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CASE LAW UPDATE
November 2008

"UNINTENDED DAMAGE"

IN THE CONTEXT OF CONTRACT WORKS POLICIES

ALLIANZ INSURANCE LTD V RHI REFRACTORIES AFRICA (PTY) LTD

INTRODUCTION

This is a matter in which the Supreme Court of Appeal was called upon to interpret the meaning of a contract works policy, more specifically the meaning and scope of the defective design or workmanship exclusion clause within the policy.

Defective design or workmanship exclusion clauses, in the context of contract works policies, are notorious. They have given rise to much debate and argument. A substantial body of case law has developed in relation to these clauses, primarily in England and Australia.

The case law that has developed is not always helpful because of the many different wordings (which are also amended from time to time).

In the decision under review, an opportunity for our Courts to examine the general meaning of such clauses did not present itself – instead, by virtue of what became a stated case and because it was not argued that the clause in question was obscure, uncertain and ambiguous, the clause was determined on a literal approach and in accordance with its plain and ordinary meaning.

THE FACTS

The Respondent ("*the Insured*") had concluded a written construction contract with Indian Ocean Fertilizer (Pty) Limited. The Respondent had undertaken to effect an epoxy lining to various parts of the Indian Ocean Fertilizer acid plant in order to protect the underlying concrete from acid erosion. In terms of the contract, the Insured remained liable for all physical damage to the construction works during the course of the works.

The Insured safeguarded itself by concluding a Contract Works Policy with the Appellant ("the Insurer"). In terms of the Policy the Insurer undertook to indemnify the Insured against physical loss or damage to the property Insured, which comprised the works under construction.

The indemnity was subject to the following defective design on workmanship exclusion:-

> *"The Insurer will not indemnify the Insured for:*
>
> *1. The costs necessary to replace, repair or rectify any defect in design, plan or specification, materials or workmanship, but should unintended damage result or ensue from such a defect, this Exclusion shall be limited to the additional costs of improvement to the original design, plan or specification."*

The epoxy lining applied by the Insured failed, or delaminated, resulting in physical damage that had to be repaired. The Insured claimed for the expenses incurred to repair this damage (which amounted to R9 million), contending that these expenses were covered by the policy.

The Insurer contended on the other hand that these expenses were excluded in terms of the defective design or workmanship exclusion.

At the trial the Insured had sought to introduce an expert witness, a Mr Chisholm in support of its interpretation of the exclusion. According to Mr Chisholm's expert summary, he would explain how, over time similar clauses have evolved in the short term insurance industry.

The Insurer had objected at the trial to the admissibility of Mr Chisholm's evidence on the basis that the Insured had not contended that the exclusion clause was ambiguous. The trial Court agreed, ruling that Mr Chisholm's evidence was irrelevant therefore inadmissible.

Following this ruling the parties reached an agreement that the trial would proceed with reference to the following stated assumptions:

"1. There was a defect in the design, specification and/or workmanship of, and/or pertaining to, the epoxy lining.

2. The epoxy lining delaminated and was damaged.

3. The delamination and damage to the epoxy lining was caused and brought about the defect(s) referred to in paragraph 1 above."

The stated issues to be determined by the Court were:

"1. Does the expression 'unintended damage' in Exclusion Clause 1 refer to (a) damage to the epoxy lining or (b) damage to the Insured property other than damage to the epoxy lining?

2. Having regard then to the finding in respect of paragraph 1 above, is the risk of delamination of the epoxy lining expressly excluded in terms of Exclusion Clause 1 or is the exclusion limited to the additional costs of improvement to the original design, plan or specification?"

THE DECISION ON APPEAL

To qualify under the policy the Insured had to establish that there had been physical damage to the Insured property. With due regard to the stated assumption, the Insurer had, in effect, conceded this fact, i.e. the epoxy lining (being Insured property) delaminated and was damaged. The question before the Supreme Court of Appeal then was whether this damage was excluded by virtue of the exclusion clause.

The Court reasoned that:

- because of the stated assumptions and issues formulated:

  The dispute regarding the meaning of the exclusion clause had "*been narrowed down substantially*"; and

  As such, there was no need to determine the general meaning of the clause (with reference to expert testimony). The meaning of the clause therefore fell to be determined in accordance with its plain ordinary meaning:

  - It was clear that the clause did not expressly exclude damage to the epoxy lining itself.

- The question then was whether the physical damage which resulted from the failure of the epoxy lining constituted "*unintended damage*". To quote from the Judgment:

> "*If the failure of the epoxy lining (which the parties admit constituted damage) was unintended, the [Insurer] is liable for the costs of repair*".

The Insurer argued that the damage was excluded because the adjective ("*unintended*") must be understood "*as something akin to 'unforeseen' or 'unexpected'*". As the failure of the lining was an inherent consequence of the Insured's defective planning or workmanship, the damage could not be understood to be unintended; rather it was a natural and foreseeable consequence of the Insured's failure to comply with its obligations under the construction contract.

The Court disagreed. According to its plain ordinary meaning, "*intended*" contemplated consequences that were planned or intentionally brought about. As the failure of the epoxy lining has not been planned or intended, the damage was "*unintended*" and the Insurer was accordingly liable under the policy.

The Court accordingly dismissed the Insurer's appeal with costs.

CONCLUSION

The Supreme Court of Appeal reaffirmed two fundamental rules of interpretation:

- Firstly, a contract of insurance has to be construed like any other written contract, so as to give effect to the intention of the parties as expressed in the policy. Thus the terms are to be understood in their plain ordinary sense, unless it is evident from the context that the parties intend them to have a different meaning.

- Secondly, whilst the ordinary rule is that the Insured must prove itself to fall within the primary risk Insured against by the policy, an exception clause is restrictively interpreted against the Insurer, because it purports to limit what would otherwise be a clear obligation to indemnify.

It is a pity that the evidence of the expert, as to the general meaning of defective design and workmanship exclusion clauses in the context of Contract Works Policies, was held to be inadmissible. This was primarily due to the fact that ambiguity was not relied on.

It is perhaps ironic that the Judge himself found the clause "*very difficult to understand*". It is perhaps even more ironic that the Insured was successful in recovering the expenses incurred to repair the damaged ("*defective*") epoxy lining, its failure being a direct consequence of a defect in design or defective workmanship, the very cause/s that the policy was designed to exclude.

What then of the general meaning of defective design or workmanship clauses within the context of Contract Works Policies:

- Generally, the intention is to ensure that Insurers only bear the risk of fortuities causing loss or damage to the works but not the risk of defective design or workmanship (which a contractor would have to rectify in any event).

- Such clauses should be drafted so that they should only extend to <u>other property</u> which is free of the defective condition but is nonetheless damaged unintentionally in consequence thereof.

Had the clause been worded to accord expressly with what is understood to be the general meaning of such clauses, the matter would have been decided differently.

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