IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

I TE KŌTI MATUA O AOTEAROA
TĀMAKI MAKAURAU ROHE

CIV-2018-404-1991
[2019] NZHC 1823

BETWEEN	BARBARA ANNE CORBETT, FREDERICK JOHN McCALL and GIBSON SHEAT TRUSTEES LIMITED as trustees of the Mathews Family Trust Plaintiff
AND	VERO INSURANCE NEW ZEALAND LIMITED Defendant

Hearing: 7 March 2019

Counsel: NR Campbell QC for plaintiffs
CM Brick and AR Durrant for defendant

Judgment: 30 July 2019

JUDGMENT OF FITZGERALD J

This judgment was delivered by me on 30 July 2019 at 3:45 pm,
pursuant to Rule 11.5 of the High Court Rules.

Registrar/Deputy Registrar

Date……

Solicitors: Gibson Sheat, Wellington (F Collins)
Fee Langstone, Auckland

Introduction

[1] This proceeding turns on whether windows which were scratched during the construction of a house are "damaged", or "defective", or "defective" because they are "damaged".

[2] The issue arises because if the windows are damaged but not defective, the cost to repair or replace them will be covered by a construction works policy taken out by the plaintiffs with the defendant (Vero). If the windows are defective, however, an exclusion clause in the policy will apply and cover will be excluded. The windows are bespoke, high quality, triple-glazed joinery made in Germany. The cost to repair or replace them has been estimated at around $385,000.

[3] In December 2018, Associate Judge Bell directed that there be a hearing of the following separate question:

> Is the plaintiffs' claim under the contract works insurance policy for scratching to the 54 glazing units as pleaded in the statement of claim excluded by the following exclusion in the policy:
>
> *The Company will not indemnify the insured against:*
>
> *6. the costs of repairing, replacing or rectifying any part of the contract works which is defective in material or workmanship.*
>
> *However, this exclusion shall only apply to that part of the machine or structure immediately affected, and not to loss or damage to other parts of the contract works resulting therefrom.*

[4] This judgment determines the separate question.

Factual background

[5] The plaintiffs are the trustees of a family trust which owns the property and house in question. In or around December 2015, they contracted with a building contractor for the construction of a new house on the property (the construction contract).

[6] At the same time, the plaintiffs took out a Contract Works Insurance Policy with the defendant (Vero) in respect of the construction contract (the Policy).

[7] Under the construction contract, the builder was obliged to leave the new house clean and tidy at practical completion. In fulfilment of this obligation, the builder engaged a subcontractor to carry out a clean of the entire house prior to practical completion, which included cleaning the windows. The cost of the cleaning work was included in the contract price payable by the plaintiffs.

[8] In about late May 2017, prior to practical completion or the plaintiffs taking possession of the new house, the subcontractors cleaned the house, including the windows. There was dust and grit on the windows which was not removed before the main clean. As a result, the dust and grit was rubbed into the windows' glass, with the result that all or many of the windows were scratched.

[9] In August 2017, the plaintiffs made a claim under the Policy in relation to the scratched windows. There is no dispute for the purpose of determination of the separate question that:

(a) the subcontractors' cleaning works were works carried out under the construction contract;

(b) the cleaning works were part of the works to be carried out in order to achieve the contractual works under the construction contract;

(c) the windows were part of the 'contract works' as defined in and insured under the Policy at the time the scratching occurred;

(d) the scratching occurred during the period of insurance under the Policy; and

(e) that as a result of the scratches, the windows have suffered physical damage.

[10] Vero declined cover on the basis that, as a result of being scratched, the windows were "defective in workmanship," and thus the exclusion clause set out at [3] applied (Exclusion 6).

Other relevant terms of the Policy

[11] The Policy's insuring clause provides as follows:

> If at any time during the period of insurance *physical loss of or damage* occurs to any item of the property insured, then subject to the terms, conditions and exclusions of this policy the Company will indemnify the insured for such loss or damage.
>
> [Emphasis added]

[12] The clause refers to the "property insured", a term which is not defined in the Policy. However, as noted at [9](c), the parties agree the windows were part of the contract works insured under the Policy.

[13] The Policy then contains a series of exclusions to the above insuring clause (including Exclusion 6). It is necessary to set them out in full:

> **The Company will not indemnify the *Insured* against:**
>
> 1. loss or damage directly or indirectly caused by earthquake, hydrothermal activity or volcanic eruption;
>
> 2. loss or damage to any item of machinery or plant, which has been installed as part of the *insured contract*, directly caused to that item by its testing or commissioning.
>
>   However, this exclusion shall not apply to new building services plant forming an integral part of new buildings being constructed and insured by this policy, unless such plant is more specified by the sub-contractor(s);
>
> 3. consequential loss, loss of use, loss due to delay, penalties, fines, liquidated damages aggravated, punitive or exemplary damages, or liability of any nature whatsoever;
>
> 4. loss or damage to property directly caused by cessation of work whether total or partial;
>
> 5. the cost of repairing, replacing or rectifying any part of the *contract works* in which there is a fault, defect, error or omission in design, plan or specification.
>
>   However, this exclusion shall only apply to that part of the machine or structure immediately affected by such fault, defect, error or omission, the Company's liability in respect of loss or damage to other parts of the contract works resulting therefrom shall not exceed $25,000;

6. the cost of repairing, replacing or rectifying any part of the contract works which is defective in material or workmanship.

