

## **Defective Windows and Dodgy Mince meat; what amounts to “damage to property” for product liability cover?**

**A lecture given by Andrew Prynne QC to the British Insurance Law Association on 7 October 2005**

### **Introduction**

Liability insurance indemnifies the insured against his liability arising out of defined occurrences. One of them is where his product causes physical damage to other tangible property. What does that mean and what kind of losses does it encompass?

Lord Hoffmann in **Banque Bruxelles Lambert S.A. v Eagle Star**<sup>1</sup> said that when considering the proper measure of damages for a negligent valuation, the Court of Appeal<sup>2</sup> had started the from the wrong place.

*“Before one can consider the principle on which one should calculate the damages to which a plaintiff is entitled as compensation for loss, it is necessary to decide for which kind of loss he is entitled to compensation. A correct description of the loss for which the valuer is liable must precede any consideration of the measure of damages. For this purpose it is better to begin at the beginning and consider the lender’s cause of action.”*

With that passage in mind I suggest that an analysis of what “damage to property” actually means should start with a review of how it has been defined by the general law of tort and contract.

The construction of insurance policies should not be considered in isolation. They are contracts like any other and the same basic rules apply. At the same time the courts should be striving for some consistency between these various

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<sup>1</sup> [1997] A.C. 191

<sup>2</sup> [1995] Q.B. 375, Sir Thomas Bingham M.R. and Rose and Morritt L.JJ

interconnected branches of the law. It can hardly be desirable for the same words to mean different things merely because they fall to be considered in different circumstances.

## **Tort**

In tort actual damage to property or injury to the person is the very foundation of a cause of action that does not permit recovery for what is termed pure economic loss, other than in limited circumstances<sup>3</sup>. It is necessary to look at how the courts have treated what amounts to damage to property, in tort. First, the insurer needs to know whether there is an underlying liability to the third party, in tort and therefore any liability to indemnify. Secondly, the nature of the primary liability should, at least, be consistent with the how the obligation to indemnify is defined. Thirdly, the test in tort was regarded by the Court of Appeal as a relevant consideration in determining how damage to property was to be construed in a written contract of sale<sup>4</sup>.

In **Murphy v Brentwood D.C.**<sup>5</sup> the House of Lords held that for there to be liability in tort it was essential that there be damage to other property. The court rejected the submission that defective foundations had damaged the building. All they had done was to create a defective building.

Applying that test to a defective product Lord Keith said:

*“...there is no liability in tort upon a manufacturer towards the purchaser from a retailer of an article which turns out to be useless or valueless through defects due to careless manufacture. The loss is economic.”*<sup>6</sup>

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<sup>3</sup>See *Caparo Industries plc v Dickman* [1990] 2 A.C. 605

<sup>4</sup>*Bacardi Martini Beverages Ltd v Thomas Hardy Packaging Ltd* [2002] 2 Lloyds Rep 379

<sup>5</sup>(HL) [1991] 1. A.C. 398 negligently passed by the building inspector, for whom the local authority was responsible,

<sup>6</sup>Page 478 E-G

Lord Bridge rejected the so called “complex structure” theory that one part of a complex structure could be said to have damaged another. He agreed that: “*a manufacturer incurs no liability to in tort for damage occasioned by a defect in a product which injures itself*”<sup>7</sup>.

Examples of what has been held by the courts to amount to damage to property include dust nuisance engraining carpets<sup>8</sup>, irradiation of top soil<sup>9</sup> and acid spilt upon the deck of a ship<sup>10</sup>. A perhaps more borderline case was loss of paint when the buckets in which it was contained collapsed in tropical heat on the quayside<sup>11</sup>. It is to be noted that in each of those cases, there was identifiable and extant other property that was damaged.

## **Contract**

What has all this got to do with construing a contract? It might be said that the limits set for recovery in tort, as a matter of policy, have little application to circumstances where parties have chosen to regulate the nature of their relationship and their obligations to each other by agreement. That was the very point I argued, without success, in **Bacardi v THP**<sup>12</sup>, before the Court of Appeal. Mance L.J., as he then was, who gave the leading judgment, considered the tortious test, was an aid to the construing what was meant by “direct physical damage to property” in a clause that limited the liability of the seller in respect of physical damage to the sum of £500,000. Mance L.J. made specific reference to **Murphy**, including the passages quoted above. Having done so, he concluded that the contamination of the Bacardi Breezer with CO<sub>2</sub> that contained trace levels of benzene did not constitute damage to the Breezer.

