ENSafrica Construction ENSurance

recent influential court decisions and what they may mean for your business

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Introduction

We are delighted to present you with this booklet on Construction Insurance topics with reference to judicial decisions made in 2019 and 2020. Although many of these decisions originate in the United Kingdom, Australia and Canada these are worth paying attention to as they may prove to be influential on future decisions made by South African courts.

We have selected five topics and we provide our expert analysis and commentary in respect of each one. The five topics and the judicial decisions to which they relate, serve to demonstrate the significant interconnectedness between the fields of construction and insurance law. The selected topics are:

1. The status of **interim payment certificates** on cancellation of a construction contract and implications for construction guarantees and guarantee insurers.
2. Coverage implications for insurers in a construction contract in circumstances where the construction all risks insurance policy and the reinsurance policy are not back-to-back.
3. Contractual liability **exclusion clauses** in liability insurance cover, including construction all risks covers.
4. The rectification of an on-demand construction performance guarantee issued by an insurer and the doctrine of **strict compliance**.
5. The controversial **defective workmanship exclusion** in construction all risks insurance policies.

While this is not intended to be a reference work, we do hope that it will be useful to those in the construction and insurance industries.

Leading South African corporate firm with a growing presence in the insurance space

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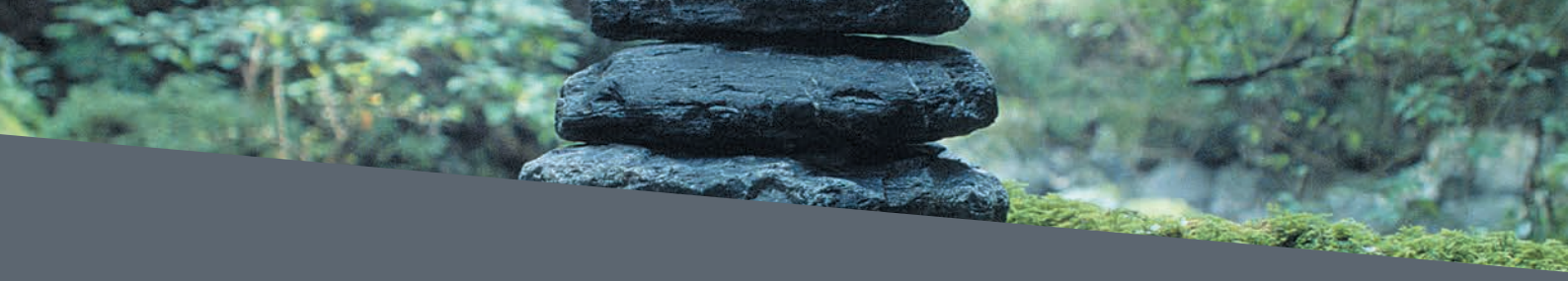


Part One | The status of interim payment certificates on cancellation of a construction contract and implications for construction guarantees and guarantee insurers

In a recent 2019 decision of the South African Supreme Court of Appeal **("SCA")** in ***Intech Instruments v Transnet Limited t/a South African Port Operations,*** the court ruled that the cancellation of a construction contract rendered interim or provisional payment certificates, issued in terms of the construction contract, to be of no force and effect. In doing so, the court recognised and followed a previous decision it made some 32 years ago in the matter of ***Thomas Construction (Pty) Limited (in liquidation) v Grafton Furniture Manufacturers (Pty) Limited.***

The SCA held:

> "Where a client lawfully terminates a construction contract, as is the case here, the Contractor's claim for retention monies and unpaid invoices are not self-standing claims, separate and independent from the remainder of the contract. And, upon such termination, the interim certificates ceased to be of any force and effect. They cannot sustain a basis for payment where there can be, in view of the cancellation, no further expectation of a completion of the works".

Comment and analysis

The decision is based on the principle, well described by the SCA, in the 2016 decision of ***Nurcha Finance Company (Pty) Limited v Oudtshoorn Municipality***, in the following terms:

> "… that payment ultimately depends on the delivery of a finished product of work" such that "Cancellation of the contract strikes at the very foundation of the claim and therefore debars a claim based upon the interim payment certificate".

The principle will apply in all instances, subject to any contrary provision in the underlying construction contract between the employer and the contractor. For instance, a clause to the effect that an interim certificate will remain of force and effect, notwithstanding a cancellation of the contract. In this matter, the contract was based on the standard form General Conditions of Contract wording, which does not serve to preserve the enforceability of an interim payment certificate beyond a cancellation of the underlying construction contract. The position is the same in relation to the standard form JBCC ontract.

This principle and the consequence of a cancellation of an underlying construction contract in relation to the validity and enforceability of an interim payment certificate, is often forgotten. However, it has important consequences for contractors following the cancellation of a construction contract.

This principle means that, following a cancellation of a construction contract, a contractor is not able to sue the employer based on the interim certificate, and the contractor's only available remedy is to sue the employer for contractual damages.

Implications for guarantees

This principle also has implications for insurers in relation to demands for payment in terms of on-demand insurance construction guarantees, as such demands very often follow a cancellation of an underlying construction agreement. By virtue of the operation of this principle, a guarantor, faced with a demand from the employer in terms of a performance guarantee, is unable to take cession of a contractor's claims for payment under interim payment certificates, in order to defend the claim on a performance guarantee on the basis of set-off.