   However, this exclusion shall only apply to that part of the machine or structure immediately affected and not to loss or damage to other parts of the *contract works* resulting there from;

7. loss or damage to:

   a. any employees tools and equipment unless otherwise agreed by endorsement;

   b. any item of contractors plant (which may also be described as construction plant) shown in the policy schedule directly caused by its own explosion, mechanical or electrical breakdown, derangement or other operating cause, but resultant damage arising from such causes is insured;

8. loss or damage caused by wasting, wearing away, discolouration, staining, aesthetic defects, delamination, corrosion, erosion or gradual deterioration, including that due to atmospheric conditions;

9. loss or damage arising out of or resulting from rot, mould, mildew, fungi;

10. loss or damage to accounts, bills, bonds, currency, stamps, deeds, evidence of debt, money, notes, securities, cheques, credit cards, files, computer software, drawings and plans;

11. loss of any property by disappearance or shortage revealed only by the making of an inventory or by periodic stocktaking, and where such loss is not traceable to any specific event;

12. loss or damage to the *contract works* or any part thereof which has been taken into use or occupation by the principal, unless such loss or damage occurred during any *maintenance period* specified in the policy schedule and arose in the course of any operations carried out by the contractor solely for the purpose of complying with the stated obligations under the maintenance clauses of the contract;

13. loss or damage to any existing structures belonging to the principal, unless such loss or damage occurred to property specified in the policy schedule which forms part of the *insured contract* and arose directly out of the performance of the *insured contract;*

14. loss or damage arising out of rectifying existing or aggravated defects not forming part of the *insured contract;*

15. the excess shown in the policy schedule which shall be the amount borne by the *Insured* in respect of each and every claim for which indemnity is provide under Section 1.

For the purposes of this exclusion:

a. a series of events arising from or caused by subsidence, erosion, flood, inundation, landslip, cyclone, storm or tempest during any period of 72 consecutive hours will be treated as one event for the purposes of applying the excess;

b. the excess shown as applying to contract works shall also be applicable to architects fees and *removal of debris*. In the event of a loss arising from the same source and original cause giving rise to a claim against more than one of these items, the excess will not be cumulative. The aggregate adjusted loss will be subject to the highest excess only being applied.

[14] There then follows a series of conditions, only the first of which is relevant:

In the event of loss or damage to the property insured, for which indemnity is provided under this policy, the basis of any settlement shall be:

(a) in the case of damage which can be repaired, the cost of the repairs necessary to restore the item(s) to their condition immediately before the occurrence of the damage less any salvage; or

(b) in the case of a total loss, the actual value of the item(s) immediately before the occurrence of the loss less salvage.

[15] There follows a series of "General exclusions", none of which are relevant for current purposes.

The parties' submissions

Plaintiffs' submissions

[16] The crux of the plaintiffs' argument is that the scratched windows are not *defective* in material or workmanship, but rather they are *damaged*. They say it does not matter that the damage was caused by work carried out under the construction contract. They say Vero could have, but did not, exclude damage *caused by* defective workmanship. They say there is no basis for rewriting Exclusion 6 of the Policy, which Vero drafted, in its favour.

[17] The plaintiffs expand on the above key proposition by submitting the following.

[18] First, prior to the cleaning, the windows were not in any sense defective (either in material or in workmanship). During the cleaning, the windows were scratched. They thereby underwent a *physical change* that (the plaintiffs say) made them less useful.

[19] As a matter of ordinary language, settled usage in the insurance industry and as a matter of construction of the Policy, the plaintiffs say the windows were therefore *damaged*. They did not become *defective.* Items being defective do not involve a physical alteration or change.

[20] Mr Campbell QC, counsel for the plaintiffs, submits the Policy wording itself, including the proviso to Exclusion 6, draws a clear distinction between property that is defective and property that is damaged. By reference to a number of New Zealand and international authorities, Mr Campbell submits this distinction is also well-recognised and understood in insurance law and practice. He says Vero's approach collapses the distinction between defective and damaged property.

[21] The plaintiffs say the above interpretation is consistent with the purpose of Exclusion 6, which is to ensure that where a part of the contract works is defective, and it then suffers loss or damage (thus triggering the insuring clause), Vero does not have to pay for the cost of repairing, replacing or rectifying that part – given it would have needed to be repaired, replaced or rectified in any event. In this context, the plaintiffs rely on the English Court of Appeal's decision in *CA Blackwell (Contractors) Ltd v Gerling* (*Blackwell*), in which the Court considered a similar (but not identical) exclusion clause. In *Blackwell*, Tuckey LJ said the following:[1]

> [The exclusion clause's] purpose is clear. It prevents the insurer from having to pay for the replacement, repair or rectification of property which was already in a defective condition at the time the fortuity covered by the policy occurred. If the defect is one of design, plan, specification, materials, or workmanship the property would have had to be repaired, etc. by the contractor or others in any event.

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1 *CA Blackwell (Contractors) Ltd v Gerling Allegemeine Verischerungs* [2007] EWCA Civ 1450 at [16]. Lord Justices Kay and Hooper agreed with Tuckey LJ.

[22] The plaintiffs say it is accordingly clear that Exclusion 6 does not apply where property that is *not* defective is damaged, even if the *cause* of the damage is defective material or workmanship. The plaintiffs again refer to *Blackwell*:

> [17] … [T]he exclusion would not apply [in such circumstances]. The damage would have been caused by defective workmanship but the property insured was not in a defective condition.

[23] The plaintiffs emphasise that Exclusion 6 must be interpreted in the context of the broader Policy. They say the insuring clause of the Policy provides indemnity for *physical loss of or damage* to any item of the property insured. In the case of damage that can be repaired, condition 1(a) (reproduced at [14] above) provides that the basis of indemnity is the cost of repairing the item to its condition before the damage occurred. Mr Campbell notes that these two clauses reflect two different concepts, being:

(a) first, under the insuring clause, the *insured event* – being physical loss of damage to any item of the property insured; and

(b) second, under condition 1(a), the *financial loss* resulting from that insured event, typically the cost of repair or replacement, in respect of which indemnity is provided.

[24] Mr Campbell says those two concepts are in turn reflected in the exclusions in Vero's Policy (reproduced at [13] above):

(a) some of the exclusions (namely 1, 2, 4, 7(b), 8, 9 and 14) are directed at the insured event, and thereby exclude loss or damage *caused* by certain risks;

(b) others (exclusions 3 and 15) are directed at *types of financial loss* that may result from an insured event;

(c) some (exclusions 7(a), 10, 12 and 13) are directed at *certain types of property*, irrespective of what might have caused the loss or damage to them; and

(d) exclusions 5 and 6 exclude certain *types of financial loss* in respect of *certain types of property*, again irrespective of what caused that financial loss.

