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# Policy triggers and exclusions in construction insurance

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*Contract works and contractors' all risks policies comprise a critical component of risk allocation in major construction projects. The following article examines common policy triggers in construction liability policies, and the scope for the implication of a term obliging an insurer to meet expenditure incurred by an insured to mitigate a liability to a third party. It thereafter considers what constitutes "damage" or "physical damage" under a contract works policy. It concludes by analysing authorities in relation to contract works policy exclusions enlivened when property is allegedly damaged in consequence of defective workmanship, material or design.*

## CONSTRUCTION LIABILITY POLICIES

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

- (a) a legal liability to pay "compensation";
- (b) in respect of personal injury or "property damage"; and
- (c) as a result of an "occurrence".

Ordinarily, "compensation", "property damage" and "occurrence" will be defined terms within the Policy as follows:<sup>1</sup>

"Compensation" means monies paid or agreed to be paid by judgement or settlement.

"Property Damage" [the meaning of which will often also be the trigger for policy response under contract works policies] includes:

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

"Occurrence" is an event 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 also clear that the obligation to pay compensation does not have to be one that arises from a tortious liability; it 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 Plc*,<sup>2</sup> it was said:

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* [1939] 63 LIL Rep 143 at p 145. "Loss or damage to property" is a reference to the property of the third party claimant and not that of the insured.

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<sup>1</sup> The precise wording of the definitions will vary from policy to policy.

<sup>2</sup> *Yorkshire Water Services v Sun Alliance & London Insurance Plc* [1997] 2 Lloyd's Rep 21 (Stuart-Smith LJ).

Mr Crowther relied on the cases of *Post Office v Norwich Union Fire Insurance Society* [1967] 1 Lloyd's Rep 216; [1967] 2 QB 363 and *Bradley v Eagle Star Insurance Co Ltd* [1989] 1 Lloyd's Rep 465; [1989] 1 AC 957 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 MR in the *Post Office case* said at p 219, coll 1; p 373F:

...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*:

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 sums must be established. See per Lord Goff or Chievey in *Firma C-Trade Ltd v Newcastle Protection and Indemnity Association Ltd* [1990] 2 Lloyd's Rep 191 at p 202; [1990] 2 All ER 705 at p 717.<sup>3</sup>

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, 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.<sup>4</sup>

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*, the trial judge and Court of Appeal both 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.<sup>5</sup>

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,

<sup>3</sup> *Yorkshire Water Services v Sun Alliance & London Insurance Plc* [1997] 2 Lloyd's Rep 21 at 28-29.

<sup>4</sup> 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) 81 SASR 585; [2002] SASC 32.

<sup>5</sup> *Yorkshire Water Services Ltd v Sun Alliance & London Insurance Plc* [1997] 2 Lloyd's Rep 21 at 30.

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.

Reference should also be made to *Guardian Assurance Co Ltd v Underwood Constructions Pty Ltd*.<sup>6</sup> 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*<sup>7</sup> 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 and McPherson JJA; 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*<sup>8</sup> in the following terms:

[25] ... 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):

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.

[26] 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"

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<sup>6</sup> *Guardian Assurance Co Ltd v Underwood Constructions Pty Ltd* (1974) 48 ALJR 307.

<sup>7</sup> *Re Mining Technologies Australia Pty Ltd* [1997] Qd R 60.

<sup>8</sup> *PMB Australia Ltd v MMI General Insurance Ltd* (2002) 12 ANZ Ins Cas 61-537 at [25]-[26]; [2002] QCA 361.

expenditure to avoid “imminent damage”. Those featured do not characterise this case.

The effect of the majority judgements is uncertain because the judges in the majority gave different rationales for the result.

McPherson JA 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.<sup>9</sup>

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

His Honour’s reasons were not, however, adopted by Davies JA – nor was his Honour referred to the *Yorkshire Water Services case*.<sup>10</sup> Ultimately, his Honour concluded that the process of retrieving the trapped equipment was one of “repair” within the partial loss provisions of the Policy.

