant passage from the case appears at pages 497 and 498.

That case considered the phrase *'error or omission in design specification or advice . . .'* and *'defect, error or omission in design, plan, specification or formula.'* In that case there was a design or specification for a building with some special provision for the piles and foundations. There was no specification expressly for the floor slab. Because of failures or omissions in the design specification, there was inadequate support for the floor slab and possibly for the beams, which resulted in damage to the building.

It was argued that, because of the absence of design or specification of the floor slab, the exclusion could not apply because, by its very wording, it assumed and required that there should be a design or a specification, that is, that the failure to provide a design or specification was not an 'omission' in the design or specification which required and presumed the existence of such a design or specification.

Greig J, in rejecting this submission, held that that was too 'refined' an argument to avoid the clear intention and the express words of the exclusion. His Honour concluded that there was a design and a specification and there was a failure or omission in that to provide adequately for the floor slab and the other foundation parts which resulted in the damage.

In the *Queensland Government Railways* case, Windeyer J said that:

'Faulty workmanship I take to be reference to the manner in which something was done, to fault on the part of a workman or workmen. A faulty design, on the other hand, is a reference to a thing.'

²³⁹ [1992] 2 NZLR 483.

Consistent with this distinction, the test applied by the New South Wales Court of Appeal in the case of *Rickard Constructions Pty Ltd v Richard Hails Moretti Pty Ltd*,²⁴⁰ was that in determining whether something constituted ‘defective workmanship’ it was necessary to consider whether or not it was ‘good construction practice’. The Court of Appeal also held that the failure to appreciate what good construction practice called for, would not excuse the party guilty of defective workmanship.

London Market design clauses and the London Engineering Group ‘defects wording’

The London Market design clauses offer five distinct levels of coverage against defects in design, materials and workmanship (as set out in Annexure A). These clauses are also becoming increasingly common in contract works policies emanating from Australian Underwriters.

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 – 1 being no cover, 5 being significant cover for design.

In general terms DE2 and DE3 permit 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. The distinction between DE2 and DE3 is only that DE2 also excludes damage to property insured which relies for its support or stability upon the defective property, whereas DE3 omits that provision and thus allows cover in that respect.

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”.’

²⁴⁰ [2006] NSWCA 356.

In the case of *C A Blackwell (Contractors) Ltd v Gerling Allegeneie Verisherungsgesellschaft*,²⁴¹ 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 London Engineering Group ‘*defects wording*’ (as set out in Annexure B) is also commonly in use in both the UK and Australian market.

In relation to the LEG 3/96 exclusion, in light of observations made in the 2005 Court of Appeal Case *Skanska Construction Ltd v Egger (Borony) Ltd*²⁴² LEG introduced a new exclusion known as LEG 3/06, which made clear that ‘*damage*’ includes any patent detrimental change in the physical condition of the Insured Property.

The operation of commonly encountered defective workmanship, material or design exclusions emanating from both the Australian and the UK market, is considered below by reference to three commonly encountered loss scenarios, being:

- road and pavement failure;
- scratching to glazed surfaces; and
- stainless steel piping failures,

followed by a detailed analysis of a recent Australian case authority in relation to the first of those areas.

Road and pavement failures

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 provisos or ‘*carve outs*’ to the exclusion.

²⁴¹ [2008] 1 All ER (Comm) 885.

²⁴² [2003] Lloyd’s Rep IR 479.

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 a context other than a road or pavement failure. These cases have been considered earlier in this publication. The first is a case of *Graham Evans & Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd*.²⁴³

The subsequent Australian case which considered a similar issue was *Walker Civil Engineering v Sun Alliance & London Insurance Plc*.²⁴⁴ 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*.²⁴⁵ That case considered a policy containing a DE3 exclusion clause, which is set out below.

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.

²⁴³ [1986] 4 ANZ Ins Cas 60-869.

²⁴⁴ [1996] 9 ANZ Ins Cas 61-311.

²⁴⁵ [2003] EWCA Civ 310.

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.'

The UK Authorities

The case of *Skanska Construction Ltd v Egger*²⁴⁶ 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.

²⁴⁶ Ibid.

The first case is that of *Seele Austria GMBH & Co KG v Tokio Marine Europe Insurance Ltd*.²⁴⁷ 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 subcontractor 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 the decision of the Court of Appeal in *C A Blackwell (Contractors) Ltd v Gerling Allgemeine Verischerungs AG*.²⁴⁸

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:

²⁴⁷ [2008] All ER(D) 68.

²⁴⁸ [2008] 1 All ER (Comm) 885.

- (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 bowsters 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.'*

Summary

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*,²⁴⁹ which was an appeal from the decision of *McDougal J Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd*.²⁵⁰

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:²⁵¹

*'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.'*

²⁴⁹ [2006] NSWCA 356.

²⁵⁰ [2004] 220 ALR 267.

²⁵¹ *Ibid* 313.

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 DE3 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.

His Honour 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.

Scratching to glazed surfaces

It is not uncommon on major building projects for scratching to glass panes or panels to be observed pre-practical completion (or during the defects liability period), and a question can thus arise as to whether contract works policies are likely to respond to indemnify the project participants with respect to damage of this nature.

This damage is often caused by one or more combinations of the following:

- Scratching during installation;
- Scratching post installation;
- Weld splatter;
- Cleaning of the glass.

The London Market Defect Exclusions

The case of *CA Blackwell (Contractors) Ltd v Gerling Allegemain Versicherungs AG*²⁵² (which, as has been noted, considered the operation of a DE3 Exclusion to the context of a claim in respect of road failure) at first blush seems to suggest that a policy containing an exclusion in that form would not exclude the liability of insurers to indemnify the insured with respect to so called scratched glass claims.

This is because in that case, the Court 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. The Court went on to say that a failure, if there was one, to implement other measures which were designed to protect [in that instance, the capping] could not be characterised as a defect in the condition of the capping. For that reason, the court held the exclusion did not apply, because of the limitation.

That conclusion was, however, premised upon a finding by the Judge at first instance, that the drainage (which had failed due to it being defective) was separate and distinct from the capping and that the ‘*Property Insured*’ was not defective. This may be readily distinguishable from a scenario arising in relation to scratching of glass panels, for reasons to be outlined shortly.

The critical passage from the Court of Appeals’ judgment, in understanding the operation of the exclusion, appears at paragraph 17 as follows:

‘What is important to note is that the exclusion is not of loss or damage caused by a defect in workmanship, etc . . . Provided the insurer can show that the property was in a defective condition, the exclusion applies.’

²⁵² [2008] 1 All ER (Comm) 885.

In *Seele Austria GmbH & Co KG v Tokio Marine Europe Insurance Ltd*,²⁵³ the Court of Appeal had cause to consider the operation of an exclusion in identical terms. The key issue before the court in that case however, was whether, even though no accidental damage had occurred as a result of the installation of defective windows, the additional indemnity clause sought to be relied upon in the policy was a free-standing term allowing the appellant, once a defect had been discovered, to recover access costs to enable the defective windows to be replaced. It therefore does not provide guidance to the question posed.