[25] Mr Campbell says the contrast between Exclusion 6 (and exclusion 5) and the other exclusions therefore emphasises what Exclusion 6 does not do, namely to exclude "loss or damage" *caused by* defective materials or workmanship. Rather, he submits the clause only extends to excluding financial loss to items that are in a particular state, namely defective in either material or workmanship.

[26] The plaintiffs acknowledge that in *Holmes Construction Wellington Ltd v Vero Insurance NZ Ltd,* the District Court considered an exclusion clause in the same terms as Exclusion 6, and its application to facts not dissimilar to this case, and held the exclusion applied.[2] I will discuss *Holmes* in more detail later in this judgment. For present purposes, however, Mr Campbell submits the Judge's reasoning was flawed, in that he effectively assumed the contract works in that case were "defective" simply because they were "damaged". Mr Campbell says this overlooks the distinction between the two concepts. He contrasts this with the Supreme Court of Canada's decision in *Ledcor Construction Ltd v Northbridge Indemnity Insurance Company,*[3] which again concerned facts similar to this case. In that case, windows had been scratched by cleaners hired to clean during the construction of a building. They had to be replaced and an insurance claim was made. The insurers denied coverage, relying on an exclusion in the following terms:[4]

> This policy section does not insure:
>
> […]
>
> (b) The cost of making good faulty workmanship, construction materials or design unless physical damage not otherwise excluded by this policy results, in which event this policy shall insure such resulting damage.

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2 *Holmes Construction Wellington Ltd v Vero Insurance NZ Ltd* DC Masterton CIV-2005-035-315, 4 December 2007.

3 *Ledcor Construction Ltd v Northbridge Indemnity Insurance Company* [2016] SCC 37, [2016] 2 SCR 23.

4 At [10].

[27] The Supreme Court held that the exclusion merely excluded from cover the cost of redoing the faulty cleaning work; it did not exclude the cost of replacing the windows that had been *damaged* by the faulty workmanship. While the clause is in different terms to Exclusion 6, Mr Campbell nevertheless says the decision highlights the distinction between defective property and damaged property.

[28] Finally, on the plaintiffs' interpretation, something which is defective in workmanship would not be covered by the Policy, given the insuring clause is triggered by physical loss or damage. The question of redundancy therefore arises. Mr Campbell submits, however, that Exclusion 6 "still has work to do" in such circumstances, because it will apply where contract works which *are* defective (in either material or workmanship) are then damaged. Referring again to *Blackwell*, Mr Campbell reiterates that the rationale of the exclusion applying in those circumstances is because the relevant item of contract works would have had to have been repaired or replaced in any event, irrespective of the later damage.

Vero's submissions

[29] For the purposes of determining the separate question, Vero accepts the Policy's insuring clause applies to the scratched windows and therefore that the windows have suffered physical loss or damage. Ms Brick, counsel for Vero, also accepts that Vero bears the onus of satisfying the Court that Exclusion 6 applies.

[30] Relying on dictionary definitions of "defect" and "defective", Ms Brick submits that the scratching of the windows falls squarely within the concept of the windows being "defective" as a result. She agrees with Mr Campbell that there is a settled meaning or understanding of the concept of "damage" in insurance law, namely a detrimental physical change or alteration to the property concerned. She says, however, there is no such settled meaning of the words "defective" or "defective in workmanship".

[31] Ms Brick says that for the purposes of Exclusion 6, there is no proper distinction between a part of the works being defective and being damaged; it is a natural and ordinary use of language to describe the windows as defective in

workmanship due to the shortcomings in the work performed directly on them. In her written submissions, she submits the following:

> Where a building or an item is under construction, it is an ordinary use of language to describe the item as defective in workmanship where it has been marred because the workmanship was done in a faulty or incorrect way. This is the case whether the item was constructed incorrectly from the outset, or it has been damaged while being worked on. For example, the architrave around a doorway may be defective in workmanship because it was built out of square, or because the builder has gauged it with tools or split the timber in the process of attempting to fix the architrave to the wall. In both cases, the architrave will be readily described as defective in workmanship.

[32] Reinforcing the proposition that there is no distinction between damage and defects, Ms Brick notes that it is common in the construction industry to prepare "defect lists," which will regularly include items that might also be regarded as damaged.[5]

[33] Ms Brick also relies on various authorities, including Prentice Builders v Carlingford Australia General Insurance Ltd, Randerson J's decision in Recreational Services v QBE Insurance (International) Ltd, the Court of Appeal's decision in Molyneux Holdings Ltd v IAG New Zealand Ltd and the District Court's decision in Holmes as supporting Vero's interpretation of Exclusion 6.[6] Rather than set out here Ms Brick's detailed submissions on each of these authorities, I address the points made in relation to them later, in the analysis section of my judgment.

[34] Ms Brick also places significant emphasis on what she says is the commercial context to the Policy, namely that it is important there be normal business incentives on contractors to build high quality products and to discourage substandard workmanship.

[35] Building on this theme, Ms Brick refers to various insurance commentaries and cases which she says demonstrate that property and liability policies are not intended

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5 Referring to *AXA Global Risks (UK) Ltd v Haskins Contractors Pty Ltd* [2004] NSWCA 138, (2004) 13 ANZ Insurance Cases 61-611, at [12]-[17].