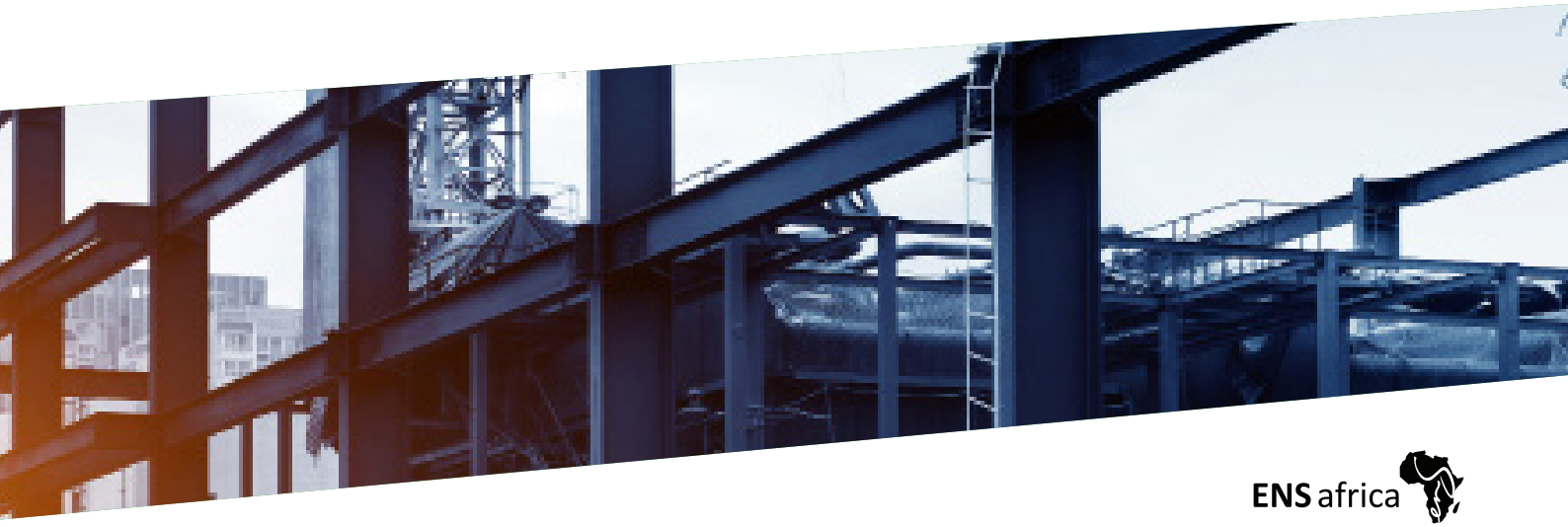
An interesting question arises in this context in relation to on-demand payment guarantees (as opposed to performance guarantees). In terms of a payment guarantee, the guarantor undertakes to pay the contractor the sum certified as payable in terms of a payment certificate issued to the contractor pursuant to an underlying agreement. **What then is the guarantor's obligation to the contractor following a demand for payment by the contractor, when the employer cancels the underlying construction agreement?**

The South African law, as it currently stands relative to on-demand guarantees, is that the obligation established in a guarantee is wholly independent of the underlying contract (known as the autonomy principle), and it is only where fraud is involved that the guarantor may decline liability. Accordingly, a court would be likely to disregard the cancellation of the underlying construction agreement, and to order payment in terms of the payment guarantee, notwithstanding this established principle.

This scenario also brings to the fore the following broader and contentious issues (which coincidentally have become relevant considerations in recent matters):

THE CONTINUED VALIDITY OF A PERFORMANCE GUARANTEE - NO EXPIRY DATE

The continued validity of a performance guarantee having no expiry date (as is very often the case), in circumstances where the underlying construction contract is completed such that the parties have, in terms of that contract, no further rights and obligations relative to performance. In some instances demands for payment are being made a number of years after the completion of a contract. The implication for guarantee insurers is that they are then compelled to reopen reserves in order to provide for such claims long after the completion of projects. This in the context of some guarantee insurers and reinsurers having discontinued the product, which has reduced the capacity of the insurance market to supply the guarantee product.