Leaving to one side the issue of whether or not the scratching to the glass could be said to satisfy the definition of ‘damage’ so as to enliven, even prima facie, indemnity under contract works policies, it is necessary in each case to analyse the operative words of the policy exclusions, having regard to the facts in a particular case, in order to form a view as to whether an exclusion will apply if indemnity were otherwise available.

The Australian and New Zealand Authorities

In *White Industries QLD Pty Ltd v Hennessey Glass & Aluminium Systems Pty Ltd*,²⁵⁴ the Queensland Court of Appeal, had cause to consider glass containing scratching prior to practical completion and whether a subcontractor was responsible.

The trial judge had found against the subcontractor in relation to the scratched glass because he found that the subcontractor was required to provide glass which was not scratched as at the date of completion of the building, regardless of how the scratching occurred, as the subcontractor was ultimately responsible for the scratches. The Court of Appeal additionally noted an obligation on the subcontractor to protect the property after installation until final handover.

The Court of Appeal went on to say:²⁵⁵

²⁵³ [2009] 1 All ER (Comm) 171.

²⁵⁴ [1999] Qld R 210.

²⁵⁵ Ibid 224.

'In summary, the final position was that the subcontractor was required . . . to supply glass that was free from scratches and other defects, it was required to protect it after installation until final handover, and on final handover the relevant glass was scratched . . . consequently the inference from the fact of damage remains, that is that the material was either supplied in a damaged condition or that the subcontractor failed to protect it adequately. In either case it is liable.'

That case considered the issue in a context other than recovery under a policy of insurance, but confirms responsibility for the defect by the subcontractor in those circumstances.

Another common exclusion found in contract works policies in relation to defective workmanship and design was considered by the New South Wales Court of Appeal in the case of *Rickard Constructions v Rickard Hails Moretti*.²⁵⁶

In this regard, it should be noted that the test applied by the Court of Appeal in that case, was that in determining whether something constituted 'defective workmanship', it was necessary to consider whether or not it was 'good construction practice'. The court also held that the failure to appreciate what good construction practice called for would not excuse the party guilty of the defective workmanship.

A case authority which considered specifically the operation of a defective workmanship exclusion in the context of damage to installed windows, is a New Zealand decision of *Holmes Construction Wellington Limited v Vero Insurance New Zealand Limited*.²⁵⁷ In that case, the Judge thought it was significant that there was an obligation cast upon the subcontractor to protect/mask all finished surfaces.

It was argued against the insurer in that case that the expression 'defective in workmanship', meant that the part of the Contract Works that was being replaced, ie the windows, had to be **inherently** [emphasis added] defective, before the insurer could rely on the exclusion.

The judge rejected that submission, finding that it was 'impractical and wrong' to separate the subcontractor's 'plastering of the walls on the one hand from its over-spraying of the plaster onto the windows and its efforts to remove the plaster from the windows on the other'.

²⁵⁶ [2006] NSW CA 356.

²⁵⁷ *Holmes Construction Wellington Limited v Vero Insurance New Zealand Limited* (Unreported, New Zealand District Court, Harrop J, 4 December 2007).

The judge reached his conclusion by reference to the wording of the subcontract and found reinforcement for it by consideration of several case authorities including *Ted Corp Holdings Ltd v QBE Insurance (International) Ltd*,²⁵⁸ *Pentagon Construction (1969) Co. Ltd v United States Fidelity & Guarantee Co*²⁵⁹ and the judgment of the Ontario Court of Appeal in *Sayers & Associates v Insurance Corp of Ireland Ltd*.²⁶⁰

In that last mentioned case, it was said:²⁶¹

‘In the present case the fault “that underlaid the “faulty workmanship” was the failure of the appellant to take protective measures; but by the terms of its contract its “work” was to install the electrical equipment and to keep it dry and clean until the contract was completed. It would be taking too narrow a view of the case to isolate one part of the work from the total contractual obligation. The damage to the equipment was the product of the failure to take protective measures, and so that fault rendered the appellant’s performance of its contractual obligations “faulty workmanship”. The damage to the ducts and the switching gear was not, therefore, “damage resulting from such faulty . . . workmanship . . .”, so as to come within the exception of the exclusion’.

It is worth repeating verbatim what was set out at paragraphs 29, 30 and 36 of the *Holmes Construction* judgment:

‘. . . his point was that the phrase “workmanship” when applied to the subcontract meant that only damage to the walls could be excluded under exclusion 6; any other part of the contract works which was incidentally damaged would not be properly described as “defective in workmanship” just because it was damaged in the course of work by that subcontractor.’²⁶²

‘As I have indicated above, I accept the argument [. . . that] where the subcontract expressly or impliedly includes work on another part of the contract works, even if it is merely of a protective or repairing nature in the event of damage, that must make that part, once damaged, “defective in workmanship”. For that, . . . the insurance company is not responsible’.²⁶³

²⁵⁸ (HC, Dunedin, CP3/00, 8 September 2000, William Young J).

²⁵⁹ [1978] Lloyds Law Reports 93, 98 – per Robertson J.

²⁶⁰ (1981) 126 DLR (3D) 681.

²⁶¹ *Ibid* 684].

²⁶² *Holmes Construction Wellington Limited v Vero Insurance New Zealand Limited* (Unreported, New Zealand District Court, Harrop J, 4 December 2007) [29].

²⁶³ *Ibid* [30].

'For completeness I mention that [the insured's counsel] submitted that if Vero's argument was upheld, it would make the insurance of limited value to Holmes because it would be possible to exclude any situation where finished elements of the construction project are damaged by any other contractor on site. I do not accept that is right. If such a finished part of the contract works is not a part on which, expressly or impliedly, the subcontractor was to prepare, work or clean up, then exclusion 6 would not apply'.²⁶⁴

Summary

It would seem that provided, under the terms of the contract between the builder and owner, the builder had an obligation to supply a building with glass that is free from scratches and other defects, and is required to protect it after installation until final handover, then arguably damage to the glass due either to a failure of the protective measures or the supply of the material in a damaged condition may be excluded from cover under a policy of contract works insurance. In each case, this will necessarily be dependent upon the wording of the primary indemnity clause and the exclusions contained within the policy.

It is worth noting that in the *Holmes Construction* decision, it was said:²⁶⁵

'It is arguable based on the above observations that even if there had been no reference to protection of the windows in surface works' subcontract then its ultimate failure to protect the windows may still have been caught by the exclusion because such protective measures are arguably an equally inseparable part of the work required to be done . . . but because of the express term in the subcontract here it is not necessary to go as far as that'.

Stainless steel piping failures

Claims may be 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.

²⁶⁴ Ibid [36].

²⁶⁵ Ibid [33].

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

Insurers will often have a valid basis to decline indemnity under their contract works policy, on the basis that the damage resulted from error in design and/or the failure of 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.

Policy Response – Is there ‘damage’?

Stainless steel pipework often develops leaks due to failures caused by corrosion over a period of time. Whether or not a contract works policy will ever, prima facie respond, may well be dependent 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 oxidation 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 Lts & Anor v Hepburn*,²⁶⁶ the Judge, Mr Justice Pearson, 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*²⁶⁷ the court considered the meaning of the expression ‘physical damage’, and concluded that ‘functional utility is different from physical damage’.

²⁶⁶ [1960] 1 Lloyd’s Rep 304.