6 *Prentice Builders v Carlingford Australia General Insurance Ltd* (1990) 6 ANZ Insurance Cases 60-951; *Recreational Services v QBE Insurance (International) Ltd* HC Auckland CIV-2004-404-7111, 14 September 2005; *Molyneux Holdings Ltd v IAG New Zealand Ltd* [2007] NZCA 254; *Holmes Construction Wellington Ltd v Vero Insurance NZ Ltd,* above n 2.

to insure contractual performance, or to insure the quality of contract works.[7] She also refers to the insurance text *The Law of Liability Insurance*, in which the authors explains that business risk exclusions are meant to prevent the insured from passing on to their insurers the ordinary costs of doing business, including, relevantly, the ordinary cost of poor performance.[8]

[36] Ms Brick says that if the plaintiffs' approach to interpretation is correct, there is also an element of redundancy in the very presence of the clause. She notes that if there is a distinction between a part of the contract works being defective and being damaged, then a defective element of the contract work would not trigger the insuring clause in the first place. There would accordingly be no need for Exclusion 6. Ms Brick therefore submits the very presence of Exclusion 6 reinforces the proposition that loss or damage to a contract work (when caused by poor or faulty workmanship) is encapsulated within the meaning of "defective in workmanship".

[37] Finally, in response to a query from me as to whether Vero's interpretation would result in the exclusion clause becoming extremely wide (in terms of not covering *any* physical loss or damage to the construction works caused or attributable to defective workmanship on site), Ms Brick submits there would still be meaningful policy coverage. Vero accepts the concept of being "defective *in* workmanship" means the workmanship which causes the damage must be workmanship done in relation to that particular item itself. Ms Brick gave the example of a workman working on a top floor of a building dropping a hammer, which falls through a number of (yet to be constructed) floors and causes damage to a part of the contract works on the ground floor. She says that even though defective workmanship might have caused the damage, the ground floor contract works would not be "defective *in* workmanship", because the defective workmanship was too removed from the damaged item itself. Ms Brick accepts the dividing line could become grey or unclear at times, but says that will be inevitable whenever there is a dividing line. Ms Brick further says the hammer example is captured by the proviso to the exclusion, which carves out from

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7 Noting that a Contract Works Policy is not a performance bond, citing *ANZ Insurance Commentary* (online looseleaf ed, CCH) at [1-660].

8 Desmond Derrington and Ronald Ashton *The Law of Liability Insurance* (3rd ed, LexisNexis, Sydney, 2013) at [10-80].

the exclusion physical damage to *other* parts of the contract works caused by defective workmanship.

Analysis – proper approach to interpretation

[38] Insurance contracts are to be interpreted according to the ordinary principles of contractual interpretation.[9] On this basis, the approach is an objective one, the aim being to ascertain the meaning which the document would convey to a reasonable person, having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.[10]

[39] While context is relevant, the text of the contract remains centrally important. If the language at issue, construed in the context of the contract as a whole, has an ordinary and natural meaning, that will be a powerful, albeit not conclusive, indicator of what the parties meant.[11] But the wider context may point to some interpretation other than the most obvious one, and may also assist in determining the meaning intended in cases of ambiguity or uncertainty.[12]

[40] In terms of the "structure of the bargain" (or the "commercial purpose" of the contract[13]), the majority of the Supreme Court in *Firm PI v Zurich* confirmed that courts should have regard to commercial purpose and to the structure of the parties' bargain when interpreting commercial contracts, "to the extent that they can reliably be identified".[14] The majority noted there are some dangers in this approach, however,[15] and that "where contractual language, viewed in the context of the whole contract, has an ordinary and natural meaning, a conclusion that it produces a commercially absurd result should only be reached in the most obvious and extreme cases".[16]

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9 *Trustees Executors Ltd v QBE Insurance (International) Ltd* [2010] NZCA 608, (2011) 16 ANZ Insurance Cases 61-874 at [38].

10 *Firm PI 1 Ltd v Zurich Australian Insurance Ltd* [2014] NZSC 147, [2015] 1 NZLR 432 (SC) at [60].

11 At [63]. See also the Court of Appeal's recent decision in *Malthouse Ltd v Rangatira Ltd* [2018] NZCA 621, at [21]-[23], where the Court reinforced the central importance of the contract's text.

12 *Firm PI 1 Ltd v Zurich Australian Insurance Ltd*, above n 10, at [63].

13 Kim Lewison *The Interpretation of Contracts* (5th ed, Sweet & Maxwell, London, 2011) at 42, as cited by the majority in *Firm PI 1 Ltd v Zurich Australian Insurance* Ltd, above n 10, at [77].

14 At [79].

15 At [79]

16 At [93].

[41] Parties to contracts will also sometimes use words that have specialised meaning within a particular profession, industry, trade or locality, and a court is entitled to receive evidence which demonstrates that the parties have adopted such a specialised meaning.[17] I mention this point for two reasons. First, as noted earlier, the parties agree that the concept of "physical damage" has an agreed and specialised meaning in the insurance industry. Second, the concept of something being "defective in material or workmanship" is perhaps not the most natural or ordinary usage of language. This becomes relevant to the discussion later in this judgment of the potential origin of Exclusion 6 in long-standing exclusion clauses drafted by the insurance industry.

[42] In addition, there is no doubt that if the overall meaning of a policy wording is unclear, the policy, as the insurer's document, falls to be interpreted on a contra proferentem basis.[18] In cases of ambiguity, exclusion clauses in insurance policies should also be read down, in favour of cover.[19]

[43] One final matter worth noting at this point is Ms Brick's submission that a key aspect of the commercial context in which Exclusion 6 ought to be interpreted is that an insurer will not unreasonably insure a risk.[20] In my view, some care needs to be taken in this regard. If the approach to interpretation outlined above leads to a particular result, then it may or may not be viewed, by the insurer at least, as meaning it unreasonably insures a risk. What is and is not unreasonable will "tend to lie in the eye of the beholder".[21] I return to these points later in this judgment when addressing Vero's submissions on the commercial context. But a case relied on by both parties, *AXA Global Risks (UK) Ltd v Haskins Contractors Pty Ltd,* is a good example of the outcome of a particular interpretation not altering what the words, in their plain and ordinary usage, mean.[22] Windeyer J in that case observed:[23]

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17 At [84].
18 *Tower Insurance Ltd v Skyward Aviation 2008 Ltd* [2014] NZSC 185, [2015] 1 NZLR 341, at [32].
19 *Fund Managers Canterbury Ltd v AIG Insurance New Zealand Ltd* [2017] NZCA 325, (2017) 19 ANZ Insurance Cases 62-146, at [39].
20 Referring to observations of Fogarty J in *Body Corporate 83501 v Christchurch City Council* [2013] NZHC 2472 at [51]-[57].
21 *Firm P1 Ltd v Zurich Australian Insurance Ltd*, above n 10, at [90], albeit in the context of considerations of commercial absurdity.
22 *AXA Global Risks (UK) Ltd v Haskins Contractors Pty Ltd* , above n 5.
23 At [88].