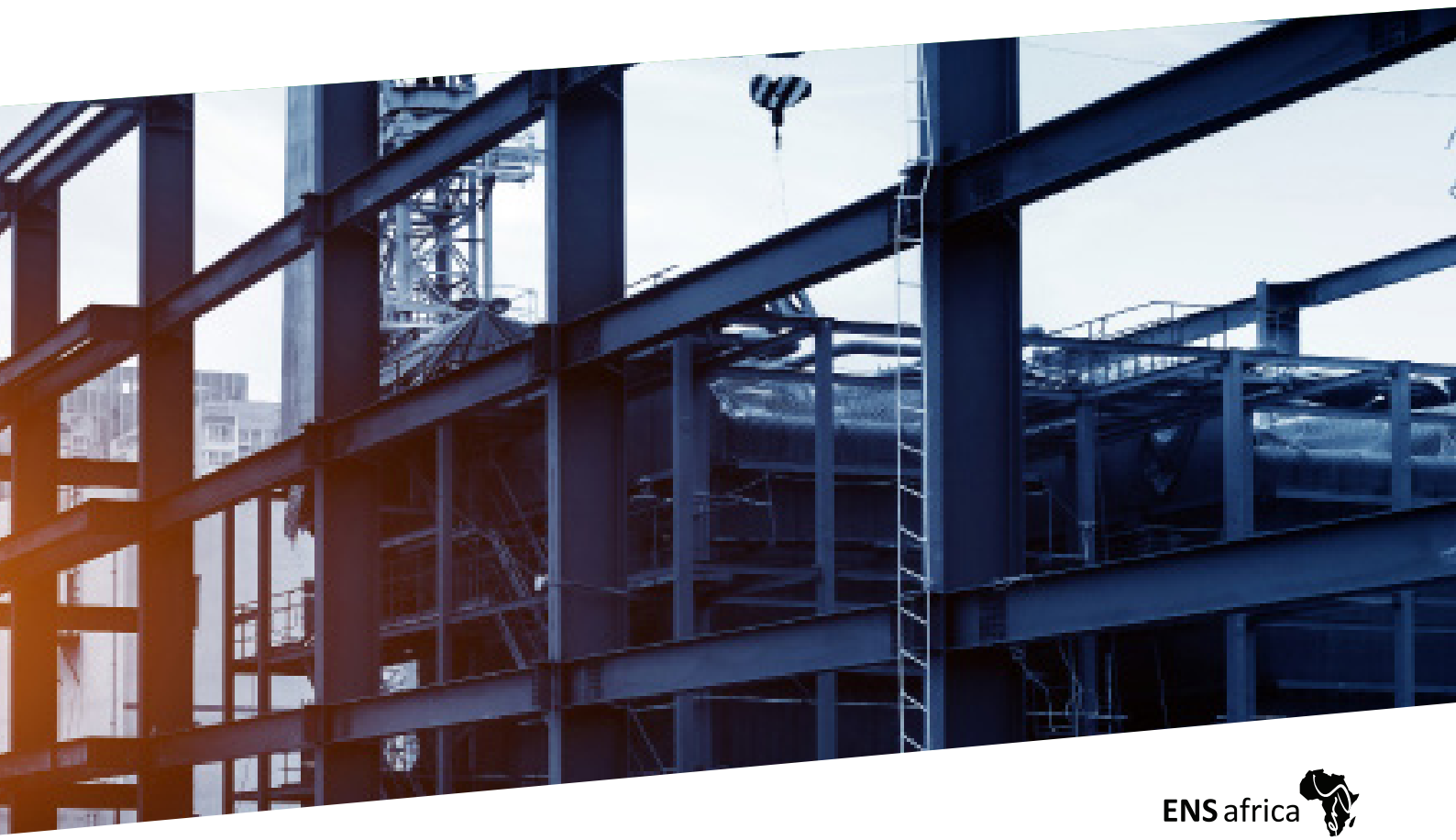
THE VALIDITY OF A GUARANTEE - THE UNDERLYING CONSTRUCTION CONTRACT

The validity of a guarantee in circumstances in which it becomes apparent that the underlying construction contract was subject to an initial impossibility of performance, and as such is void or unenforceable. This question arose in a recent 2019 decision of the South Gauteng High Court in ***Transnet SOC Limited v ABSA Insurance Company Limited and Others.*** After emphasising the principle that a performance guarantee is wholly independent of the underlying contract, the court ruled that "Whether or not the underlying contract exists in an enforceable form or not and whether or not a beneficiary is actually entitled to be paid under the underlying construction contract has no bearing on the matter". In the court's view, "the only concern … is to determine whether or not in terms of the demand document, the allegations required by the performance guarantee are contained in the document".

Serious consideration ought to be given to whether these circumstances should not serve, as is the case with the fraud defence, as exceptions to the autonomy principle. **The question is, more specifically, whether it is reasonable and in conformance with public policy that in these instances the autonomous nature of on-demand guarantee should continue to trump commercial reality?** There is, in this regard, authority that may be drawn on not only in the English law in relation to letters of credit, but also in the South African law in relation to negotiable instruments, such instruments not being unlike on-demand guarantees.

In our view, this is an issue that needs to be carefully considered and decided upon by the SCA.

By *Rob Scott* and *Zara Sher*



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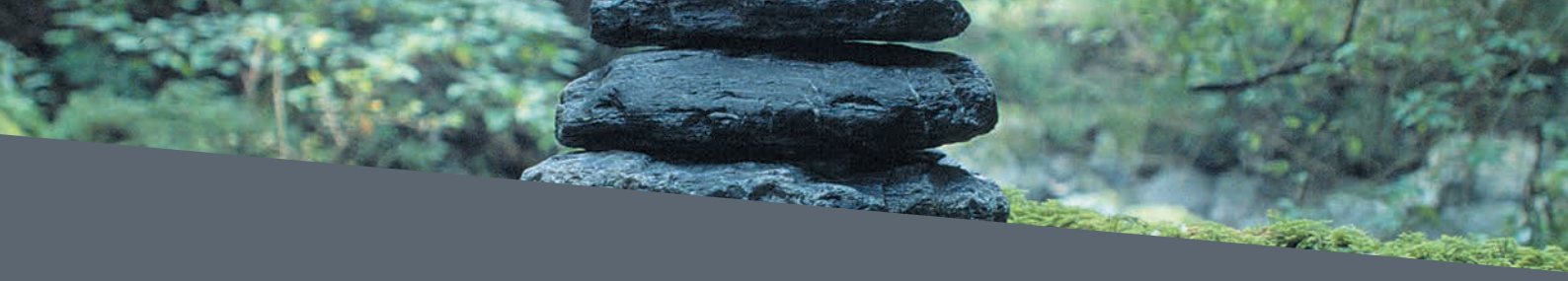

Part Two | Coverage implications for insurers in circumstances where the construction all risks insurance policy and the reinsurance policy are not back-to-back

In a 2019 decision of the English High Court of Justice in the matter of ***Munich Re Capital Ltd v Ascot Corporate Name Ltd***, the court had to consider the proper construction of a Facultative Excess of Loss Reinsurance Policy, more particularly the "maintenance period" provision in the Reinsurance Policy. The principal Insurance Policy was an off-shore Construction All Risks Policy, relative to a very substantial offshore construction project in the Gulf of Mexico. The Reinsurance Policy incorporated all the terms and conditions of the Insurance Policy. The intention was that it would operate "back-to-back" with the Insurance Policy.

The Insurance and Reinsurance Policies covered physical loss and/or physical damage caused to the project works occurring during the project period. In terms of both policies, the project period was date defined and the maintenance period extended cover for a period not exceeding a further 12 months after the expiry of the project period, but only in respect of physical loss and/or physical damage arising from a cause occurring prior to the commencement of the maintenance period. The maintenance period clause read as follows:

> "Coverage shall continue during the maintenance period(s) (subject to the terms, conditions and exclusions in the wording), up to a period of 12 months after expiry of the Project Period".

The Insurer had agreed to extend the project period on a number of occasions, due to delays in the completion of the construction of the project. As a result of an error and/or oversight on the part of the Insurer and/or its reinsurance broker, the Reinsurer was not notified of the extensions. Accordingly, the project period under the Reinsurance Policy was not similarly extended to coincide with the project period under the Insurance Policy.

Substantial losses arose within the 12-month period after the expiry of the initial project period. These losses were also due to causes occurring during the initial project period. The Insurer was required to indemnify the Insured under the Insurance Policy, but did not have corresponding reinsurance cover as the project period under the Reinsurance Policy had not been extended to coincide with the project period under the Insurance Policy. The Insurer accordingly sought an indemnity under the Reinsurance Policy, for the limited cover applicable under the maintenance period provision (of the Reinsurance Policy) on the basis that the losses arose both during the 12-month period after the date (as recorded in the Reinsurance Policy) on which the project period expired and the maintenance period began, as well as from causes occurring during the initial project period. The Reinsurer declined cover contending that the Insurer sought cover "where none was intended".

The Insurer contended that in this instance **"a literalistic approach is the correct one".**

This contention was based on a reasoning that the possibility of mismatching policies was reasonably foreseeable, such that the parties would have been expected to address this possibility explicitly (in the Reinsurance Policy) "if they did not want the plain language of the contract to bind them". The parties had not done so.

The court disagreed with this "theoretical" scenario as "the whole structure of the Reinsurance Policy was to mirror the Insurance Policy; that was its commercial rationale". The court refused to apply a literal interpretation of the wording in relation to the Reinsurance Policy, as such an interpretation would not take into account the commercial reality, that being that the project period had not yet expired, such that "there was no project to be covered during the "maintenance period(s)". The court accordingly dismissed the Insurer's claim.

Comment and analysis

While the Insurer did not pursue the argument, prior to the institution of proceedings it had argued that an "automatic extension" of the Reinsurance Policy had occurred when the Insurance Policy was extended.