²⁶⁷ [1997] 9 ANZ Ins Cas 61-336.

English cases have drawn a distinction between property which is damaged and that which is merely defective at the moment of its creation.²⁶⁸ If pinhole leaks emanate from the welds, it may 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 *Pikington v CGU Insurance*²⁶⁹ Potter LJ said:²⁷⁰

'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*²⁷¹ 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 by contractors on site. Moore-Bick LJ, [48], considered that the pinholes did not constitute damage to the works but rather *'I think that it 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 the court in a case of *Raincar v Frigmobile*.²⁷²

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'.

²⁶⁸ *Bacardi v Thomas Hardy Packaging* [2002] 2 Lloyds Rep 379.

²⁶⁹ [2004] BLR 97.

²⁷⁰ *Ibid* 107.

²⁷¹ [2009] 1 All E.R. (Comm).

²⁷² [1983] 2 ANZ Ins Cas 60-525.

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*,²⁷³ the appellants contended that faulty workmanship in the weld was not itself damage to the insured property (so that there could have been so subsequent damage when a reclaimer collapsed). The Queensland Court of Appeal rejected that argument, holding that the faulty weld impaired the value of 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 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 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.

²⁷³ [2005] QCA 369.

Exclusions are also often encountered in like terms to that which arose for consideration by the New South Wales Court of Appeal in the case of *Rickard Constructions Pty Ltd v Hails Moretti Pty Ltd*.²⁷⁴ 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 could 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*,²⁷⁵ 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.²⁷⁶ 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*,²⁷⁷ rust or oxidation or corrosion would be likely to lead, almost by definition, to a gradual deterioration in the Property Insured.

²⁷⁴ [2006] NSWCA 356.

²⁷⁵ [1991] 79 DLR (4d) 729.

²⁷⁶ (See for example: *Underwriters at Lloyd's London v SMI Reality Management Corp* – No.06-0016, from the First Court of Appeals at Houston, Texas No 01-03-01340-CV).

²⁷⁷ [2005] QCA 369.

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 a few weeks to many months, it 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*,²⁷⁸ it was said by the Court²⁷⁹ '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*,²⁸⁰ in which the court concluded²⁸¹ 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 to apply to any other parts sustaining damage. Such an expression was considered by the Australian Courts in the previously considered case of *Walker Civil Engineering v Sun Alliance and London Insurance Plc*.²⁸² In that case Sheppard AJA, who delivered the leading judgment of the NSW Court of Appeal said as follows:

'It is perfectly true that the complex 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.'

²⁷⁸ [1996] ACTSC 123.

²⁷⁹ Ibid [31].

²⁸⁰ *African Products (Pty) Ltd v AIG South Africa Ltd* (659/2007) [2009] ZASCA 27 (27 March 2009).

²⁸¹ Ibid [25].

²⁸² [1998] 10 ANZ INS CAS 61-418.

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*²⁸³ (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 work “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 damage . . .’.

Summary

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 ‘unforeseen’. Assuming all of the primary indemnity triggers are satisfied, there remain potential hurdles 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 many instances it would appear that loss of this nature may not be uninsured.

Conclusion

Recovery under contract works policies can provide fertile ground for dispute, particularly when property is allegedly damaged in consequences of defective design, material or workmanship. Although recovery in any given instance must necessarily be determined having regard to the particular factual matrix and the precise wording of the primary insuring clause and applicable exclusions, a number of the authorities considered above are instructive when considering the likely attitude of the courts to such claims.

The analysis provides a salient reminder that other than in limited circumstances, the existence of contract works insurance is unlikely to afford a contractor indemnity with respect to its own defective design, material or workmanship where the only ‘damage’ to ‘Insured Property’ is comprised of the defect itself.

²⁸³ [1997] 2 Lloyd’s Rep 146.

DETAILED ANALYSIS OF AUSTRALIAN CASE AUTHORITY IN RELATION TO A DEFECTIVE WORKMANSHIP EXCLUSION IN A CONTRACT WORKS POLICY

The construction and application of an exclusion clause, in relation to a defect in material, workmanship and design in a Contract Works Insurance policy, was considered by the New South Wales Court of Appeal on 14 December 2006: *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd*.²⁸⁴ The Appeal was from a decision of the trial judge, McDougall J, in *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd*.²⁸⁵

Facts

The plaintiff ('Rickard Constructions') constructed a pavement for a container depot at Port Botany. The third defendant, an insurer, issued a contract works insurance policy ('the policy') for the project in favour of Rickard Constructions. The pavement failed shortly after it was put into service.

In the case at first instance, Rickard Constructions claimed against the insurer under the policy. The trial judge held that an exclusion in relation to defective workmanship was engaged, and that Rickard Constructions had not proved what it had to prove in order to make out the recovery left to it under the clause.

The trial judge found that the pavement failed because the asphalt wearing layer was placed over basecourse which was, in sections, excessively wet, and the pavement was put into use before the basecourse had any opportunity to dry out. (Basecourse in flexible pavement road design is the primary load bearing pavement layer). The trial judge preferred the view of the majority of the experts that there was a build up of excessive moisture in the basecourse. When the pavement was loaded by the operation of heavy forklift trucks, there was an increase in pore pressure which caused its ability to resist load to diminish sharply, so that it was unable to support the loaded asphalt wearing layer and the pavement collapsed.

The decision on appeal

Giles JA delivered the unanimous judgment of the Court of Appeal (which also comprised Handley and Bryson JJA).

²⁸⁴ [2006] NSWCA 356.

²⁸⁵ (2004) 220 ALR 267.

There was no appeal from the trial judge's finding as to the mechanism for the failure. The Court of Appeal noted that the trial judge, in a lengthy section of his reasons, dealt with what he described as responsibility for the failure and found that the primary responsibility should be attributed to Rickard Constructions because:²⁸⁶

... [t]he conditions that caused the failure occurred because, in substance, Rickard Constructions permitted the asphalt wearing layer to be placed over the basecourse, thereby sealing the basecourse (and the underlying layers) whilst the basecourse was excessively wet.

The Court of Appeal noted that it was the basis of the trial judge's holding that the exclusion clause in relation to defective workmanship was engaged. However, the Court of Appeal also noted that it was necessary to decide Rickard Constructions' claims not by an attribution of responsibility for the failure, but by application of the terms of the exclusion clause in the policy.

There were many issues raised on appeal including the construction of the exclusion clause.

The case against the insurer²⁸⁷

The insuring clause in the policy relevantly provided:

1. Construction period

The Underwriter will indemnify the Insured against sudden and unforeseen physical loss of or damage to Insured Property from any cause (not hereinafter excluded) occurring whilst at the Situation and during the Construction Period stated in the Schedule . . .

2. Maintenance Period

The Underwriter will indemnify the Insured against sudden and unforeseen physical loss of or damage to Insured Property provided such loss or damage:

2.1 manifests itself during the Maintenance Period described in the schedule; . . .

²⁸⁶ Ibid 296.

²⁸⁷ Summarised from the Court of Appeal's findings. *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd & Ors* [2006] NSWCA 356, [60] – [67].

The finding of the trial judge was that the pavement had failed either during the Construction Period or during the Maintenance Period. In either case, the cause of the physical loss of or damage to Insured Property was qualified by 'not hereinafter excluded' or 'unless hereafter excluded', and his Honour held that an exclusion applied.