> Although I find it extraordinary that an insurer should agree to indemnify an insured on the basis that, when a wall which was always badly built, falls down as a result of being badly built, the falling down will be damage to property covered by the policy and the insured will be entitled to reinstatement by way of a wall properly built, I am satisfied for the reasons given by Mason P, that is the position.

Analysis – does Exclusion 6 apply to exclude cover in this case?

Exclusion 6 in its contractual context

[44] I begin by considering Exclusion 6 in its contractual context. For ease of reference, I set out the text of the clause again:

> The Company will not indemnify the insured against:
>
> …
>
> 6. the costs of repairing, replacing or rectifying any part of the contract works which is defective in material or workmanship.
>
> However, this exclusion shall only apply to that part of the machine or structure immediately affected, and not to loss or damage to other parts of the contract works resulting therefrom.

[45] As noted earlier, the phrase "defective in material or workmanship" is not a particularly natural or ordinary usage of language. I consider that what the phrase seeks to convey is that the exclusion applies to any part of the contract work which is defective *due to* the materials used in it, or workmanship carried out on it. In this way, the use of the word "in" can be seen to be a short form way of saying "due to".

[46] I am of the view that there is a natural distinction between a part of a contract work being "damaged" and being "defective". Before being scratched, the windows in this case had been installed correctly and there is no suggestion they were not capable of performing and being operated as expected. The windows were therefore not in a defective condition (due to either materials or workmanship) at the point at which they were then *damaged,* in the sense of having undergone a physical transformation. And as a result of being damaged, (and even if due to defective workmanship), I do not consider they became "defective". The concept of something

being "defective" conveys an inherent issue or fault with the windows or the way in which they have been built.[24]

[47] The contractual context to Exclusion 6 supports this interpretation. As Mr Campbell notes, the exclusions to the insuring clause are directed to different things. Exclusion 6 is *not* directed to the insuring event itself (i.e. physical loss or damage) or, importantly excluding certain risks which *cause* that damage (for example, defective workmanship). Rather, it is directed to contract works which are in a particular state. The distinction is also seen in the proviso to Exclusion 6, which carves out of the exclusion loss or *damage* to other parts of the contract works resulting from the part which is *defective*.

[48] Mr Campbell refers to a number of authorities to demonstrate that an exclusion for physical loss or damage caused by defective workmanship is not uncommon, and reinforces that this is not what Exclusion 6 does.[25] Some care is required in this context, given Exclusion 6 might simply be another way of saying the same thing. But I accept the form of the exclusion clauses in the authorities to which Mr Campbell has referred me is a much more natural and ordinary way of expressing the result Vero says should occur in this case.

Authorities which draw a distinction between "defective" and "damaged"

[49] I also agree with Mr Campbell that a number of authorities support the distinction between something being "damaged" and being "defective".

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[24] Both parties referenced various dictionary definitions of "defect", "defective" and "damage". I do not draw any significant guidance from those definitions; reference to many different dictionaries will inevitably disclose some stated meaning which supports a given case. But the definitions do not undermine or disprove the ordinary and natural usage of the language I have set out at [45]-[46] above.

[25] See, for example, the exclusions in *Pentagon Construction (1969) Co Ltd v United States Fidelity & Guaranty Co* [1978] 1 Lloyd's Rep 93 at [16] ("loss or damage caused by (i) faulty or improper material, or (ii) faulty or improper workmanship, or (iii) faulty or improper design…"), *Walker Civil Engineering Pty Ltd v Sun Alliance* (1999) 10 ANZ Insurance Cases 61-418 (exclusion for "loss or damage directly caused by defective workmanship, construction or design"); *Graham Evans & Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd* (1986) 4 ANZ Insurance Cases 60-689 (set out at [50] below). In a text relied on by Vero, Derrington and Ashton, above n 8, a number of other examples of exclusion clauses concerning damage caused by defective workmanship are given (at [10-123]). Again, however, these are framed in a different way to Exclusion 6, and expressly provide for the exclusion of damage caused by work/defective work by the contractor.

[50] In *Graham Evans & Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd,* the Supreme Court of New South Wales considered the ambit of an exclusion clause in the following terms:[26]

> Loss or damage directly caused by defective workmanship, construction or design or wear and tear, or material breakdown or normal upkeep or normal making good but this exclusion shall be limited to the part which is defective and shall not apply to other part or parts lost or damaged in consequence thereof.

[51] Foster J stated:[27]

> Leaving aside the question of whether the word "defective" carries with it a connotation of fault or negligence, it is apparent that, even if it does not, the impugned workmanship in the present case can relate only to the preparation and/or application of the Sno-Cen primer coat. There is no doubt in my mind that *the workmanship was defective in that the primer coat, after its application, suffered damage* in that it lost both adhesion and cohesion so that it ceased to function as a primer. It clearly underwent changes which, in my view, can property be described as damage to it. Insofar, therefore, as there was *damage directly caused by defective workmanship* it was caused to the primer coat, in my opinion.
>
> [Emphasis added]

[52] Accordingly, "defective" workmanship led to "damage" to insured property.

[53] A similar distinction is evident in the Supreme Court of Canada's decision in *Ledcor Construction Ltd v Northbridge Indemnity Insurance Co*.[28] As noted above at [26]-[27], that case involved remarkably similar facts to this case; windows scratched by the builder's cleaners.

[54] The Supreme Court held that the exclusion (set out at [26] above) merely excluded from cover the cost of redoing the faulty cleaning work, and did not exclude the cost of replacing the windows that had been damaged by the faulty cleaning work. No particular guidance can be taken from the exclusion clause itself, which is framed in very different terms to Exclusion 6. But the decision supports a distinction between the concepts of something being faulty (or defective) and physical damage.