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<sup>7</sup> Page 476 E-F

<sup>8</sup> Hunter v Canary Wharf Ltd [1997] A.C.655

<sup>9</sup> Blue Circle Industries plc v MOD [1999] Ch. 289

<sup>10</sup> The Orjula [1995] 2 Lloyds Rep 395

<sup>11</sup> See the interesting discussion between Lloyd L.J and Nicholls L.J. in Aswan Engineering v Lupdine Ltd. [1986] 2 Lloyds Rep 347

<sup>12</sup> see footnote 4

He reached his decision saying that the admixture of the CO<sub>2</sub> was part of the creation of a new product.

He put the matter thus:

*“The new product was not damaged but merely defective from the moment of its creation. The alternative and more persuasive way of justifying any tort claim on Bacardi’s behalf seems to me to be to argue that damages can be claimed for the spoiling of the (without doubt valuable ) concentrate that Bacardi supplied. But this concentrate did not survive and was never intended to survive, as such. It was always going to be merged in the finished Breezer. The real complaint relates to the finished product. The loss which is claimed is also not by reference to the value of the concentrate (or with reference to losses consequential upon its spoiling), but by reference to the value of the finished product and losses consequential upon the need to recall it. Accordingly, the tort cases (which are in my view of some assistance) tend to confirm the conclusion that I would anyway favour without them.”*<sup>13</sup>

### **Product Liability Insurance**

I turn then to the question of how the point falls to be considered in a contract that provides for an indemnity to be given to the insured against his liability when his product has caused damage to other property. This is a standard type of product liability insurance cover.

First, it is necessary to consider the nature of the liability in respect of which indemnity is sought. If it is tortious, then there must be damage to property, as defined in the **Murphy** for the liability to arise at all. However, as is evident, the introduction of a component or ingredient product supplied by the insured to a manufacturer which when added or mixed with other components or

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<sup>13</sup> Page 386, first column

ingredients causes the end product to be defective may give rise to a liability in contract but not in tort.

If, on the face of it, contractual liabilities are covered by the policy, which they often are, what is the position? <sup>14</sup> What guidance is given by the authorities?

### **Insurance Authorities**

In **Rexodan v CU**<sup>15</sup> defective soap powder, supplied by the insured, damaged the buyer's cartons. The cartons in turn deteriorated so as to cause caking of the powder. The Court of Appeal<sup>16</sup> held that the powder had damaged the cartons which appeared to be covered under the policy. However, the actual liability in respect of which indemnity was sought was in respect of the damage the cartons had caused to the powder. Damage to the actual product supplied by the insured, i.e. the powder, was specifically excluded from cover<sup>17</sup>. The insured was not entitled to indemnity.

In **Pilkington U.K. Ltd v CGU**<sup>18</sup> the insured supplied glass panels that were incorporated in the roof of the Eurostar terminal at Waterloo. A few of them turned out to be defective and developed cracks, such that remedial action had to be taken to prevent glass falling onto the floor below. As well as **Rexodan**, The Court of Appeal referred to **James Budgett Sugars v NU**<sup>19</sup> and **AS Screenprint v BRI**<sup>20</sup>. In the former, Moore-Bick J. found that it was common ground that "an event in the form of physical damage to property" had occurred when the insured's contaminated sugar had been mixed with the buyer's mincemeat. The actual argument revolved around whether the losses, in respect

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<sup>14</sup> N.B. Some policies appear to exclude cover for express obligations in the contract that were voluntarily assumed by the insured, over and above those imposed by operation of law, such as under the Sale of Goods Act 1979. Such clauses give rise to another debate beyond the remit of this paper.

<sup>15</sup> CA (1997)

<sup>16</sup> Hobhouse L.J. gave the leading judgment.

<sup>17</sup> As is usually the case in product liability policies.