The exclusion in the policy relevantly included:

The Underwriter will not indemnify the Insured against:

1. The costs of repairing, replacing or rectifying Insured Property in which there is a fault, defect, error or omission in material or workmanship, but the Underwriter will pay the cost of loss or damage caused directly by such fault, defect, error or omission less the costs which would have been incurred in repairing, replacing or rectifying the faulty or defective material or workmanship immediately prior to the loss or damage occurring.
2. The costs of repairing, replacing or rectifying Insured Property in which there is a fault, defect, error or omission in design, plan or specification, but the Underwriter will pay the costs of loss or damage caused directly by such fault, defect, error or omission in design, plan or specification less the cost which would have been incurred in repairing, replacing or rectifying the fault, defect, error or omission in design, plan or specification immediately prior to the loss or damage occurring . . .
3. Consequential loss, loss of use, penalties, fines, liquidated damages, or aggravated, punitive or exemplary damages.

The trial judge had held that there was 'fault, defect, error or omission in material or workmanship' within cl1 of the exclusions, but not 'fault, defect, error or omission in design, plan or specification' within cl2 of the exclusions.

This was based upon the trial judge's finding that there had been 'defective workmanship' attributed to Rickard Constructions, summarised by his Honour²⁸⁸

' . . . that Rickard Constructions, in sealing the pavement knowing that portions of it were wet and soft and in any event without retesting the whole, knowing it to have been severely affected by moisture, did not follow good construction practice.'

²⁸⁸ *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* (2004) 220 ALR 267, 297.

As the Court of Appeal noted,²⁸⁹ following from his finding that cl1 of the exclusions was engaged, the trial judge said:²⁹⁰

The reason why cl1 of the exclusions affords a complete answer to the claim is simple. Where that clause applies (ie, where its opening words ‘the costs . . . workmanship’ are engaged), [the insurer’s] only liability is to pay the costs of loss or damage directly caused by defective workmanship (to use a compendious term) less the costs that would have been incurred in rectifying that defective workmanship immediately prior to the occurrence of loss or damage.

The opening words of the clause make it clear that [the insurer] is not liable for the cost of repairing, replacing or rectifying Insured Property in which there was defective workmanship. It is, however, liable to pay the cost of loss or damage caused directly by that defective workmanship. That liability is limited because there must be subtracted from it the costs that would have been incurred in repairing the defective workmanship immediately prior to the occurrence of the loss. Clearly, when cl1 of the exclusions is read in conjunction with cl6 it is apparent that no element of consequential loss is recoverable.

The trial judge found that Rickard Constructions had incorrectly claimed the cost of rectifying the pavement, less the cost of alternate methods of rectifying the defective workmanship, and in doing so, proceeded on an incorrect construction of the exclusion clause. It had failed to address what was to be quantified (in respect of which it bore the burden) namely, the (costs of loss or damage caused directly by the) defective workmanship and the costs which would have been ‘incurred’ in rectifying the defective workmanship immediately before the occurrence of the loss.

The findings on appeal

On appeal, Rickard Constructions accepted the finding that it was not good construction practice to apply an asphalt wearing layer over basecourse material that was excessively wet. However it submitted that the trial judge erred in finding that it knew that this was not good construction practice.

²⁸⁹ Ibid 286.

²⁹⁰ Ibid 311.

Although the Court of Appeal concluded that this finding was amply supported by the evidence, it determined that it did not in any event matter as Rickard Constructions undertook in the contract to construct the pavement ‘in a workmanlike manner’, and by the specification was obliged to carry out the works in ‘a sound, efficient and workmanlike manner, and in accordance with sound engineering practice and principles.’ The Court of Appeal held that failure to appreciate what good construction practice called for would not excuse it.

The Court of Appeal went on to find that on the evidence as a whole, the trial judge was entitled to find that Rickard Constructions permitted the asphalt wearing layer to be placed over the basecourse while it was excessively wet, creating the conditions for the failure. No error had been shown in the trial judge’s finding of defective workmanship, as cl1 of the exclusions was engaged as there was a defect in workmanship creating the conditions that caused the failure.

The Court of Appeal then turned to consider the application of the exclusion and stated²⁹¹ as follows:

Rickard Constructions accepted that the finding of defective workmanship in the pavement would mean that it could not recover the ‘cost of repairing, replacing or rectifying’ the pavement (‘costs A’), and would leave it with only the recovery expressed by the ‘costs of loss or damage caused directly by’ the defect in workmanship (‘costs B’) less the ‘costs which would have been incurred in’ rectifying the defective workmanship immediately prior to the loss or damage occurring (‘costs C’).

It submitted that costs B could be the same as costs A, and in the present case were. And it submitted that costs C were less than those costs because immediately prior to the failure of the pavement it could have been repaired or rectified simply by allowing the materials to dry out (at no cost) or by removing the asphalt wearing layer, working the materials so as to reduce the moisture, recompacting and reasphalting (at less cost, or so Rickard Constructions said).

²⁹¹ Ibid 118, 119.

The court went on to say:²⁹²

The policy was a contract works policy. The insuring clause indemnified Rickard Constructions against loss of or damage to Insured Property, being the contract works and relevantly the pavement. It did not insure defective workmanship by the contractor, with recovery for the costs of making good the defect in workmanship in the Insured Property. That was made plain by the exclusion of costs A and the deduction of costs C. There could be different recovery of costs B, that it was different being made clear by the restriction to loss or damage ‘caused directly by’ the defect in workmanship. The loss or damage the subject of costs B was not that there was the defect in workmanship in the Insured Property.

The Court of Appeal found that it was not necessary, as Rickard Constructions’ submission seemed to assume, to give the exclusion clause a construction whereby a costs B had to be found – in its submission, the costs of repairing, replacing or rectifying the pavement.

In dismissing the appeal (and finding that the insurer’s policy did not respond) the Court of Appeal concluded that Rickard Constructions’ difficulty was that, on the facts of the case, there was not a costs B, or at least none which it put forward.

Conclusion

The decision both at first instance and on appeal reflects a correct and sound approach to the construction of both the primary indemnity clause and exclusions contained within a contract works policy. Although recovery in any given instance must necessarily be determined having regard to the particular factual matrix and the precise wording of the primary insuring clause and applicable exclusions, the decision provides an illustration of the manner in which it is generally intended that such policies will operate.

Ordinarily, such policies will afford indemnity with respect to damage occasioned by external events (an example given by the Court of Appeal was storm activity breaching a building after lock up with rain water causing damage). By contrast,²⁹³ if the window flashing is defectively installed and rain water enters the building and causes damage

²⁹² Ibid 120.

²⁹³ To further use the illustration adopted by the Court of Appeal. *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd & Ors* [2006] NSWCA 356 [121].

... the contractor cannot recover the cost of rectifying the building (costs A), but may be able to recover the cost of the loss or damage from water entry (costs B) less the costs which would have been incurred in rectifying the faulty flashing (costs C). Why less costs C? Lest in recovery of costs B the contractor is paid for doing what it should have done to rectify the defective flashing.