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26 *Graham Evans & Co (Qld) Pty Ltd v Vanguard Insurance Co Ltd*, above n 25, at 74,100.
27 At 74,101.
28 *Ledcor Construction Ltd v Northbridge Indemnity Insurance Co*, above n 3.

[55] *AXA Global Risks (UK) Ltd v Haskins Contractors Pty Ltd (AXA v Haskins)* is perhaps more relevant again, in that it considered the difference between defective property and damaged property.[29] In that case, the insuring clause provided that:[30]

> Underwriters will indemnify the insured in respect of all physical loss or damage to the property insured occurring during the period of insurance arising from any cause whatsoever subject to the exclusions and conditions stated herein as set out in this schedule".

[56] The case concerned a crib retaining wall, and it was accepted that, because of the way it had been built, the wall was "defective". It was also accepted that the policy only responded when physical loss or damage occurred to the wall. The issue before the Court was the timing of the damage; the insurer's position was that the wall was defective when built and "doomed from the start"; collapse was inevitable. As such, it said the damage had occurred at that point, and not at a later time during the period of insurance.

[57] In rejecting that submission, Mason P stated the following:[31]

> The insurer did not suggest that the Policy would not have responded merely because the original work and materials were defective. But it submitted that the Judge's findings went further, in establishing that the eastern wall was doomed from its inception. So much may be conceded, *but there remains a critical distinction between property that is liable to become damaged and property that is damaged.* The Policy did not respond until physical damage actually occurred. The Insuring Clause extended to physical loss or damage "arising from any cause whatsoever". It cannot be rewritten merely because of the absence of an exclusion clause broad enough to cover the subcontractors' bad work and inadequate materials.
>
> [Emphasis added]

[58] Mr Campbell says, and I agree, that Mason P's reference to "property that is liable to become damaged" is property which is defective. I accept the question before the Court was almost the opposite to that in this case. In *AXA v Haskins*, the issue was whether "defective" property was "damaged" property, whereas here, the issue is whether "damaged" property is "defective" property. But the decision nevertheless supports a distinction between the two.

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29 *AXA Global Risks (UK) Ltd v Haskins Contractors Pty Ltd*, above n 5.
30 At [3].
31 At [52].

[59] Perhaps the authority of most relevance is the English Court of Appeal's judgment in *Blackwell*.[32] The policy exclusion in that case was framed as follows:

> This policy excludes loss of or damage to and the costs necessary to replace repair or rectify
>
> a) Property insured which is in a defective condition due to a defect in design plan specification materials or workmanship of such Property insured or any part thereof.
>
> …
>
> Exclusion a) above shall not apply to other Property insured which is free of the defective condition that is damaged in consequence thereof.
>
> For the purpose of the Policy and not merely this Exclusion the Property insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property insured or any part thereof.
>
> [Underlining added]

[60] Mr Campbell submits that the underlined text is essentially the same as Exclusion 6, with the additional words effectively running together Exclusions 5 and 6 in this case. I accept that submission. And as noted at [45] above, in my view, the word "in" in Exclusion 6 is a short form way of saying "due to". The exclusion in *Blackwell* was also directed to excluding from cover property in a certain state, rather than excluding the insured event when *caused* by certain risks.

[61] Lord Justice Tuckey, delivering the judgment of the Court of Appeal in *Blackwell*, first considered the proper interpretation of the exclusion clause, before turning its application to the facts. He said:

> 16. Before engaging with these submissions it is I think important to construe the exclusion clause without regard to its application to the facts of this case. Its purpose is clear. It prevents the insurer from having to pay for the replacement, repair or rectification of property which was already in a defective condition at the time the fortuity covered by the policy occurred. If the defect is one of design, plan, specification, materials or workmanship the property would have had to be repaired, etc. by the contractor or others in any event.
>
> 17. What is important to note is that the exclusion is not of loss or damage caused by a defect in workmanship, etc. The cause of the loss or damage is irrelevant. Provided the insurer can show that the property

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[32] *CA Blackwell (Contractors) Ltd v Gerling Allegemeine Verischerungs*, above n 1.

> was in a defective condition the exclusion applies. So, taking the example given by Mr Ronald Walker QC for Blackwell in his skeleton argument, if the capping and sub-formation were in a defective condition when damaged the exclusion would apply even if the damage had been caused by a bomb falling onto it. Conversely, if it was not in a defective condition, but the damage had been caused by a failure, say, to cover some part of the road with a tarpaulin, the exclusion would not apply. The damage would have been caused by defective workmanship but the property insured was not in a defective condition. The insurers might have protected themselves by a policy condition requiring the contractor to take reasonable precautions to prevent loss or damage, but this policy contained no such condition.
>
> 18. All this is, I think, self-evident from the wording of the exclusion. …
>
> [underlining in original]

[62] The Court's observations, and the tarpaulin example given, draw a clear distinction between items being in a *defective condition*, and being *damaged because of* defective workmanship. The distinction may seem slight, but it highlights the purpose of the exclusion and the differing coverage which results. Like in *Blackwell*, I accept the purpose of an exclusion clause such as Exclusion 6 is to exclude the cost of repairing, replacing, or rectifying any part of the contract works which is defective (either as a result of materials or workmanship), irrespective of separate damage done to it – and the cause of that damage. As noted, the rationale is that the defective part of the contract works would need to be repaired, replaced or rectified in any event.

[63] For completeness, I note that Vero suggests that *Prentice Builders Ltd v Carlingford Australia General Insurance Ltd* is an example where property initially correctly constructed became defective in workmanship.[33] But the exclusion clause in that case was framed in quite different terms to Exclusion 6, and, importantly, did not require an inquiry into whether a contract work was "defective in workmanship". Rather, the exclusion clause excluded from cover the "cost of rectifying defective workmanship", and was limited to "the part which is defective and shall not apply to any other part or parts lost or damaged in consequence thereof". A key issue in *Prentice Builders* was the suggested division between defective and non-defective parts for the purposes of the carve out to the exclusion. That does not assist in the interpretation of the phrase "defective in workmanship", and the question of the carve out to Exclusion 6 is not at issue in this case.

