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Perils Exclusion 4 in ISR Mark IV: Time to revisit the decision in *Prime Infrastructure*?

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Prime Infrastructure

In *Prime Infrastructure (DBCT) Management Pty v Vero Insurance Limited and Ors*[1] ***(Prime Infrastructure)***, the Queensland Court of Appeal considered an exclusion clause in an Industrial Special Risks (**ISR**) insurance policy arising out of a catastrophic failure due to defective construction.

The background to that case was 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. Reclaimers lift the coal from the stockpile onto the conveyer belts.

The respondent was also the insured under an ISR 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 conveyer 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 conveyer 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 through 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.[2]

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.[3]

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.[4]

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.[5]

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.[6] 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 failure[7] 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.[8]

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.[9] 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.[10]

The collapse of the reclaimer also caused damage to two conveyor belts.

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.[11]

The Relevant Extracts from the ISR 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 property 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 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:

'The Insurer(s) shall not be liable … 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,[12] Chesterman J, considered that the proviso required that the 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)'?

Chesterman J concluded that:[13]

> *'... 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 outcome of the case at first instance[14] having stated 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 4) was **subsequent** [writer's emphasis] damage to the damage excluded in Perils Exclusion 4.[15]

The President of the Court of Appeal McMurdo P said:[16]

> *'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.'*

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:[17]

> *'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'.*

Special Leave to Appeal

Application for Special Leave to Appeal from the Queensland Court of Appeal decision in *Prime Infrastructure* to the High Court of Australia was refused by Gummow and Crennan JJ on the ground that :

'There are insufficient prospects of success on an appeal in displacing the construction which the relevant provisions …were given by the majority in the Court of Appeal of Queensland'.[18]

The Strategic Property Holdings Cases

In ***Strategic Property Holdings No 3 Pty Limited v Suncorp Metway Insurance Limited***[19] Gray J noted [at para 39] that the question of the construction of an identical provision to the one under consideration in that case had been considered by the Queensland Court of Appeal in *Prime Infrastructure*, and that the construction which the majority judges in *Prime Infrastructure* (McMurdo P, with whom Mullins J agreed) had placed on the provision was accepted by the defendant, thus making it unnecessary for the Judge in that case to consider the contrary view expressed in the dissenting judgment of Jerrard JA.

Gray J did observe [at para 44] that in *Prime Infrastructure*, in respect of the application of the proviso to the relevant Perils exclusion [4] the parties seemed to be at such cross purposes that no-one articulated the peril that was a *'not otherwise excluded'* peril resulting from the design and construction inadequacies that had been identified.

Gray J went on to note [at para 45] that would not seem to matter as the defendant in the case before the Court had accepted that those inadequacies would entitle it to exclude liability to indemnify the defendant in respect of replacement of certain roof trusses and adjoining supports, but accepted that the resultant damage to the roof was covered by the proviso to the perils exclusion.

In the related case of ***Strategic Property Holdings No.3 Pty Ltd v Austbrokers RWA Pty Ltd***[20] Stevenson J who was called on to determine a professional negligence claim against an insurance broker simply noted [at paragraph 125] that the insurer had taken the position in the aforementioned trial that Strategic's claim for indemnity in relation to the costs of replacement of certain roof trusses fell within the Faulty Designs Exclusion, and was excluded; but that Strategic's claim for indemnity in relation to the *'resultant damage to the roof'* fell within the proviso to the Faulty Designs Exclusion, and was not excluded.

Stevenson J noted [at para 127] that in *Prime Infrastructure* the Queensland Court of Appeal considered a clause identical to the one with which the Court was concerned in this case and found [at para 130-131] that as factually the *Prime Infrastructure* case was closely analogous it was foreseeable that the insurer would construe the identical clause in the Policy consistently with the decision in *Prime Infrastructure*.

Mobis Parts Australia

More recently Stevenson J had cause to briefly revisit *Prime Infrastructure* in ***Mobis Parts Australia Pty Ltd v XL Insurance Company SE***[21] in which his Honour observed [at para 426] that the Queensland Court of Appeal had considered a proviso similar to the one under consideration by the Court in the present case, to mean damage *'occurring or coming later or after; following in order of succession'* or *'causing or*

occurring later or after or following in order'. The Judge observed that the Court of Appeal found that it was not necessary that the *'subsequent damage'* be separate and distinct from the initial damage.

Stevenson J noted [at para 427] that in that case the words *'a peril (not otherwise excluded)'* was held to mean a peril that is not excluded by any other provision in the policy. That is, the *'proviso peril'* could be a peril excluded by the clause containing the proviso, but not any other exclusion in the policy.

In the case before his Honour, as all damage (other than to the building itself) was subsequent to the actual collapse of the warehouse and not *'otherwise excluded'* it was not caught by the exclusion and as a result, all that was capable of exclusion was the claim for damage to the building itself not the claim for loss of stock, contents or for business interruption.