The decision supports the approach taken by the New South Wales Court of Appeal in the earlier decision in *Mutual Acceptance Insurance Ltd v Nicol*,²⁹⁴ in which the Court accepted that ‘Defect or Deficiency’ is to be read in the broad sense of ‘shortcoming, fault, flaw or imperfection.’ It also follows logically from the decision of the Full Court of the Victorian Supreme Court in *Prentice Builders Ltd v Carlingford Australia General Insurance Ltd*,²⁹⁵ which confirmed that ‘workmanship’ means the performance or execution of work as a whole.

²⁹⁴ (1987) 4 ANZ Ins Cas 60-821.

²⁹⁵ (1989) 6 ANZ Ins Cas 60-951.

CONSTRUCTION PROFESSIONAL INDEMNITY INSURANCE – POLICY RESPONSE UNDER A CONTRACTOR’S D&C POLICY.

In addition to the proliferation of so called ‘first party’ professional indemnity policies in the context of Project Alliances (and on occasions major infrastructure projects delivered other than by the Alliance methodology), professional indemnity policies tailored to the requirements of major contractors embarking upon Design and Construct projects, have recently come into vogue. A particular feature of such policies is often a purported attempt (not always without attendant difficulties) to extend the cover afforded under the policy to the contractor’s design consultants.

In this regard, attention is drawn to the decision of the New South Wales Court of Appeal in the case of *Baulderstone Hornibrook Engineering Pty Ltd v Gordian Runoff Ltd & Ors*.²⁹⁶ This decision of Allsop, Bezley JA and Campbell JA delivered on 9 October 2008 is worthy of further consideration, given the increasing popularity of policies of this nature the decision’s potential implications for the interpretation of such policies.

Background

The appeal arose out of a dispute between the Federal Airports Corporation and Baulderstone Hornibrook Engineering (BHE) about the adequacy of the construction of the reinforced earth walls forming the perimeter of the third runway at Sydney Airport, and the adjacent area known as the Millstream Channel Diversion.

BHE was engaged as head contractor on the contract and engaged subcontractors in relation to the design of the reinforced earth walls on the project and engineers in relation to the provision of engineering services, including the reinforced earth walls.

Various insurance policies were put in place which covered professional indemnity risks and not construction risks.

Work commenced in early 1993 with practical completion in August 1994. By late 1996, subsidence of backfill behind the facing panels of the reinforced earth walls was discovered. BHE notified its insurers.

²⁹⁶ [2008] NSWCA 243.

The Decision at First Instance

At first instance, Einstein J concluded that none of the professional indemnity policies responded because the liability of BHE for the principal's claim against it under the design and construction contract could be described for the purpose of the policies as *arising out of* (uninsured) construction risks and not *arising out of* (insured) professional indemnity risks. BHE appealed, and the appeal was dismissed.

The Appeal Judgment

There are a number of potentially interesting facets to the appeal judgment. Firstly, the appeal court found that special provision 2 (which was in similar terms to a common extension of coverage to consultants and subcontractors while acting '*for and on behalf of*' the named insured) was an extension of the indemnity to cover acts, errors and omissions by specialist designers or consultants in the conduct of '*professional activities or duties*' acting on the insured's behalf or for whom the insured was responsible. There was not required to be an act, error or omission of the insured itself [273].

The Cause of the Failure

In the case, the primary judge had identified the central issue as being ascertainment of the true cause of the sand loss behind the walls. Once one understood the cause of that loss, one could characterise the claim which was made for indemnity under the policies.

The contractor had contended that the cause of the sand loss was the inappropriately specified geotextile material that was placed over unsealed joints. This geotextile material was said to have holes that were too large, such that water was permitted not only to enter and leave (as intended) but also sand was permitted to escape (not as intended).

In contrast, the insurers contended that there were no design defects; that the cause of excessive sand loss was the failure of the contractor properly to construct the walls by its failure to compact uniformly to 80% D1 and by its failure to test and certify that fact; but in the alternative, if inadequate compaction was not the sole cause of the sand loss, it was a substantial contributing cause, which alone would have been sufficient to have caused the need to undertake the rectification of the work; and further, in the alternative, that the sand loss was caused by defective affixation (in construction) of the geotextile material, permitting sand to be trapped between the panel wall and the geotextile creating a path for sand to escape.

It should further be noted that there was a fall back position by the contractor which was that there was a design error in the document setting out the construction method, being a stated requirement in the design documents for construction to compact uncompacted backfill layers to a depth of 375mm (at the Millstream walls) and 660mm (at the Seawall). In effect, if compaction was not achieved, it was not achieved because the design documents and method statements required a method that was nigh on impossible to achieve.

The Court of Appeal concluded that none of the documents relied upon by the contractor told ‘an experienced contractor’ how to compact. The Court of Appeal went on to say:²⁹⁷

‘It may be accepted from the above analysis that . . . the contractor . . . had design responsibility. Once, however, it is accepted that the design documents did not mandate the particular [defective] method of backfilling and compacting in the hand compaction zone that was used in construction, one is left with the findings of the trial judge about the comprehensive failure to comply with testing in the hand compaction zone and the adoption of inadequate construction techniques, including a failure to experiment and test.’

And then:²⁹⁸

‘To state that the construction faults could and should have been prevented by a specification which descended to the detail of telling . . . the contractor . . . how to do the things that the witnesses said . . . the contractor . . . as an experienced constructor, would be taken to know, is to seek to have logic replace evidence.’

It was stated:²⁹⁹

‘The contractor did . . . however prove that it had design responsibility to the FAC under the head contract, that it shared that responsibility with [the other consultants] under the subcontracts and that it was involved in designing considerations and discussions.’

²⁹⁷ Ibid [228].

²⁹⁸ Ibid [232].

²⁹⁹ Ibid [236].

The Exclusion

The court went on to consider an exclusion contained within the professional indemnity policy. The Court of Appeal said:³⁰⁰

'The evident commercial purpose in exclusion 1(p) is to remove from the scope of indemnity claims that arise out of the performance of construction work.'

And then:³⁰¹

'On the evidence here, and given the absence of proof as to reliance on the act, error or omission . . . the proximate cause of the claim by FAC and SACL was the defective construction.'

Even if one were to conclude that the design error and omission, for which [the consultants] were held responsible by the primary judge, should also be held to be the responsibility of . . . the contractor . . . as designer, and that the claim can be seen (for the purposes of insuring clause 1 and special provision 2) to arise out of the error and omission of the designers . . . one is still left with his Honour's conclusion that the claim arises out of construction work by the contractor for the purposes of exclusion 1(p).'

Then:³⁰²

'In these circumstances, where there are two or more causes and one falling within an insuring clause and another falls within the exclusion, the policy will not respond' [citing a well known authority of Wayne Tank and Pump Co Ltd v The Employers' Liability Assurance Corp Ltd [1974] QB 57.

Here, exclusion 1(p) is tolerably clear; the policy 'shall not indemnify' the contractor in respect of a claim made against it arising out of construction work performed involving the means, methods, techniques, sequences, procedures and lists of equipment of any nature whatsoever . . . in executing any phase of the works.

³⁰⁰ Ibid [259].

³⁰¹ Ibid [260], [261].

³⁰² Ibid [263] – [265].