In the course of its Judgment, the court considered whether such an argument could possibly be made. It dismissed the possibility in stating that such a "theoretical scenario" was clearly not what the parties had intended, as had the Insurer been unable to agree terms for a corresponding extension of the Reinsurance Policy, the Insurer could always have refused to extend the project period in the Insurance Policy. The court's view also accords with the general principle, applicable to facultative reinsurance, that **insurers, in extending liability under the original insurance and after the conclusion of a facultative policy, cannot unilaterally increase reinsurers' liability.**

Notably the wording of the Reinsurance Policy also did not support such a possibility as it explicitly contemplated the basis on which an extension of the policy period would be effected in the following terms: "The policy period may be extended at terms and premium to be agreed by the Slip Leaders and the agreement parties. All dates are inclusive and at the location of the risk". In fact the Insurer had not paid any premium relative to the maintenance period, but only for the project period.

On this point, there is a very old (1914) decision of the Cape Provincial Division in ***General Accident, Fire and Life Assurance Company Limited v National British and Irish Millers' Insurance Co Limited***, in which the court ruled as follows:

> "Upon the point of custom, I may say at once that the Plaintiffs have, in my opinion, entirely failed to prove any custom as existing between insurance companies in this country according to which the Defendants [Reinsurers], upon renewal by the Plaintiffs of the [underlying] policies, automatically continued liable as before upon their guarantee policies, with the rights to premiums as before".

In our view, a contemporary South African court would be likely to reach the same conclusion. The interpretive process in the English law is similar to the interpretive process applied in South African law. In South African law, the interpretive process is both a unitary and an objective legal exercise, with equal regard to language, context/purpose, and the application of a commercially sensible interpretation.

The judgment of course serves as an important reminder to insurers and brokers to ensure that facultative placements are indeed updated and remain back-to-back with principal covers.

By *Rob Scott*, *Zara Sher* and *Zoë Wein*

Acts for a diverse range of policy holders, in addition to insurers, reinsurers and underwriters

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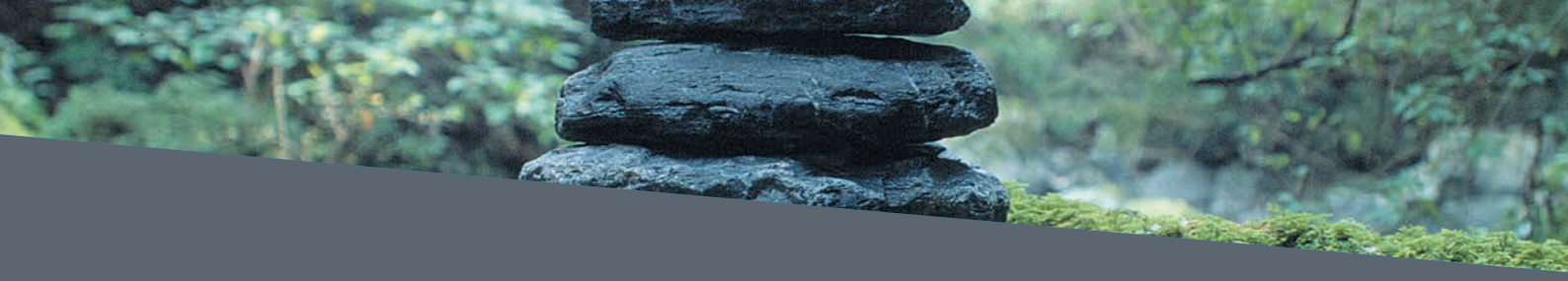


Part Three | Contractual liability exclusion clauses in liability insurance covers, including construction all risks covers

There is a common misconception that liability policies do not cover liability in contract, but only provide cover against liability in delict, or liability arising from the breach of a duty of care imposed by law.

LIABILITY COVERS GENERALLY

Generally, liability covers are worded to cover an insured where the insured is "legally liable" or "liable at law" to pay compensation consequent upon personal injury suffered by any person and/or loss of or damage to property. These words are broad enough to cover an obligation to pay both delictual damages and damages for breach of contract, but then within the limitations imposed by other terms of the policy.

CONTRACTUAL LIABILITY EXCLUSION CLAUSES

Contractual liability exclusion clauses are cardinal terms in this respect. They may be omitted entirely or they may be worded very broadly to exclude all liability arising out of a contractual relationship or for all claims based in contract, thereby restricting coverage under the policy to claims arising in delict only.

More commonly, contractual liability exclusion clauses are qualified to exclude only the insurer's liability in respect of contractual liability assumed or accepted under contract. Such clauses are generally framed to exclude additional liability assumed or accepted by an insured under any contract or agreement, save to the extent that such liability would otherwise have been implied by law, or would have attached in the absence of such contract or agreement. Accordingly, **cover for liability in terms of a standard commercial contract**, which encompasses a range of obligations normally associated with liability relative to the type of contract in question, or where the liability is an ordinary legal or common law incident of a relationship, **will be preserved under the policy in question (but importantly always subject to the range of perils/events that the policy seeks to cover).**

The reach and scope of such a clause in the context of a general liability cover was considered in a recent 2019 decision of the Federal Court of Australia in the matter of ***R & B Directional Drilling Pty Ltd (in liq) v CGU Insurance Limited.*** The Federal Court of Australia is a court of general federal jurisdiction, also having jurisdiction to hear appeals from state courts exercising exclusive state jurisdiction.

The policy in question was a business insurance policy consisting of various sections, one of which being a liability section (covering both products and public liability). The policy had been taken out to cover work carried out by a sub-contractor (the sub-contractor but not the contractor being the insured) pursuant to a sub-contract. The operative clause in terms of the liability section of the policy read:

> "Subject to the limits of indemnity stated in the schedule and the terms and conditions of this cover section, we will pay all sums that the insured person shall become legally liable to pay for compensation in respect of:
> • personal injury;
> • property damage;
> • advertising liability;
> happening during the period of insurance within the territorial limits as a result of an occurrence in connection with your business or products".

In terms of the sub-contract, the sub-contractor had undertaken to perform the works efficiently, in accordance with the specifications and the plan and the sub-contractor indemnified the contractor against all damage, expense, loss or liability, of any nature, in relation to its property or to any other property, arising out of the performance/ non-performance of the sub-contract.

The contractor claimed damages from the sub-contractor for property damage caused by the sub-contractor based on a breach of contract in failing to carry out the works in accordance with the sub-contract. The sub-contractor in turn claimed indemnification from the insurer under the general liability section of the policy, for its liability to the contractor in respect of alleged property damage. The insurer denied coverage under the policy on the basis of the contractual liability exclusion clause under the policy, as the damages had arisen in terms of a liability or obligation assumed under an agreement or contract. The contractual liability exclusion clause provided that the insurer would not pay anything in respect of:

> "Any liability or obligation assumed by an insured person under any agreement or contract except to the extent that:
> (a) The liability or obligation would otherwise have been implied by law..."

