Case note

DEFECTIVE WORKMANSHIP EXCLUSIONS IN CONTRACT WORKS INSURANCE

RICKARD CONSTRUCTIONS PTY LTD v RICKARD HAILS MORETTI PTY LTD [2006] NSWCA 356

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 in this decision of the New South Wales Court of Appeal delivered 14 December 2006. The Appeal was from a decision of the trial judge, McDougall J in *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* (2004) 188 FLR 278; [2004] NSWSC 1041.

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. He preferred the view of the majority of the experts that there was a build up of excessive moisture in the basecourse and that, 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 GA delivered the unanimous judgement of the Court of Appeal which also comprised Handley and Bryson JJA.

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 dealt in a lengthy section of his reasons with what he described as responsibility for the failure and found that the primary responsibility should be attributed to Rickard Constructions because:

> The 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.[1]

The Court of Appeal noted that, while it was the basis of the trial judge's holding that the exclusion clause in relation to defective workmanship was engaged, it was necessary however 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 INSURER

The insuring clause in the policy relevantly provided:[2]

1. **Construction period**

[1] *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356 at [133].

[2] Summarised from *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356 at [60]-[67].

> 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**
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> 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.

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:
>
> 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.
>
> 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
>
> …
>
> 6. consequential loss, loss of use, penalties, fines, liquidated damages, or aggravated, punitive or exemplary damages.[3]

The trial judge had held that there was "fault, defect, error or omission in material or workmanship" within cl 1 of the exclusions, but not "fault, defect, error or omission in design, plan or specification" within cl 2 of the exclusions.

This was based upon his Honour's finding that there had been "defective workmanship" attributed to Rickard Constructions, summarised by his Honour:

> [T]hat 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 effected by moisture, did not follow good construction practice.[4]

As the Court of Appeal noted, following from his finding that cl 1 of the exclusions was engaged, the trial judge said:

> [211] The reason why cl 1 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 or loss or damage.
>
> [212] 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 cl 1 of the exclusions is read in conjunction with cl 6 it is apparent that no element of consequential loss is recoverable.[5]

[3] *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356 at [62].

[4] *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* (2004) 188 FLR 278 at 309; [2004] NSWSC 1041.

[5] *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356 at [66].

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) being 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 submitted that the trial judge erred in finding that it knew that this was not good construction practice.

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 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 cl 1 of the exclusions was engaged since 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 stated 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. 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).[6]

The court went on to say:

> 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.[7]

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 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.

[6] *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356 at [118]-[119].

[7] *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356 at [120].

IMPLICATIONS OF THE DECISION

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, 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.[8]

The decision is consistent with the approach taken by the New South Wales Court of Appeal in the earlier decision in *Mutual Acceptance Insurance Ltd v Nicol*,[9] 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 Supreme Court of Victoria in *Prentice Builders Ltd v Carlingford Australia General Insurance Ltd*,[10] which confirmed that "workmanship" means the performance or execution of work as a whole.

The case is 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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[8] To further use the illustration adopted by the Court of Appeal: *Rickard Constructions Pty Ltd v Rickard Hails Moretti Pty Ltd* [2006] NSWCA 356 at [121].

[9] *Mutual Acceptance Insurance Ltd v Nicol* [1987] 4 ANZ Ins Cas 60-821.

[10] *Prentice Builders Ltd v Carlingford Australia General Insurance Ltd* [1990] 6 ANZ Ins Cas 60-951.