Leeds Beckett University

The decision in *Prime Infrastructure* was recently considered by The Honourable Mr Justice Coulson in the 2017 case in the High Court of Justice Queen's Bench Division Technology and Construction Court of ***Leeds Beckett University (formerly Leeds Metropolitan University) v Travelers Insurance Company Limited***.[22]

In that case there was a proviso to the relevant exclusion making it clear that damage caused by or consisting of gradual deterioration or faulty/ defective design (amongst other things) *'shall not exclude subsequent damage which itself results from a cause not otherwise excluded'*.

Although the *'proviso argument'* was not pleaded, the Judge felt obliged to address it in any event, noting [at para 268] that the main version of the argument was to the effect that whilst the original damage was the damage to the blockwork, the subsequent damage was the cracking and the other damage to the superstructure of the Building. It was contended by Counsel for the Claimant that this subsequent damage resulted from water flowing in and through the blockwork, which was a cause that was *'not otherwise excluded'*.

Coulson J noted that the principal case relied upon by the Claimant's Counsel in respect of the proviso was the Australian Case of *Prime Infrastructure*. The Judge firstly observed [at para 274] that the Queensland Court of Appeal held, by majority, that the failure of the weld amounted to *'initial damage'* and the collapse of the machine was *'subsequent damage'* and therefore fell within the proviso, and that they had held that *'subsequent damage'* was damage after the *'initial damage'* and did not need to be distinct, independent or separate from the initial damage.

Coulson J then continued on [at para 275]:

> *'I am bound to say that I find that decision somewhat surprising. It seems to me to draw a potentially artificial distinction between initial and subsequent damage. I consider that the dissenting judgement of Jerrard JA (starting at paragraph 44) to be more in line with general principles'.*

Coulson J went on to note [at para 275, drawing on earlier written commentary] that two other courts had reached *'very different conclusions on similar clauses, holding that such subsequent loss must be caused by a non-excluded peril separate and independent but resulting from the original excluded peril: see Acme Galvanised & Co Inc v Firemans Funded Insurance Co* 221 Cal. App.3d 170 at 179 and Weeks v Co-Operative Insurance Cos 149 N.H 174 at 177.'

Coulson J went on to say [at para 275]:

> *'So since none of these three cases is binding on me, and the law which they embody is in any event far from clear, I consider that I should approach the operation of the proviso from first principles'.*

Then [at para 276]:

> *'First, it seems to me that 'subsequent Damage' must be a reference to different damage: damage that can be distinguished in some way from the damage originally caused. Second, because that different damage must be caused by something which is 'not otherwise excluded', that must mean a new or different cause to the gradual deterioration or the faulty /defective design. It must mean a new or different cause because it is a cause not otherwise excluded and, as we know, gradual deterioration and/or faulty/defective design are both causes which are excluded'.*

And further [at para 277]:

> *'In my view, the sort of situation that the proviso is intended to cover is, let us say, the collapse of a factory wall because of a faulty/defective design. The falling masonry breaks open a gas pipe, which causes a fire that destroys some adjacent houses. Whilst a claim for the cost of repairing the factory would be excluded (because of the faulty/defective design), the claim for*

repairing the buildings damaged by the fire would otherwise be a claim in respect of subsequent damage caused by something (a fire) not otherwise excluded, and would be recoverable under the policy.'

Finally [at para 278]:

'….we are a long way from that sort of situation in the present case. First, I do not accept that there is subsequent or different damage. I have already explained that, in my view, the damage in this case was all of a piece : the damage to the blockwork robbed it of its structural strength, causing the visible damage by way of the cracking to the superstructure above. That is not different damage; that is all part of the same damage, the cause of which was an excluded cause(s)…'.

It was then noted by the Judge [at para 279] that there had been an attempt by the Claimant's Counsel during the evidence to run a rather different case on subsequent damage relating to the blockwork in an attempt to suggest that the initial damage was to just the blockwork in the middle section of the eastern wall and that everything else including damage to the other blockwork on either side was subsequent damage.

In noting [at para 282] that there was no evidence to support the submission that if the damaged blocks had been found [before a certain date] they could have been replaced, whilst the wall could have been left safely intact (this involving temporal issues which could only have been addressed by the experts), Coulson J who expressed the view that the entire argument about subsequent damage was an afterthought, found [at para 283] that on the evidence adduced it could not be said that the worst of the blockwork could have been replaced [earlier] but was [later] so far gone that it sealed the fate of the entire building.

In concluding, the Coulson J said [at para 284]:

'…even if I am wrong about this….it makes no difference to the outcome. This is because such subsequent damage was not caused by something which was 'not otherwise excluded'. The cause of all the damage to all parts of the …building was the inevitable consequence of the flowing groundwater on the blockwork, and I have explained why that was an excluded cause both as 'gradual deterioration' and/or as 'faulty or defective design'. There was no other cause which gave rise to the subsequent damage. Again therefore, the proviso does not apply.'