The court disagreed with the insurer. It was of the view that the **"reach and scope of this kind of exclusion" clause is limited, and is intended to apply to contracts or agreements in which an insured assumes a liability beyond that which is normally applicable**. It quoted with approval from the earlier decision (1994) of the Supreme Court of Victoria in ***Karenlee Nominees Pty Ltd v ACN 004 312 234 Ltd***, as follows:

> "The exclusion is intended to apply to the situation where, by an agreement, an insured extends the limits of the ordinary liability arising, such as by an agreement for liability for injury without proof of fault... The exclusion is also directed to the case where the insured assumes a liability beyond that which is normally incidental to the occasion, for example, the degree of skill ordinarily expected of an expert…"

The court's view in relation to the sub-contractor's contractual undertaking, was that "there is nothing unusual about being required [to perform] efficiently (that is adequately, competently and capably)… This is within the ordinary limits of liability for such a sub-contract". The court accordingly ruled that "the contractual nature of the claim for breach" of the sub-contract and the obligation to pay contractual damages was not a liability "assumed", as contemplated in the contractual liability exclusion clause and found that the contractual exclusion clause did not serve to exclude the insurer's liability under the policy.

Comment and analysis

Importantly, while the court accepted that the policy did cover liability for a breach of contract, that liability was not a general liability, and was still governed by the terms of the operative clause of the liability section of the policy.

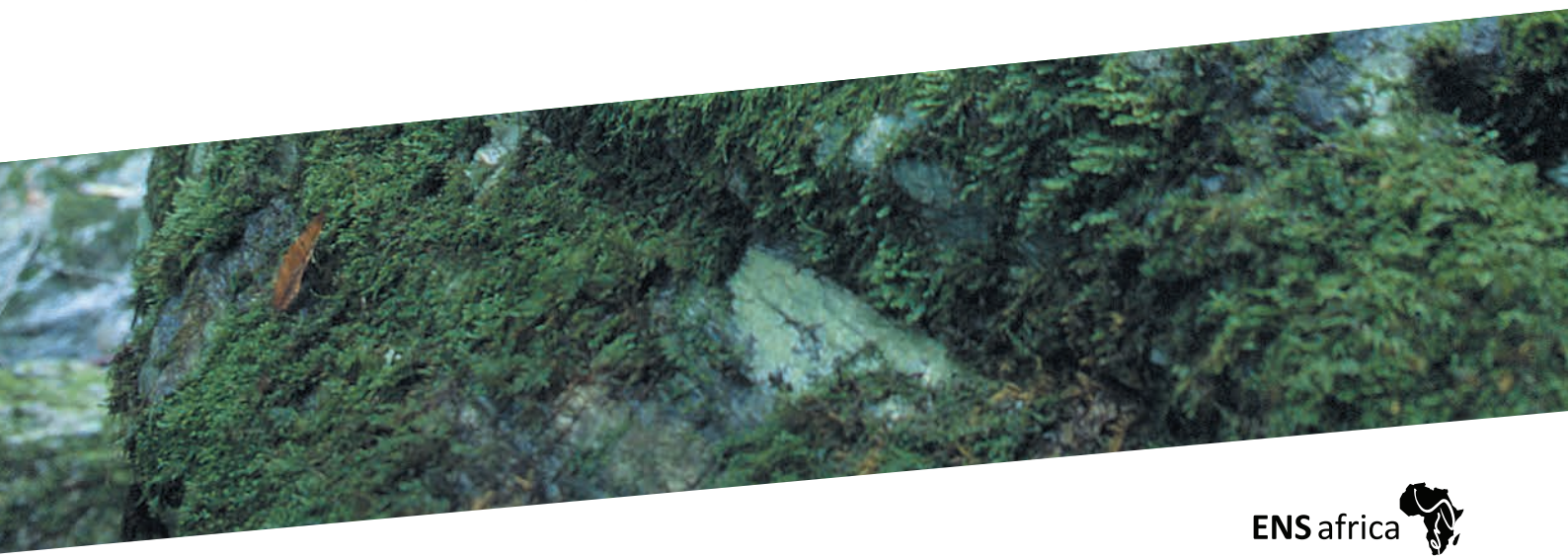
There are no reported decisions of the South African courts on the meaning and effect of such an exclusion clause. The approach of the Australian courts is not inconsistent with earlier decisions in English law on the effect of such clauses. A South African court would be expected to apply an interpretation similar to that applied by the Australian courts, and indeed have regard to the decisions of the Australian courts, as the South African principles of contractual interpretation are similar to those in Australian law.

In reaching the conclusion that they have, the Australian courts have interpreted such clauses from both a literal and commercial perspective:

From a literal perspective	• With reference to the words "liability or obligation would otherwise have been implied by law": while an obligation may arise out of a contract entered into, it does not necessarily arise only under contract, but may, in any event, also arise from a pre-existing obligation in law and independent of the contract – for instance a delictual duty of care (in other words a duty "implied by law"). A failure to exercise such duty would give rise to a claim for delictual damages. It would accordingly be illogical to limit coverage under a liability policy simply because the liability, which in any event exists in law, arises by virtue of an agreement. • Liabilities or obligations "assumed" must necessarily be read to exclude liabilities agreed to over and above those imposed by law.
From a commercial perspective	• Commercial relationships are governed by agreement. • The courts have reasoned that if such exclusion clasues were interpreted to exclude all liability arising in the context of contractual relationships generally, such an interpretation would significantly undermine the purpose of such policies, and be uncommercial.