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*.<sup>11</sup>

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”. 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. His Honour 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”.

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”.<sup>12</sup>

The Chief Justice went on to conclude:

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<sup>9</sup> *Re Mining Technologies Australia Pty Ltd* [1997] Qd R 60 at [84].

<sup>10</sup> See also Pincus JA’s analysis of *Guardian Assurance in Re Mining Technologies Australia Pty Ltd* [1997] Qd R 60 at 65-66.

<sup>11</sup> *Windsurf Pty Ltd v HIH Casualty and General Insurance Ltd* [1999] QCA 360.

<sup>12</sup> *Windsurf Pty Ltd v HIH Casualty and General Insurance Ltd* [1999] QCA 360 at [7].

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.<sup>13</sup>

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 undertaken 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*<sup>14</sup> – 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.

### **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 Co Ltd*,<sup>15</sup> 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*.<sup>16</sup>

The English Court of Appeal case of *Promet Engineering v Sturge*<sup>17</sup> 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:

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.<sup>18</sup>

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<sup>13</sup> *Windsurf Pty Ltd v HIH Casualty and General Insurance Ltd* [1999] QCA 360 at [9].

<sup>14</sup> *Bridgeman v Allied Mutual Insurance* [2000] 1 NZLR 433.

<sup>15</sup> *Graham Evans and Co (Qld) Pty Ltd v Vanguard Insurance Company Ltd* (1987) 4 ANZ Ins Cases 60-772.

<sup>16</sup> *Graham Evans and Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd* (1985) 4 ANZ Ins Cases 60-689 at 74.

<sup>17</sup> *Promet Engineering v Sturge* [1997] 2 Lloyd’s Rep 146.

<sup>18</sup> *Promet Engineering v Sturge* [1997] 2 Lloyd’s Rep 146 at 156.

In *Prime Infrastructure (DBCT) Management Pty Ltd v Vero Insurance Ltd*,<sup>19</sup> 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*<sup>20</sup> also saw the court adopt the “ordinary meaning of the word damage”. Green CJ 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.<sup>21</sup>

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”.<sup>22</sup>

The requirement that there be a physical alteration or change is illustrated in two subsequent British decisions.<sup>23</sup> The first is in the case of *Bacardi v Thomas Hardy*.<sup>24</sup> 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, and held that the new product was not damaged, but merely defective at the moment of its creation.<sup>25</sup> The distinction was confirmed in a construction context by the English Court of Appeal in *Skanska v Egger*.<sup>26</sup>

The second case is *Pilkington v CGU Insurance*,<sup>27</sup> 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.<sup>28</sup>

The case can be contrasted with that in *Austral Plywoods v FAI General Insurance Co Ltd*.<sup>29</sup> 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.

<sup>19</sup> *Prime Infrastructure (DBCT) Management Pty Ltd v Vero Insurance Ltd* [2005] QCA 369.

<sup>20</sup> *Ranicar v Frigmobile* [1983] 2 Tas R 113 at [78]; 2 ANZ Ins Cas 60-525.

<sup>21</sup> *Ranicar v Frigmobile* [1983] 2 Tas R 113 at [78]; 2 ANZ Ins Cas 60-525.

<sup>22</sup> *Ranicar v Frigmobile* [1983] 2 Tas R 113 at [78]; 2 ANZ Ins Cas 60-525.

<sup>23</sup> As identified in Longley N, “What is ‘Damage’ in Contract Works Claims” (28 September 2005).

<sup>24</sup> *Bacardi-Martini Beverages Ltd v Thomas Hardy Packaging Ltd* [2002] 2 Lloyd’s Rep 379.

<sup>25</sup> *Bacardi-Martini Beverages Ltd v Thomas Hardy Packaging Ltd* [2002] 2 Lloyd’s Rep 379 at 386.