<sup>18</sup> [2004] EWCA Civ 23

<sup>19</sup> [2003] Lloyds Rep 110

<sup>20</sup> [1999] Lloyds Rep IR 430

of which indemnity was sought, related to that damage. The judge held not. In the latter the insured printed gift boxes for Maltesers that, due to a defect, contaminated the Maltesers. The matter went to the Court of Appeal, not on the issue of damage, which appears to have been assumed, but rather whether a claim for the loss of goodwill, suffered by the manufacturer of the Maltesers, due to the loss of a valued customer, was covered as a loss in respect of physical loss or damage. The Court of Appeal<sup>21</sup> said not.

Potter L.J. who gave the leading judgment in **Pilkington** agreed that it had been accepted or assumed in the trio of cases referred to that “*physical damage had indeed been so caused when the supplier’s product was absorbed into the product of the third party.*”<sup>22</sup> Potter L.J. rejected the US approach to Pilkington’s claim against the insurers and, in holding there was no damage to property within the meaning of the policy, said:

*“...damage requires some altered state, the relevant alteration being harmful in the commercial context. This plainly covers a situation where there is a poisoning or contaminating effect upon the property of a third party as a result of the introduction or intermixture of the product supplied : cf the three English cases to which I have referred. However, it will not extend to a position where the commodity supplied is installed in or juxtaposed with the property of the third party in circumstances where it does no physical harm and the harmful effect of any later defect or deterioration is contained within it.”*

Potter L.J. went on to say:

*“In the context of insurance law it makes commercial sense of an agreement which is designed to protect the insured against liability for physical damage to physical property and not to afford an indemnity by way of guarantee for the quality and fitness of the commodity supplied.”*

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<sup>21</sup> Hobhouse and Beldam L.JJ.

<sup>22</sup> Paragraph 33

In **Tioxide v CGU**<sup>23</sup> a pigment manufactured and sold by the insured was used to make white PVC window and door frames. Due to a defect, it caused pinking of some of the end product. Langley J. did not refer to **Bacardi** or **Murphy**<sup>24</sup>. While the insured's claim failed for other reasons, he accepted the insured's case that the physical injury to tangible property consisted of the discolouration in the PVC products containing the pigments. He said:

*“if there was physical injury, therefore, it was to the products manufactured using compounds containing Tioxide's pigments, not to the compounds, and it occurred at the earliest when those products were installed in environmental conditions in which pinking was liable to occur. The precise mechanism of pinking is I think of less importance: an unwanted change of colour is in ordinary language a physical change and, if it impairs the value of the product, in my judgment it is a physical injury.”*

## **Conclusion**

The point relied upon by the Court of Appeal in **Bacardi**, reinforced as it was by the position in tort, does not appear to have been considered by the courts when considering the issue of insurance coverage in cases where, at the time of the admixture of the contaminating material, the property said to be damaged was in the process of being manufactured. When or if the point is so considered it will be interesting to see whether the logic applied to a clause limiting liability in a contract of sale will be adopted in order to construe an indemnity clause that defines an insured occurrence in the same or similar terms.

Courts can be expected to lean in differing directions in differing circumstances. However, the basic rules as to the construction of written contracts provide that the court should give the actual words used their normal and natural meaning, viewing them within the document as a whole and within

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<sup>23</sup> [2004] EWHC 2116 (Comm), 2003 Folio 320, (Transcript)

<sup>24</sup> Even though I have since learnt that they were referred to by counsel for the insurers

its commercial context so as to ascertain from those words what was actually agreed. The contra proferentem rule only applies where there is found to be genuine ambiguity. No such ambiguity has been held to arise on these policy wordings thus far.

As to the future, where the insured is producing products for human consumption, the policy wording could expressly include or exclude, as an insurable occurrence, liability for contamination introduced by the insured's product during the course of manufacture of another product. Both the insurer and the insured would then be clear as to the nature of the actual risks that were being underwritten and the premium could be assessed accordingly<sup>25</sup>.

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<sup>25</sup> The remedy for food and drugs seems fairly simple, applying it to other commodities may be less straight forward. The drafting of policy wording would have to reflect the nature of the products that the insured was producing and their intended use in the onward chain of supply..