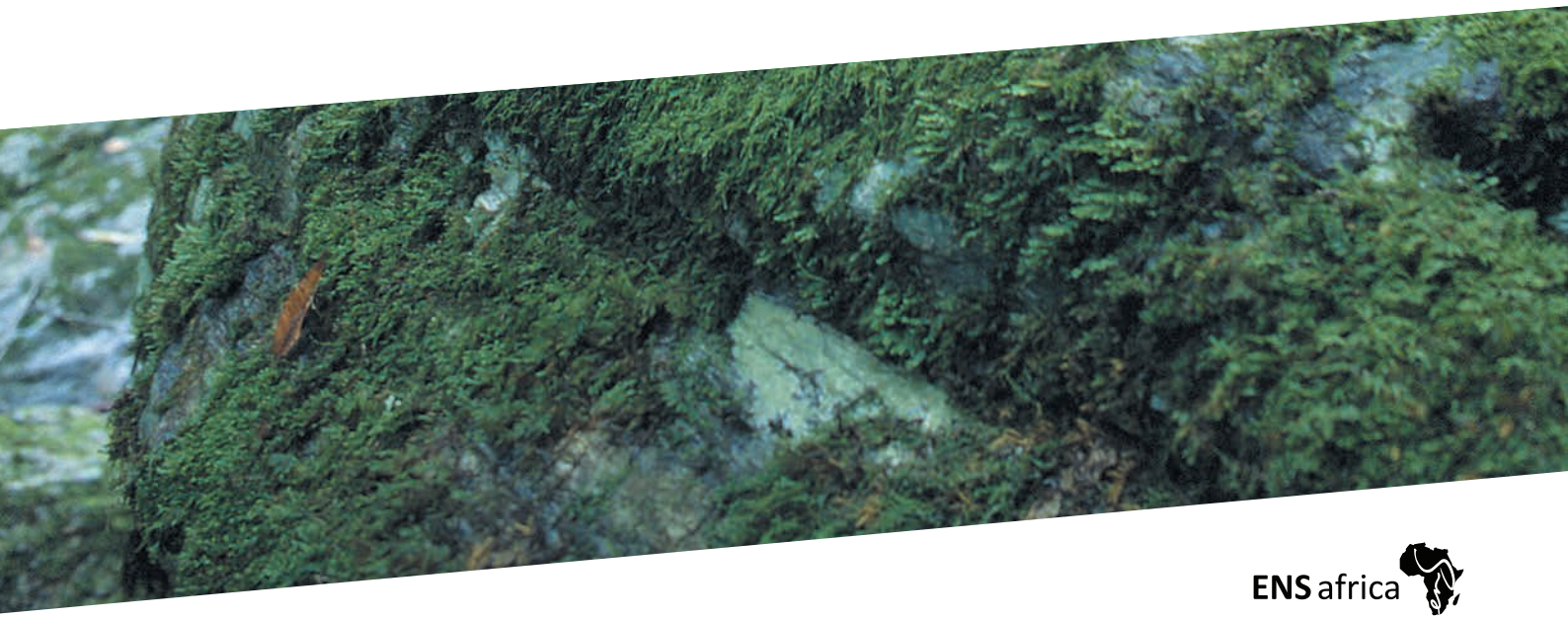
Such contractual exclusion clauses may contain wording different to the wording considered in the R&D Drilling case, and different consequences may also arise relative to the type of liability insurance in question. In this regard:

Products and cyber liability covers	• Contractual exclusion clauses, as are generally found in products liability and cyber liability covers, may be worded to exclude cover "arising out of a liability based upon any guarantee, warranty, contractual term or liability assumed or accepted by an insured under any contract or agreement, except to the extent that such liability would have attached to the insured in the absence of such contract or agreement". • The law in relation to the supply of goods and products is generally concerned with the protection of consumers' interests, and imposes obligations in the nature of guarantees, warranties and often strict liability. Accordingly, in relation to an underlying claim based in contract, where the law imposes strict liability upon a supplier in relation to the supply of defective goods to consumers, the contractual liability exclusion clause in question will not serve to exclude the insurer's liability under the policy.



Construction all risks covers ("CAR")

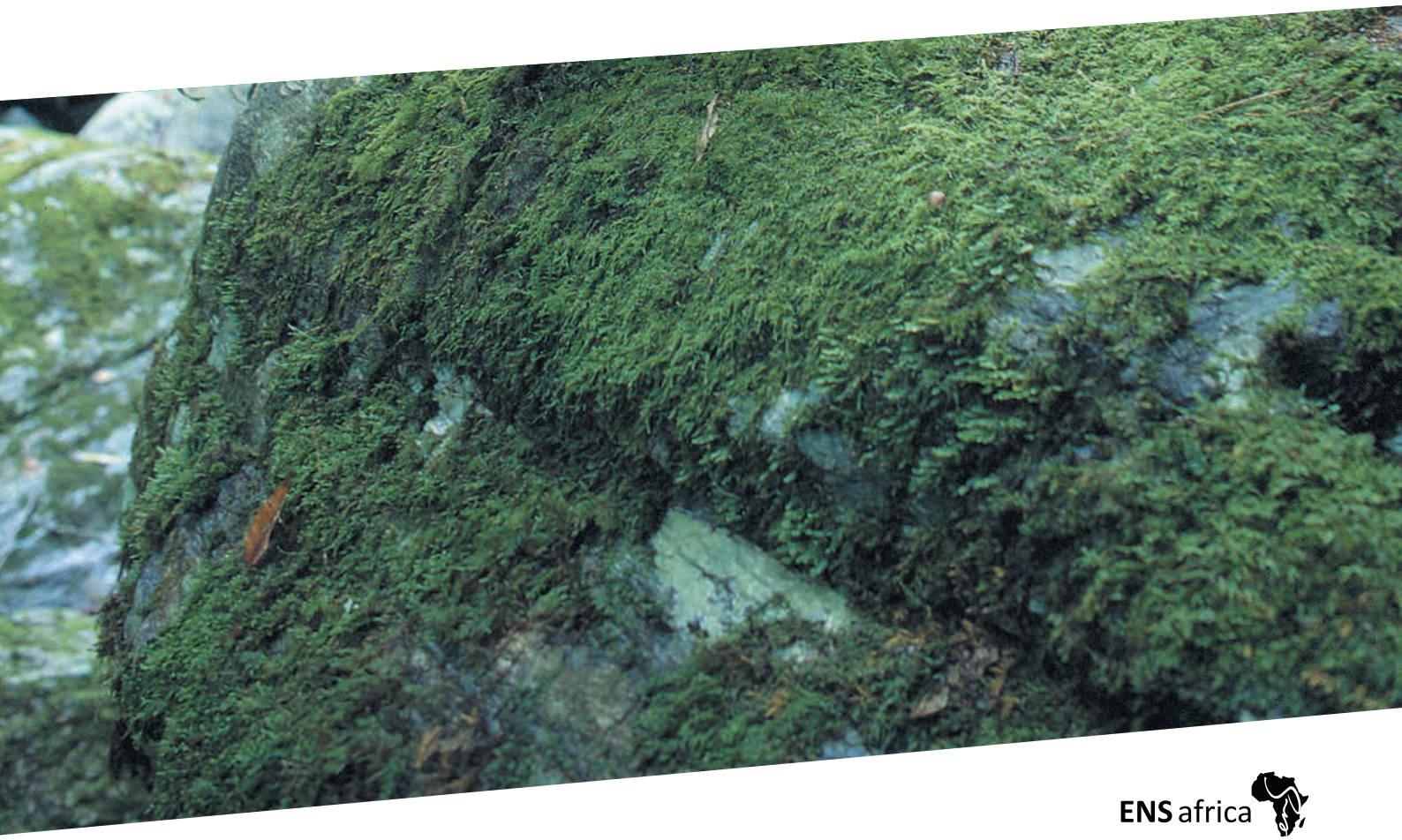
- CAR covers provide cover for risks in relation to the insured property (being the contract works) and associated with the work of all participants in the construction contract, the usual participants being the employer, the contractor, sub-contractors and suppliers (these risks being covered under the contract works section of the policy). The policy is accordingly composite, each participant being an insured party under the policy.
- Contractual liability clauses such as the clause under discussion in the R&B Directional Drilling case are also found in the public liability section of a construction works insurance policy. However, the contract exclusion clauses in such policies generally provide that the exclusion clause "shall not apply to the insured contract or sub-contract agreements", or to "any other specific agreement which has been advised to and accepted by the insurer in writing". This does not necessarily mean that a contractual claim between insured parties will be covered under the liability section. The reason for this is that:
    - The public liability section of a construction all risks policy is only intended to provide cover for liability to third parties, being members of the public, who are not parties to an underlying construction contract, and then only in respect of contractual liability assumed in respect of risks limited to the physical impact on a third party's person, property or property rights.
    - These risks, as between parties to an underlying construction contract (being the insureds in terms of the policy), are to be dealt with under the contract works section of the policy, or under other policies.