No point was taken in argument contrary to . . . conclusion . . . that there could be more than one operative cause in the answer to a question about the response of an insurance policy in this context. Here, the flaws in the contractor's construction means and techniques were plainly an operative cause of the claim such that it can be said to arise out of them. That is sufficient.'

Conclusion

To summarise the effect of the *Baulderstone* decision:

- Non defective construction or implementation of a design which contains a flaw is unlikely to lead to the engagement of an exclusion in relation to '*defective workmanship*'.
- If the contractor has to exercise its own judgment in implementation of a design and does so in a manner which leads to the works being defective, the exclusion is likely to be engaged.
- If the '*proximate cause*' of the losses is a combination of the defective design and defective workmanship, the exclusion in relation to the defective workmanship is likely to take precedence over the indemnity clause and exclude the entirety of the claim (insofar as the damage is referable to that combined cause).
- There is no requirement that there be an act, error or omission of the insured provided the act, error or omission is of one of the insured's consultants (either an insured itself) or specialist designer or consultant within the extension of cover. It is sufficient to trigger policy response at the behest of the Insured provided that act, error or omission arises in the conduct of '*professional activities or duties*' acting on the insured's behalf or for whom the Insured was responsible.

Each matter must, of course, be considered having regard to the particular circumstances which have given rise to the claim for indemnity under the policy and the wording in each case of the policy called upon to respond.

The findings of the New South Wales Court of Appeal are however, instructive when assessing the likely approach a Court will take to similar matters arising under policies of this nature.

POLICY RESPONSE UNDER ISR POLICY

In the Queensland Court of Appeal case of *Prime Infrastructure (DBCT) Management Pty Ltd v Vero Insurance Ltd*,³⁰³ the Court considered an exclusion clause in an ISR Policy arising out of a catastrophe failure due to defective construction. The facts of the case were as follows:

At the Dalrymple Bay Coal Terminal, located at Hay Point north of Mackay, coal mined in Central Queensland is stockpiled prior to its loading on ships for export. The respondent was the lessee of the terminal and the owner of the terminal's structures and machinery. The respondent's conveyor belts carried the coal from the stockpile along a jetty to a wharf where the coal was mechanically loaded into the holds of cargo ships. Very large machines called reclaimers lift the coal from the stockpile onto the conveyor belts. The respondent was also the insured under an Industrial Special Risks Insurance Policy ('the policy') issued by the appellant insurance companies for the period 30 June 2003 to 1 September 2004 in respect of loss or damage to the respondent's property at the terminal. On 15 February 2004 one of the respondent's reclaimers collapsed onto two conveyor belts and the reclaimer and belts were extensively damaged.

The respondent sought and obtained a declaration from the primary judge that the appellants were required to indemnify it under the policy for approximately \$8 million for the cost of repairing the reclaimer and conveyor belts. The appellants appealed from that order contending that the learned primary judge erred in construing the terms of the policy.

For the purposes of the primary proceedings, the parties thought their lawyers signed a statement of agreed facts which, in addition to those already mentioned, included the following.

Agreed Facts

The collapse of the reclaimer was initiated by the final severing of an internal fatigue crack in a defective weld in one of the reclaimer's undercarriage legs. This was the result of faulty workmanship at the time of the original construction or assembly of the reclaimer.³⁰⁴

³⁰³ [2005] QCA 369

³⁰⁴ *Ibid* [4]

Over time, this crack grew progressively, detaching connections between the top flange of the leg box from an internal diaphragm. Immediately prior to the accident, the crack had effectively totally severed this connection.³⁰⁵ With the stabilising influence of this welded connection removed, the leg structure then buckled, causing the undercarriage to begin to collapse downwards. The resulting motion of the undercarriage rotated the entire superstructure of the reclaimer backwards, elevating the bucketwheel boom. The boom then continued to travel upwards reaching an angle of about 80 degrees to the horizontal before descending again and finally hitting the ground.³⁰⁶ The major damage to the undercarriage, the bucketwheel boom and associated conveyer, the yard conveyers, and many other components of the reclaimer was caused during the collapse process, subsequent to the ultimate failure of the weld in the undercarriage leg.³⁰⁷

The first overtly observable event in the sequence of events in the collapse of the reclaimer was a relatively sudden structural failure of the north-eastern leg of the undercarriage.³⁰⁸ This was primarily caused by the progressive fatigue cracking of the weld attaching the internal diaphragm at the knee of the north-eastern leg to the adjacent flange. This cracking developed over a relatively long period of time, starting at a weld defect or at several defects and growing progressively larger as the weld was loaded and unloaded in response to cyclical stresses during normal operation of the reclaimer. The developing fatigue crack accelerated as it grew longer. The crack grew quite rapidly immediately before its ultimate failure³⁰⁹ by which time the flange of the leg box over an area of about 1100mm leaving the diaphragm attached to the flange only at its ends.³¹⁰ The fatigue crack developed into a rapid ductile (tearing) fracture and the welds at the end of the diaphragm and along the sides of the top flange progressively failed by ductile fractures as the machine slewed towards its final slew angle of 37 degrees, loads on its north-eastern leg increased progressively. The reclaimer slewed anti-clockwise towards its pre-accident position placing near maximum loads on the leg of the reclaimer.³¹¹ When the internal diaphragm connection severed, the top flange of the leg box became unstable and deflected upwards leading to a progressive failure of the adjacent welds and a total buckling failure of the reclaimer's leg structure.³¹² The collapse of the reclaimer also caused damage to two conveyor belts.

³⁰⁵ Ibid [4]

³⁰⁶ Ibid [4]

³⁰⁷ Ibid [4]

³⁰⁸ Ibid [5]

³⁰⁹ Ibid [5]

³¹⁰ Ibid [5]

³¹¹ Ibid [5]

³¹² Ibid [5]

After investigation of the collapse of the reclaimer the respondent first learned of the risk of a weld defect inside the concealed box section of all reclaimer undercarriage legs. It arranged for inspections of its three remaining reclaimers at the terminal and discovered and repaired one similar weld deficiency. Had a like inspection and repair been effected on the collapsed reclaimer prior to 15 February 2004 the damage the subject of the respondent's claim (or at least most of it) would not have occurred.³¹³

The Relevant Extracts from the Industrial Special Risks Insurance Policy

In the preamble to the policy the insurers agreed ' . . . subject to the terms, Conditions, Exclusions, . . . limitations and other provisions, contained herein or endorsed hereon, to indemnify the Insured . . . against loss arising from any insured events which occur during the Period of Insurance stated in the Schedule . . . '.

Included in the schedule under the heading 'Material Loss or Damage' was the following:

'The Indemnity in the event of any physical loss, destruction or damage . . . not otherwise excluded happening at the Situation to the Property Insured described in This Policy the Insurer(s) liability, indemnify the Insured . . . '

The 'Property Insured' was defined to be:

'All real and personal property of every kind and description (except as hereinafter excluded) belonging to the Insured or for which the Insured is responsible . . . '

The parties agreed that the damaged reclaimer and conveyor belts were properly insured by the policy and that the damage which happened at the situation was covered by the policy, namely the coal terminal.

The policy contained two sets of exclusions, 'Property Exclusions' and 'Perils Exclusions', the latter of which is relevant here. The policy provided that '[t]he Insurer(s) shall not be liable under in respect of 'the specified perils exclusions in cl 1 – cl 9.