<sup>26</sup> *Skanska Construction Ltd v Egger (Barony) Ltd* [2002] BLR 236.

<sup>27</sup> *Pilkington UK Ltd v CGU Insurance Plc* [2004] BLR 97.

<sup>28</sup> *Pilkington UK Ltd v CGU Insurance Plc* [2004] BLR 97 at 107.

<sup>29</sup> *Austral Plywoods v FAI General Insurance Co Ltd* [1992] 7 ANZ Ins Cas 61-110.

In *Hunter v Canary Wharf*,<sup>30</sup> 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.<sup>31</sup>

In the decision of *The Orduja*,<sup>32</sup> 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”.<sup>33</sup>

### “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 v Hepburn*,<sup>34</sup> 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 Ltd v AH Hunt (Capacitors) Ltd*,<sup>35</sup> 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 *SCM (United Kingdom) Ltd v WJ Whittall & Son Ltd*<sup>36</sup> 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.

The case of *Hunter v Canary Wharf* suggested that the deposit of dust was capable of constituting physical damage. However, Lord Justice 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.<sup>37</sup>

Finally, reference should be made to the Canadian case of *Canadian Equipment Sales & Service Co Ltd v Continental Insurance Co*<sup>38</sup> 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.<sup>39</sup>

The issue of what constitutes “physical damage” was considered by the New South Wales Court of Appeal in *Transfield Constructions Pty Ltd v GIO Australia Holdings Pty Ltd*.<sup>40</sup> 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

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<sup>30</sup> *Hunter v Canary Wharf Ltd* [1996] 1 All ER 482.

<sup>31</sup> *Hunter v Canary Wharf Ltd* [1996] 1 All ER 482 at 499; Longley, n 23, p 10.

<sup>32</sup> *The Orduja* [1995] 2 Lloyd’s Rep 395.

<sup>33</sup> Longley, n 23, p 10.

<sup>34</sup> *Lewis Emanuel and Son Ltd v Hepburn* [1960] 1 Lloyd’s Rep 304.

<sup>35</sup> *British Celanese Ltd v AH Hunt (Capacitors) Ltd* [1969] 2 All ER 1252.

<sup>36</sup> *SCM (United Kingdom) Ltd v WJ Whittall & Son Ltd* [1971] 1 QB 337.

<sup>37</sup> *Hunter v Canary Wharf Ltd* [1996] 1 All ER 482 at 499.

<sup>38</sup> *Canadian Equipment Sales & Service Co Ltd v Continental Insurance Co* [1975] 59 DLR (3d) 333.

<sup>39</sup> This case (and the four preceding cases) are referred to in Harvey MD, “A Tale of Blocked Pipes, Fly Tipping, Acid, Degas and an Alcoholic Beverage”, Paper presented at the General Meeting of the Association of Average Adjusters (11 May 2005).

<sup>40</sup> *Transfield Constructions Pty Ltd v GIO Australia Holdings Pty Ltd* (1997) 9 ANZ Ins Cas 61-336.

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 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:

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.<sup>41</sup>

### Policy exclusions

In the case of *Chalmers Leask Underwriting Agencies v Mayne Nickless Ltd*,<sup>42</sup> 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.<sup>43</sup>

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. 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.<sup>44</sup>

### Coffer dam and bank

In that case no claim was made in respect of the coffer dam or bank or for its rectification. However, in *Walker Civil Engineering v Sun Alliance & London Insurance Plc*,<sup>45</sup> 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 v Vanguard*.<sup>46</sup> 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.

<sup>41</sup> *Transfield Constructions Pty Ltd v GIO Australia Holdings Pty Ltd* (1997) 9 ANZ Ins Cas 61-336 at 76,716.

<sup>42</sup> *Chalmers Leask Underwriting Agencies v Mayne Nickless Ltd* (1983) 155 CLR 279.

<sup>43</sup> *Chalmers Leask Underwriting Agencies v Mayne Nickless Ltd* (1983) 155 CLR 279 at 281.