Professional liability covers	• Such covers on the whole seek to indemnify an insured against a general duty (contractually undertaken) to exercise reasonable skill and care xpected of a member of their profession, and not in respect of an undertaking of duties in contract higher than the general duty. • Accordingly, such policies may also contain contractual liability and performance guarantee exclusion clauses to exclude claims arising out of, based upon or attributable to any obligations assumed, that go beyond the duty to use reasonable skill and care (such as an obligation to achieve a fit for purpose standard), and claims relating to guarantees or warranties.

This article has sought to demonstrate that in many instances liability policies do afford a measure of contractual liability cover, which would include cover for other liability in law (as would be the case relative to a products liability cover), and that the common misconception that they do not, is misplaced.

By *Rob Scott* and *Zara Sher*



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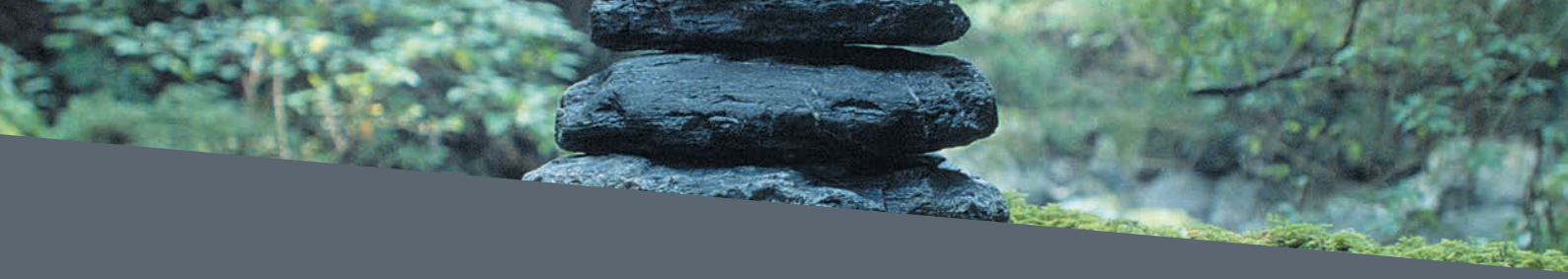

Part Four | The rectification of an on-demand construction performance guarantee issued by an insurer and "the doctrine of strict compliance"

In a recent 2020 unreported judgment of the Gauteng Local Division, ***Clarion Investments 49 (Pty) Limited v Lombard Insurance Company Limited***, the court, in granting provisional sentence against the defendant (the **"Guarantor"**) for payment in an amount of ZAR3 701 112.59, interest and costs, ordered that the name of the Employer recorded in an on-demand variable construction performance guarantee (the **"Guarantee"**) be rectified to correctly record the name of the Plaintiff.

The Guarantee had incorrectly described "the Employer" (and beneficiary of the Guarantee) as "Clarion Investments (Pty) Limited", omitting the "49" from the name of the Employer, "Clarion Investments 49 (Pty) Limited".

The Guarantor refused to make payment pursuant to a demand made by the Employer on the Guarantee on the basis that the demand was not in compliance with the terms of the Guarantee. The Employer accordingly instituted provisional sentence proceedings against the Guarantor for payment in terms of the Guarantee and for an order that the Guarantee be read, alternatively rectified, to correctly record the employer as "Clarion Investments 49 (Pty) Limited". The provisional sentence procedure allows a plaintiff with a liquid document constituting prima facie proof of indebtedness to obtain a speedy judgment with a view to avoiding a lengthy trial procedure.

The Guarantor argued that the Employer's demand for payment in terms of the Guarantee was not in strict compliance with the terms of the Guarantee, as the demand had not been made by "the Beneficiary" (the Employer) described in the Guarantee, and that the certificate of practical completion (enclosed with the demand) contained the same mistake in relation to the description of "the Employer". On this basis, the Guarantor contended that there was no obligation on it to make payment in terms of the Guarantee.

The Employer argued that the error in the Guarantee was the result of a bona fide mutual mistake, and that it had always been the common continuing intention of all of the parties that the Guarantee was to be issued in favour of "the Employer", as recorded in the underlying construction contract and in fulfilment of the contractor's obligations in terms of the underlying contract to provide security to the Employer.

The Employer accordingly contended that the Guarantee should be read in accordance with this intention, and alternatively and to the extent necessary, be rectified to reflect such common mutual intention as at the time that Guarantee was issued.

The Guarantor denied that it had erred in its recordal of the definition of "the Employer" and contended that the Employer's prayer for rectification of the Guarantee was not a competent remedy to be sought by way of the provisional sentence procedure, as the Employer was required to resort to extrinsic evidence to prove its case.

The court disagreed with the Guarantor's arguments. The court held that an order for rectification was competent in terms of the provisional sentence procedure in the circumstances, and that on the evidence (regard being had to the allegations made in the provisional sentence summons, read together with the underlying construction agreement):

> "The common continuing intention of the plaintiff, the beneficiary under the guarantee that procured the guarantee, and the defendant, that gave the guarantee, was quite obviously that the guarantee should be issued in favour of whomever was the employer in terms of the building contract, not who was defined as the employer, but who was in fact the employer. To my mind that suffices for purposes of rectification".