Whether the appellant was required to indemnify the respondent pursuant to the policy turned on the construction of the fourth of these perils exclusions and its proviso:

³¹³ Ibid [6]

'The Insurer(s) shall not be liable under in respect of :-

... .

4. *physical loss, destruction or damage occasioned by or happening through:*
 - (a) *moths, termites or other insects, vermin, rust or oxidation, mildew, mould, contamination or pollution, wet or dry rot, corrosion, change of colour, dampness or atmosphere or other variations in temperature, evaporation, disease, inherent vice or latent defect, loss of weight, change in flavour texture or finish, smut or smoke from industrial operations, (other than sudden and unforeseen damage resulting therefrom)*
 - (b) *wear and tear, fading, scratching or marring, gradual deterioration or developing flaws, normal upkeep or making good*
 - (c) *error or omission in design, plan or specification or failure of design*
 - (d) *normal settling, seepage, shrinkage or expansion in buildings or foundations, walls, pavements, roads and other structural improvements, creeping, heaving and vibration*
 - (e) *faulty material or faulty workmanship*

Provided that this Exclusion 4(a) to (e) shall not apply to subsequent loss, destruction of or damage to the Property Insured occasioned by a peril (not otherwise excluded) resulting from any event or peril referred to in this exclusion.' [writer's emphasis]

At First Instance

The judge at first instance considered that the proviso required that Perils Exclusion not apply:

1. *to subsequent damage to the insured property;*
2. *occasioned by a peril;*
3. *not otherwise excluded;*
4. *resulting from an event or peril referred in exclusion 4.*

His Honour then considered the three questions arising, namely:

1. What is subsequent damage?
2. What is meant by a peril which occasions a subsequent damage?
3. What is meant by the parenthesis '(not otherwise excluded)'?

The judge at first instance concluded that:³¹⁴

*'. . . the meaning of the proviso is that it applies where there is damage to the insured property caused by faulty workmanship: there is subsequent damage, ie damage which follows the first damage in time and consequence; the means by which the subsequent damage occurs is not a means excluded from cover under the policy by an exclusion **other than 4**'. [writer's emphasis]*

On Appeal

The Court of Appeal by 2:1 majority agreed with the judge at first instance stating³¹⁵ that the appellants would succeed in their appeal unless the damage to the insured property was caused by a peril not otherwise excluded under the policy and the damage (which resulted from an event in Perils Exclusion CL4) was subsequent [writer's emphasis] damage to the damage excluded in Perils Exclusion CL4.

The President of the Court of Appeal said:³¹⁶

'The use of the words ". . . this Exclusion 4(a) to (e) shall not apply to . . . damage . . . occasioned by a Peril (not otherwise excluded) resulting from any event or Peril referred to in this exclusion," strongly suggests that "occasioned by a peril (not otherwise excluded)" refers to excluded perils under the policy other than those in Perils Exclusion CL4. It seems a circular and improbable construction to find . . . that the proviso does not exempt damage from Perils Exclusion CL4 if the damage has been occasioned by one peril in Perils Exclusion CL4 resulting from another event of peril in Perils Exclusion CL4 . . . I consider that the words "in the proviso (not otherwise excluded)" do not encompass Perils Exclusions CL4 (a) to (e); the words in parenthesis relate to perils excluded by the policy other than in Perils Exclusion CL4 . . . In my view, for the proviso to apply, there must be damage occasioned by a peril separate to the peril in Perils Exclusion CL4.'

³¹⁴ [2004] QSC 356 [42]

³¹⁵ Ibid [28].

³¹⁶ Ibid [22] – [23].

Mullins J agreed that the appeal should be dismissed for the reasons given by the President.

Jerrard JA was in the minority and he disagreed with the majority's construction, stating:³¹⁷

'For example, it would be unsurprising if an error or omission in a design, plan or specification, or a failure or design – all CL4 (c) excluded perils – led to a gradual deterioration or a developing flaw – a CL4(b) Excluded Peril. Likewise rust or oxidisation or corrosion – CL4(a) excluded perils – would be likely to lead, almost by definition, to a gradual deterioration or a developing flaw in the property insured. If the corrosion, rust or oxidation leading to that gradual deterioration itself resulted from faulty materials, in combination with a failure of design, set out a total of 4 Excluded Perils combined to cause the same collapse of another reclaimer as occurred here, a construction of the proviso that would hold the insurer liable because more than one Excluded Peril had occurred and combined to cause catastrophic loss is a construction that fails to supply a congruent operation to the various components of the whole policy . . . I construe "not otherwise excluded" as referring to a peril for which liability, when that peril causes physical loss, destruction of or damage to property insured, is not (otherwise) excluded by any of the perils exclusion clauses 1 – 7'.

³¹⁷ Ibid [54].

MITIGATION OF RISK THROUGH INNOVATIVE INSURANCE SOLUTIONS IN PROJECT ALLIANCES AND OTHER MAJOR PROJECT DELIVERY METHODS: FIRST PARTY V THIRD PARTY PROFESSIONAL LIABILITY COVER

Types of insurances that would typically be found in a major project include contract works insurance (in an amount sufficient to cover full reinstatement of the works including costs of demolition and removal of debris and fees for all consultants), public liability insurance, workers' compensation, vehicles and plant and professional liability. In addition, the contractor may seek to insure wider risks designed to protect the cash flow including insurance against latent defects, business interruption, strikes and industrial action and advanced loss of profits. Similarly owners seeking to have protection against defective or late design under an alliance style project will generally require some tailored form of insurance given that liability insurance is unlikely to be triggered under an alliance style arrangement in the absence of 'wilful default' which most policies will exclude in any event.

Another key feature that has been observed in terms of insurance and risk allocation in recent years has been the cost and availability (or lack thereof) of professional liability insurance for design consultants, the level of that cover and the level of the deductible which the design professional is being asked to bear. As a result of this lack of cover for defective design, there has been an increased desire on behalf of principals to seek to novate their design consultant's obligations to their principal contractor and seek to impose a fit for purpose risk upon that party.

Similarly, the large deductibles increasingly found in not just professional liability insurance, but other forms of property and general liability cover have meant the need for a greater focus on both the financial wherewithal of project partners and the warranties and indemnities contained within project documentation.

Professional indemnity insurance is traditionally third party insurance cover. In regard to a design and construct project, the contract conditions would generally require both the design consultant and the contractor to effect project specific professional indemnity insurance to cover – in the case of the design consultant – errors and/or omissions relevant to the projects design: In the case of the contractor – errors and/or omissions relevant to project management.

With such policies, in the event of an alleged error or omission occurring, the principal (owner) or other relevant third party would make a claim against the design consultant or the contractor, as the case may be. The design consultant or contractor would, in turn, advise their insurer and they, together with their insurer, would use best endeavours to avoid or minimise any such claim.

The overriding purpose of a Project Alliance is maximising the chance of achieving an outstanding project delivery. The fundamental criterion to achieving this is the alignment of the contractual interests of the various parties to the alliance agreement, resulting in ‘shared gain and shared pain’ and a no blame culture.