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33 *Prentice Builders Ltd v Carlingford Australia General Insurance Ltd*, above n 6.

The broader industry context to Exclusion 6

[64] The text *Construction All Risks Insurance* contains a useful overview of exclusion clauses of the type at issue in this case, which also supports the interpretation I have reached.[34]

[65] The author provides a broad overview of the history of contract works policies, and then discusses a suite of standard form defect exclusion (DE) clauses, drafted in 1985 (and updated in 1995) by a committee of leading insurers. The clauses are referred to as "DE 1" to "DE 5", and provide in turn progressively wider coverage for the consequence of defects.

[66] DE 1 is referred to as "an outright defects exclusion", and provides as follows:

> This policy excludes all loss of or damage to the property insured due to defective design, plan, specification, materials or workmanship".

[67] The text describes the effect of DE1 as being that "defective design …[etc] is an excluded peril. This is a very wide exclusion and probably unacceptable to many contractors."[35]

[68] Exclusion 6 is not framed in a similar way to DE1. Rather, it (when run together with Exclusion 5) has all the hallmarks of DE3, described in the text as a "limited defective condition exclusion":

> This policy excludes the costs necessary to replace, repair or rectify any of the property insured which is in a defective condition due to a defect in design, plan, specification, materials or workmanship, but this exclusion shall not apply to the remainder of the property insured which is free of such defective condition but is damaged as a consequence of such defect.

[69] The author of the text states that DE3 is the most widely used of the five clauses, and that:[36]

> … it is clear that the exclusion will not apply to damage inflicted directly by negligent working; so far as workmanship is concerned, it is only errors that get 'built into' the works that trigger the clause.

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34 Paul Reed *Construction All Risks Insurance* (Thomson Reuters, London, 2014).
35 At [15-030].
36 At [15-037], also with reference to *Blackwell.*

[70] This supports the conclusion that Exclusion 6 excludes the costs to repair works in a defective condition because of workmanship carried out on them, but does not extend to works which are damaged because of defective workmanship.

The plaintiffs' interpretation does not result in insurance of contractual performance

[71] The discussion of contracts works policies in *Construction All Risks Insurance* is also relevant to Ms Brick's submission that these types of policies are not intended to insure contractual performance or insure the quality of contract works, which she says is important context to the proper interpretation of Exclusion 6.

[72] The author of Construction All Risks Insurance notes that:[37]

> There are … some risks that are rarely insured by any form of construction insurance, the most notable of which is defective workmanship of a contractor that does not result in physical damage.

[73] The reason for this is that, as Ms Brick rightly notes, it would make the insurer a guarantor for the proper performance of the construction works, removing any incentive for the contractor to complete the works to the contract standard. But that rationale is directed to the exclusion of the risk of defective workmanship that has *not resulted* in physical damage. The author of *Construction All Risks Insurance* explains:

> There is a market demand for, and willingness of insurers to provide, cover for accidental damage that is brought about by defectives in the design or build of the insured property. … As regards defective workmanship, mistakes will always occur even in well-managed projects, which result in damage to the works.

[74] As the authors of *Burrows, Finn & Todd* note, a party wishing to rely on business common sense to influence interpretation is on firmest ground when able to show that the alternative reading "makes no sense in the circumstances".[38] In my view, an outcome in which the Policy covers physical loss or damage to contract works caused by defective workmanship is not an outcome which makes no sense in the circumstances. On the contrary, it is an outcome which appears to be not unacceptable in the broader insurance market.

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37 At [1-008]. Mr Reed notes (at [1-007]) that this such risk will usually rest with the contractor.

38 Jeremy Finn Stephen Todd and Matthew Barber *Burrows, Finn and Todd on the Law of Contract in New Zealand* (6th ed, LexisNexis, Wellington, 2018) at [6.3.5].

[75] Accordingly, while Ms Brick's point may have gained more traction had the plaintiffs sought cover for the cost of re-doing the defective workmanship itself, and not only the resulting physical damage or loss, the commercial context to contracts works policies does not undermine (and if anything, tends to support) the interpretation set out at [45]-[46] above.

The interpretation reached is not altered by the authorities relied on by Vero

[76] Finally, I am also not persuaded that the authorities upon which Vero relies alter the conclusion I have reached.

[77] I am of course conscious that there is a decision of the District Court which reached a contrary conclusion to the interpretation of Exclusion 6.[39] In that case, a contractor was engaged to undertake exterior plastering and painting of a house during its construction. It failed to adequately protect or mask the recently installed windows, which resulted in overspray and spillage of plaster onto the windows. Removing the plaster from the windows revealed damage, of a type and extent which meant all the windows needed to be replaced. A claim was made under the same type of policy at issue in this case. Vero declined cover, also on the basis of Exclusion 6.

[78] The judgment in *Holmes* suggests that there was not any substantive argument on the distinction between contract works being damaged or defective. Rather, the Judge reasoned that the windows were defective because "if they had not been faulty or defective there would have been no need to replace each and every window in the building".[40] However, this would also have been the case if the windows were simply damaged, rather than being "defective in workmanship". The judgment states that the "main dispute" between the parties was the meaning of the words "in workmanship", given the subcontractor was not working on the windows, but on the external plastering. The Judge found in favour of Vero on that issue, given that the subcontractors' contractual obligations expressly extended to protecting and not damaging adjacent works.

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39 *Holmes Construction Wellington Ltd v Vero Insurance New Zealand Ltd*, above n 2.
40 At [23].

[79] Accordingly, while I am not bound by the District Court's decision, the key matter in issue in this proceeding was not the focus of the argument in the District Court in any event.