Analysis

The decision in *Prime Infrastructure* does not answer the question of what is subsequent damage in all cases. A question not uncommonly arises whether the whole sequence of process is one physical loss, destruction or damage or whether a second or subsequent stage in that sequence or process can be identified as *'subsequent loss'* to the physical loss, destruction or damage.[23]

If it is, that *'subsequent loss'* is taken out of the operation of the perils exclusion by the proviso, assuming the other requirements of the proviso are met. A review of the authorities across multiple jurisdictions however shows there is at least a degree of artificiality in the process and determining what is initial damage as opposed to subsequent damage can be a difficult question.[24]

It may be further observed that the approach taken by the Queensland Court of Appeal in *Prime Infrastructure*[25], sets the test for distinguishing between what is initial damage and what is subsequent damage at a low level as it seems to focus on the time order of the physical damage process alone.[26]

This does not mean however that damage, particularly when caused simultaneously or concurrently, can or indeed should be separated into initial and subsequent damage in every instance. If it cannot then there is quite simply no scope for the operation of the proviso.

As to the proviso itself, it might be assumed that its evident purpose is to preserve cover for loss arising from damage which, though causally connected with a peril excluded by the perils exclusion,[27] was not the immediate consequence of the excluded peril.

Although the conclusion that a peril is a risk of loss might lead one in search of a second peril, it does not follow that wherever damage occurs sequentially, all but the initial damage will be subsequent damage within the scope of the subsequent loss proviso.

In order for the proviso to operate, it is necessary that the subsequent damage be occasioned as a consequence of a peril distinct from and consequent upon another excluded peril. Where there is a single peril which was the immediate cause of both the initial and subsequent damage, it will not be possible to identify an independent *'proviso peril'* caused by the relevant *'excluded peril'* in the sense contemplated by the Queensland Court of Appeal.[28]

Notwithstanding these comments providing context to the majority decision in *Prime Infrastructure*, the example set out by The Honourable Mr Justice Coulson in *Leeds Beckett University* [at para 277] of the falling masonry opening a gas pipe causing a fire which destroys an adjacent house, is in the writer's view illustrative of the likely intended operation of the proviso.

With respect to the then President of the Queensland Court of Appeal in *Prime Infrastructure*, the writer has always preferred the view of Jerrard JA who was in the minority in that case and who came to a different construction of the proviso in Peril's Exclusion 4 and to a different result.

This is primarily because Jerrard JA, in arguably taking a more orthodox view of the text of the policy, did not consider that under the proviso the excluded perils which could limit its operation were confined to perils other than those identified in Perils Exclusion 4 itself. Certainly the views of Jerrard JA generally appear to have now found support in *Leeds Beckett University*.

The majority view in *Prime Infrastructure* that the requirement that the second peril itself be *'not otherwise excluded'* should be interpreted to mean that it is not otherwise excluded in some other provision in the policy apart from Perils Exclusion 4(a) to (e), remains however a binding determination in Queensland on a judge at first instance as to the meaning of the proviso.

The Queensland Court of Appeal seems unlikely to overturn its own decision and Courts in other Australian jurisdictions may be reluctant not to follow the decision given the comments by the High Court of Australia in dismissing the Application for Special Leave.

The fact that nothing prevents the parties from adopting different language in respect of future insurance contracts, may be a further reason why there is little judicial appetite in Australia to change the construction of the clause favoured by the majority in *Prime Infrastructure*. It is clear however from the *Leeds Beckett University* case, that Courts in overseas jurisdictions may not feel similarly constrained.

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[1] [2005] QCA 369
[2] Ibid [4].
[3] Ibid [4].
[4] Ibid [4].
[5] Ibid [4].
[6] Ibid [5].
[7] Ibid [5].
[8] Ibid [5].
[9] Ibid [5].
[10] Ibid [5].
[11] Ibid [6].
[12] *Prime Infrastructure (DBCT) Management Pty Ltd v Vero Insurance Ltd* [2004] QSC 356.
[13] Ibid [42].
[14] But not with all aspects of Chesterman J's reasoning.
[15] Ibid [28].
[16] Ibid [22] – [23].
[17] Ibid [54].
[18] See [2006] HCA, Trans 142, 10 March 2006).
[19] [2009] ACTSC 8.
[20] [2012] NSWSC 1570.
[21] (No. 7) [2017] NSWSC 1321.
[22] [2017] EWHC 558.
[23] With due attribution to then Queens Counsel.
[24] Ibid.
[25] Following the New South Wales Court of Appeal in *L'Union Des Assurances de Paris v Sun Alliance Insurance Ltd* (1995) 8 ANZ Ins Cas 61-240, in which it was held that a comparable proviso covered damage to a compressor caused by the initial failure of a rotor blade in another part of a refrigeration system on the basis that the compressor damage was subsequent damage even thought they were all part of the one refrigeration system.
[26] Ibid.
[27] The peril not being the damage itself; the majority of the Court of Appeal differing from the approach taken by the trial judge in construing the reference to *'peril'* to mean *'an exposure to injury, loss or destruction, risk, jeopardy or danger*: see *Prime Infrastructure* at para 27.
[28] With due attribution to Senior Counsel.

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