Generally, Project Alliance insurances are three-fold – contract works, construction liability and professional indemnity. The conventional insurance products in this regard, to respond correctly to the alliance concept, need to be adapted, as follows:

Contract works insurance

This will need to be issued in the joint names of all the alliance participants and, separately noted in the policy to include the interests of subcontractors and other parties, as appropriate, involved in the project. These requirements are not significantly different from those of the more conventional design and construct approach. Such policies however generally exclude losses arising out of ‘defective workmanship, materials, design and specification’.

Under non-alliance forms of contract, such an exclusion is not of concern to the principal as it will have recourse to liquidated damages and/or legal action against the contractor and/or design consultants (who will in turn ordinarily have the benefit of professional indemnity insurance cover).

To align with the first party professional indemnity cover (to be considered shortly), this standard ‘defective workmanship, materials, design or specification’ exclusion requires modification. This is achieved through use of either the DE5 or LEG 3 Clauses, which clauses only exclude from cover ‘betterment costs’.

DE5 Design Improvement Exclusion

This clause excludes:

- (a) *The cost necessary to replace, repair or rectify any Property Insured which is defective in design, plant, specification, materials or workmanship;*

- (b) *Loss or damage to the Property Insured caused to enable replacement, repair or rectification of such defective Property Insured,*

but should damage to the Property Insured (other than damage as defined in (b) above) result from such a defect, this exclusion shall be limited to:

- *The costs of additional work resulting from additional costs of Improvements to the original design, plan, specification, materials or workmanship.*

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.

LEG 3/06

The London Engineering Group Model 'Improvements' Defects Wording provides as follows:

The Insurer(s) shall not be liable for:

All costs rendered necessary by defects of material, workmanship, design and/or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property) occur to any portion of portion of the Insured Property containing any of the said defects, the cost or replacement or rectification which is hereby excluded is that cost incurred to improve the original material, workmanship, design, plan or specification.

For the purpose of the policy and not merely this exclusion, it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material, workmanship, design, plan or specification.

It should be noted that LEG 3 provides a similar cover to the earlier DE5 wording insofar as once a damage event has occurred (with the defective part also being damaged), then the policy responds to all the subsequent rectification costs. The only costs being excluded being those associated with the improvement of the original defect.

Construction liability insurance

This policy also needs to include the interests of all the alliance partners and, because of the ‘no blame’ contractual environment between them, the policy needs to be drafted accordingly. Often it is sought to refine the professional indemnity exclusion so that personal injury as a result of professional negligence, error or omission is included. This approach achieves greater sums insured for these exposures and provides cover on an ‘occurrence’ basis as opposed to the ‘claims made’ provision of a conventional professional indemnity placement.

Other parties interested in the project also can be included in the cover, with the policy including cross liability and waiver of subrogation provisions in the conventional manner.

Professional indemnity insurance

A conventional professional indemnity policy will only respond when a legal liability to another party has been incurred – most frequently, but not limited to, negligence.

Commonly, such claims arise between the project participants. In the ‘no blame’ environment of a Project Alliance, the participants have no legal liability to each other.

Accordingly, a ‘first party’ professional indemnity insurance policy is required to respond to this lack of inter participant legal liability.

The basis of cover provided by the first party professional indemnity policy is the same as that provided under a traditional professional indemnity policy – ie indemnity against loss arising out of error or omission in regard to design and project management – but there are three main differences, as follows:

1. All the alliance partners are insured by the policy, these being the principal (owner), the contractor and the design consultant;
2. In the event of the occurrence of an error or omission in regard to design or project management, all the alliance partners are meant to meet with the insurer and jointly work out the best method to deal with and rectify the consequences of the error or omission;
3. The policy includes cover in respect of mitigation, rectification and redesign costs.

Claims made by non-alliance participants would be dealt with in the conventional adversarial methodology.

Further, it is important that the professional indemnity policy provides retroactive cover back to commencement date of the alliance partners' involvement in the projects. This is to cater for design and related work undertaken prior to finalisation of the project alliance agreement.

Until fairly recently, the insurance options throughout the world in relation to first party professional indemnity cover were extremely limited. In Australia, they were initially provided by a local insurer heavily reinsured with an international reinsurance company. The placement had only been offered as a combined package (contract works, construction liability and first party professional indemnity). The placement typically by underwriting at a primary layer of \$20 million for each of the above three classes of insurance with 'top up' being available with respect to the contract works and constructions liability segments of the insurance – this excess layer protection sitting above the primary \$20 million up to the level stipulated under the Project Alliance agreement. There are now a number of local insurers and Lloyd's Syndicates offering stand alone 'first party' professional liability cover, although arguably 'not all policies are equal'.

ANNEXURE A

The First Standard – London Market Design Clauses

The five clauses, in order of increasing coverage, run as follows:

DE1: Outright Defect Exclusion

This policy excludes loss of or damage to the Property Insured due to defective design, plan, specification, materials or workmanship.

DE2: Extended Defective Condition Exclusion

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

- a) *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;*
- b) *Property Insured which relies for its support or stability on (a) above;*
- c) *Property insured lost or damages to enable the replacement repair or rectification of Property Insured excluded by (a) and (b) above.*

Exclusion (a) and (b) 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.

DE3: Limited Defective Condition Exclusion

This Policy excludes loss of or damage to and the cost necessary to replace, repair or rectify.

- a) *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;*
- b) *Property Insured lost or damaged to enable the replacement, repair or rectification of Property Insured excluded by (a) above.*

Exclusion (a) 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.

DE4: Defective Part Exclusion

This policy excludes loss of or damage to and the cost necessary to replace, repair or rectify.

- a) *Any component part or individual item of the Property Insured which is defective in design, plant, specification, materials or workmanship.*
- b) *Property Insured lost or damaged to enable the replacement, repair or rectification of Property Insured excluded by (a) above.*

Exclusion (a) 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.

DE5: Design Improvement Exclusion

This policy excludes:

- a) *The cost necessary to replace, repair or rectify any Property Insured which is defective in design, plan, specification, materials or workmanship.*
- b) *Loss or damage to the Property Insured caused to enable replacement, repair or rectification of such defective Property Insured.*

But should damage to the Property Insured (other than damage as defined in (b) above) result from such a defect, this exclusion shall be limited to:

- *The costs of additional work resulting from*
- *The additional costs of*

improvements to the original design, plan, specification, materials, or workmanship.

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.

ANNEXURE B

The London Engineering Group ‘defects wording’

LEG 1/96

The London Engineering Group Model ‘Outright’ Defects Exclusion

‘The Insurer(s) shall not be liable for:

Loss or damage due to defects of material workmanship design plan or specification.’

LEG 2/96 –

The London Engineering Group Model ‘Consequences’ Defects Exclusion

‘The Insurer(s) shall not be liable for:

All costs rendered necessary by defects of material workmanship design plan or specification and should damage occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost which would have been incurred if replacement or rectification of the Insured Property had been put in hand immediately prior to the said damage.

For the purpose of this policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship design plan or specification.’

LEG 3/06

The London Engineering Group Model 'Improvement' Defects Exclusion

'The Insurer(s) shall not be liable for:

All costs rendered necessary by defects of material workmanship design plan or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property) occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification.

For the purpose of the policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship design plan or specification'.

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