[80] Vero also relies on Randerson J's decision in *Recreational Services Ltd v QBE Insurance (International) Ltd*.[41] In that case, the appellant had been contracted to manage the greens at a golf club. It mistakenly applied herbicide to the greens instead of fungicide, which caused substantial damage to the greens. The golf club suffered a loss of profits during the time it took for the greens to be repaired. The appellant later made a claim under its liability policy with the respondent. The respondent met the cost of establishing temporary greens and the loss of profits claim. But it declined cover for the sum of approximately $70,000 incurred by the appellant in restoring and resewing the damaged greens. This was on the basis of an exclusion clause which excluded "the cost of … remedying faulty workmanship".

[81] Randerson J rejected the appellant's argument that the exclusion applied only to the cost of redoing the work, that is the cost of respraying the greens. His Honour stated:[42]

> In my view, to remedy faulty workmanship means to make it good or put it right. Faulty workmanship does not occur in a vacuum. It is carried out on some object or thing. It follows that the cost of remedying faulty workmanship must include all the costs reasonably necessary to restore the subject matter of the faulty work to the state it would have been in if the work had been performed to the proper standard, including any property damage to the subject matter caused in the course of carrying out the faulty work.

[82] Randerson J considered the appellants' argument did not give proper recognition to the natural meaning of the expression "remedy".[43]

[83] The Court of Appeal rejected an application for leave for a second appeal.[44] It stated:[45]

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41 *Recreational Services Ltd v QBE Insurance (International) Ltd*, above n 6.
42 At [13].
43 At [17].
44 *Recreational Turf Ltd v QBE Insurance (International) Ltd* (2006) 14 ANZ Insurance Cases 61-690.
45 At [9].

> In our view the issue is not one of construction but one of application. The expression "the cost of remedying faulty workmanship" is a simple phrase and tautology will add no enlightenment. In any particular case the issue will be whether the monies sought can be categorised as a cost of remedying faulty workmanship. That is essentially a question of fact. The question might be difficult to answer in some situations but in the present case the costs incurred were undoubtedly remedial. The remedy was required because of faulty workmanship, and the remedial works were in respect of the very thing to which the workmanship related, namely, the greens.

[84] Ms Brick submits that the exclusion clause in *Recreational Services* is similar to the defective workmanship exclusion in Vero's policy. She says the exclusion in *Recreational Services* applies to "the cost of … remedying faulty workmanship", and Exclusion 6 applies to "the cost of repairing, replacing or rectifying any part of the contract works which is defective in material or workmanship". She says the damage to the greens caused by the herbicide in *Recreational Services* is analogous to the damage to the windows caused by the cleaning work. She submits the reasoning in *Recreational Services* is therefore applicable to the present case.

[85] While the damage to the greens could be said to be analogous to the damage to the windows in this case (both being physical damage caused by defective workmanship), direct application of the reasoning in *Recreational Services* demonstrates the risk of adopting reasoning based on differently worded contractual provisions. The focus of the exclusion clause in *Recreational Services* was quite different to Exclusion 6, necessitating an inquiry as to whether the costs for which indemnity was sought were costs *of remedying* faulty workmanship. That required an inquiry as to causation and remoteness.[46] The inquiry was not directed to the state or condition of a part of the insured works, as in this case.

[86] Vero also relies on the Court of Appeal's decision in *Molyneux Holdings Ltd v IAG New Zealand Ltd*.[47] Molyneux operated a cherry pack house which provided services for cherry growers. The cherries were delivered to Molyneux who then washed them and quickly cooled them to preserve their quality, before packing them for export. The cherries were found at destination (mainly in Taiwan) to be rotten, which was found to have resulted from being contaminated with a pathogen during

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[46] The Court of Appeal noting (at [9]) that "the remedy was required because of faulty workmanship, and the remedial works were in respect of the very things to which the workmanship related".

[47] *Molyneux Holdings Ltd v IAG New Zealand Ltd*, above n 6.

Molyneux's cleaning process. Molyneux was liable to its growers for their losses as a result of the damage to their fruit.

[87] Molyneux claimed under a broad form liability policy. The policy contained an exclusion for liability for property damage to "any product where liability is connected with any fault or defect … in work done to the product". The exclusion was subject to a proviso that it did not apply to liability for resultant property damage to other separate property or part.

[88] The central issue was whether Molyneux's cleaning and cooling process was "work done" to the cherries for the purpose of the exclusion. Molyneux argued that for there to be "work done" to the cherries, there must have been some physical modification to the cherries, which did not occur in that case. It also argued that its work was not the proximate cause of the damage to the cherries, which was the pathogen itself.

[89] The Court of Appeal had no difficulty in dismissing the appeal. It concluded that the "process to which Molyneux was required to subject the fruit could not sensibly be described other than as 'work done' to the cherries." In particular, it saw nothing in the words of the policy or the principles of construction to suggest physical alteration to the cherries was required in order for there to be "work done" to them.[48]

[90] Ms Brick submits this decision is significant, because the Court found that a cleaning process was defective work, and that damage caused by that cleaning process was not resultant damage to other property. I do not see *Molyneux* as relevant to the issue in this case. There is no dispute the damage to the windows in this case was caused by defective workmanship. *Molyneux* concerned a quite different exclusion clause, and as noted, the key issue was whether the appellant's work was "work done" on the cherries. The outcome of the appeal was unsurprising given the wording of the exclusion. It does not shed any light on whether the windows in this case are "defective in workmanship" for the purposes of Exclusion 6.

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[48] At [28].

Result

[91] For the above reasons, I conclude that Exclusion 6 does not apply to the scratched windows in this case. The answer to the separate question is therefore "no".

Costs

[92] The plaintiffs seek costs. On the materials presently before the Court, there would seem to be no reason why costs ought not to follow the event in the ordinary way, on a 2B basis. I would not certify for second counsel.

[93] If the parties cannot agree costs, the plaintiffs may file and serve a costs memorandum within **15 working days** of this judgment. Vero may file a memorandum in response within a further **five working days**. No memorandum is to be longer than **three pages in length**. I will thereafter determine costs on the papers.

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Fitzgerald J