<sup>44</sup> *Chalmers Leask Underwriting Agencies v Mayne Nickless Ltd* (1983) 155 CLR 279 at 279.

<sup>45</sup> *Walker Civil Engineering v Sun Alliance & London Insurance Plc* (1996) 9 ANZ Ins Cas 61-311.

<sup>46</sup> *Graham Evans & Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd* (1986) 4 ANZ Insurance Cases 60-869.

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 diluted 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*.

In this case, nothing 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 English case of *Skanska v Egger*, 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. His Honour 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.<sup>47</sup>

In *Walker*, 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.

### **Sewerage tanks**

In *Walker*, 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, 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.

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<sup>47</sup> *Skanska Construction Ltd v Egger (Barony) Ltd* [2002] BLR 236 at 243.

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). 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 damage 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.<sup>48</sup>

Sheppard AJA, who delivered the leading judgment, said:

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.<sup>49</sup>

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.<sup>50</sup>

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

<sup>48</sup> *Walker Civil Engineering v Sun Alliance & London Insurance Plc* (1998) 10 ANZ Insurance Cases 61-418 at 74,684.

<sup>49</sup> *Walker Civil Engineering v Sun Alliance & London Insurance Plc* (1998) 10 ANZ Insurance Cases 61-418 at 74,693.

<sup>50</sup> *Walker Civil Engineering v Sun Alliance & London Insurance Plc* (1998) 10 ANZ Insurance Cases 61-418 at 74,693.

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.<sup>51</sup>

The case can be contrasted with that of *Promet Engineering* 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.<sup>52</sup>

### 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*.<sup>53</sup>

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”.<sup>54</sup> 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.<sup>55</sup>

### CONCLUSION

These decisions generally reflect a correct and sound approach to the construction of both the primary indemnity clause and exclusions contained within contract works policies. 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 decisions provide illustrations 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 New South Wales Court of Appeal in the recent decision in *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd*<sup>56</sup> was storm activity breaching a building after

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<sup>51</sup> *Walker Civil Engineering v Sun Alliance & London Insurance Plc* (1998) 10 ANZ Insurance Cases 61-418 at 74,694.

<sup>52</sup> *Promet Engineering v Sturge* [1997] 2 Lloyd’s Rep 146 at 156.

<sup>53</sup> *Prentice Builders Ltd v Carlingford Australia General Insurance Ltd* (1990) 6 ANZ Insurance Cases 60-951.

<sup>54</sup> *Prentice Builders Ltd v Carlingford Australia General Insurance Ltd* (1990) 6 ANZ Insurance Cases 60-951 at 76,287.

<sup>55</sup> *Prentice Builders Ltd v Carlingford Australia General Insurance Ltd* (1990) 6 ANZ Insurance Cases 60-951 at 76,288.

<sup>56</sup> *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356.

lock up with rain water causing damage). By contrast, having regard to the particular conclusion the court was called upon to consider, if the window flashing is defectively installed and rain water enters the building and causes damage:

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.<sup>57</sup>

The decision in *Rickard*, supports the approach taken by the New South Wales Court of Appeal in the earlier decision in *Mutual Acceptance Insurance Ltd v Nicol*,<sup>58</sup> 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*, which confirmed that “workmanship” means the performance or execution of work as a whole.

The cases are accordingly a salient reminder that the existence of contract works insurance is unlikely to afford a contractor indemnity with respect to its own defective workmanship (material or design) where the only damage to “insured property” is comprised of the defective workmanship (material or design) itself. In such circumstances, any attempt to distinguish between a “fault or defect” on the one hand, and damage resulting directly from such fault or defect on the other hand may be misconceived.

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<sup>57</sup> *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356 at [121].

<sup>58</sup> *Mutual Acceptance Insurance Ltd v Nicol* [1987] 4 ANZ Insurance Cases 60-821.