The court found that "the only conclusion is that the plaintiff's description in the construction guarantee is incorrectly recorded, as a result of the error bona fide pleaded in the provisional sentence summons, and should be read accordingly, alternatively, rectified". The court accordingly ordered that the Guarantee be rectified to read "Clarion Investments 49 (Pty) Limited" and that provisional sentence be granted against the Guarantor for payment in the amount of ZAR3 701 112.59, together with interest and costs.

Comment and analysis

The judgment bears on what is known as the "strict compliance" defence and whether this defence, in relation to on-demand guarantees, is part of South African law.

The South African courts have generally steered away from deciding whether strict compliance with the terms of the guarantee is required in order for a demand to be considered compliant. The courts have instead addressed the compliance aspect as a matter of interpretation, in each case, with reference to the specific terms of the guarantee in question.

The court, in this judgment, takes this aspect further, remarking that:

> **"Construction guarantees play an important role.** They are intended to facilitate important aspects of the relationship between Employer and Contractor. The Contractor agrees to provide a guarantee to enable the Employer to complete the works in the event of the Contractor's default. **Obvious errors and trivialities should not be elevated to points of substance.** A Plaintiff armed with what is prima facie a liquid document, is entitled to the long established expeditious remedy of provisional sentence.
>
> **The only basis upon which the bank can escape liability is proof of fraud on the part of the beneficiary..."** *our emphasis added.*

Importantly, the court imported, in the context of on-demand guarantees, the long standing principle in South African law that "the law does not concern itself with trivialities" in stating that "Obvious errors and trivialities should not be elevated to points of substance".

The decision of the court, while not a decision of an appeal court, is of significance in that it questions yet again whether the doctrine of strict compliance has any place in South African law. At the very least, the judgment serves to limit the scope of application of the "doctrine of strict compliance".

By *Rob Scott, Zara Sher* and *Zoë Wein*

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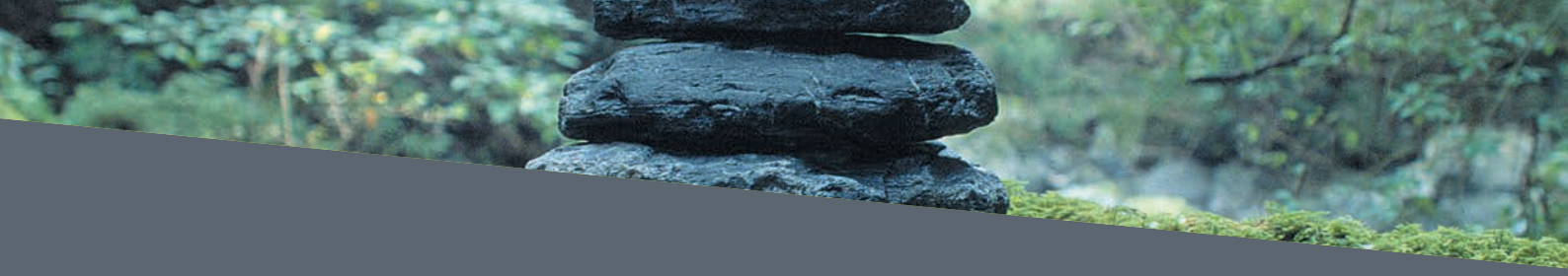


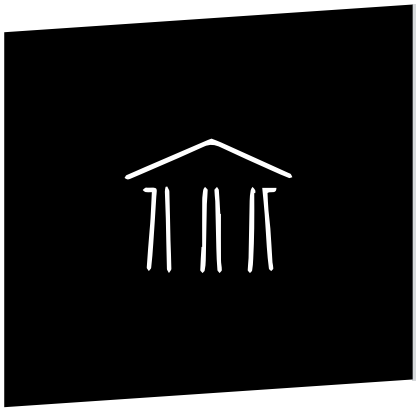
Part Five | The controversial defective workmanship exclusion in construction all risks insurance policies

The application of defective workmanship exclusion clauses in the context of construction insurance covers, more specifically contract works insurance, very often presents as a bone of contention. **Contract works insurance covers are known variously and amongst others as construction all risks ("CAR"), contract works all risks, builders' all risks, contractors' all risks and erection all risks insurance covers**.

Defective workmanship exclusion clauses serve to exclude cover for the cost of redoing/remedying defective workmanship and ensure that the insured contractor is not paid twice for work done. The cost of remedying such defects is regarded as a commercial or business risk to be borne by the insured.

Such clauses will often contain an exception ("carve-back") within the clause which writes back cover for resultant damage to property, in other words, damage which is the consequence of defective workmanship. The contentious issue centres on the complexity of the divisibility between the defective work and the resultant damage. Adding to the complexity is that the defective work and the resultant damage may be in respect of the same property. Equally, the defective work and resultant damage may be in respect of different property, whether or not in close proximity to each other.

It is interesting to consider legal cases involving the application of defective workmanship exclusion clauses (notwithstanding the very often widely differing wordings of such clauses), to understand how courts in each instance draw the line between defective work and resultant damage. While there is a dearth of reported decisions in South Africa relating to the interpretation of such clauses, builders all risks policies are widely used in Canada, and the Canadian courts have, in recent years, provided numerous decisions to consider.



The latest Canadian decision (2020) is that of the Alberta Court of Appeal in ***Condominium Corporation NO. 9312374 v Aviva Insurance Company of Canada***. The decision involved the interpretation of a faulty workmanship exclusion clause in the context of an assets all risks policy which provided broad coverage to the Insured against "all risks" of direct physical loss or damage to the property. In coming to its decision, the court had regard to and applied the principles adopted in prior decisions of the Canadian courts, in the context of builders all risks covers, thereby extending those principles into the sphere of assets covers. The following is a summary of the

The Contractor was employed to provide repair and remediation work to a parking surface in a parkade area.

The scope of work included cutting into the membrane of the parkade's surface. The Contractor was not to perform any work that would impact the structural integrity of the underlying concrete slab. In stripping the membrane from the parkade surface, the Contractor damaged the surface work to the parkade and cut too deeply into the parkade slab, causing damage to the structural integrity of the parkade.

The policy covered all risks of direct physical loss of, or damage to the insured property, but contained a faulty workmanship exclusion clause. The exclusion clause provided that coverage "does not insure the cost of making good faulty or improper workmanship". The application of the exclusion clause was however limited by an exception ("carve back") which read:

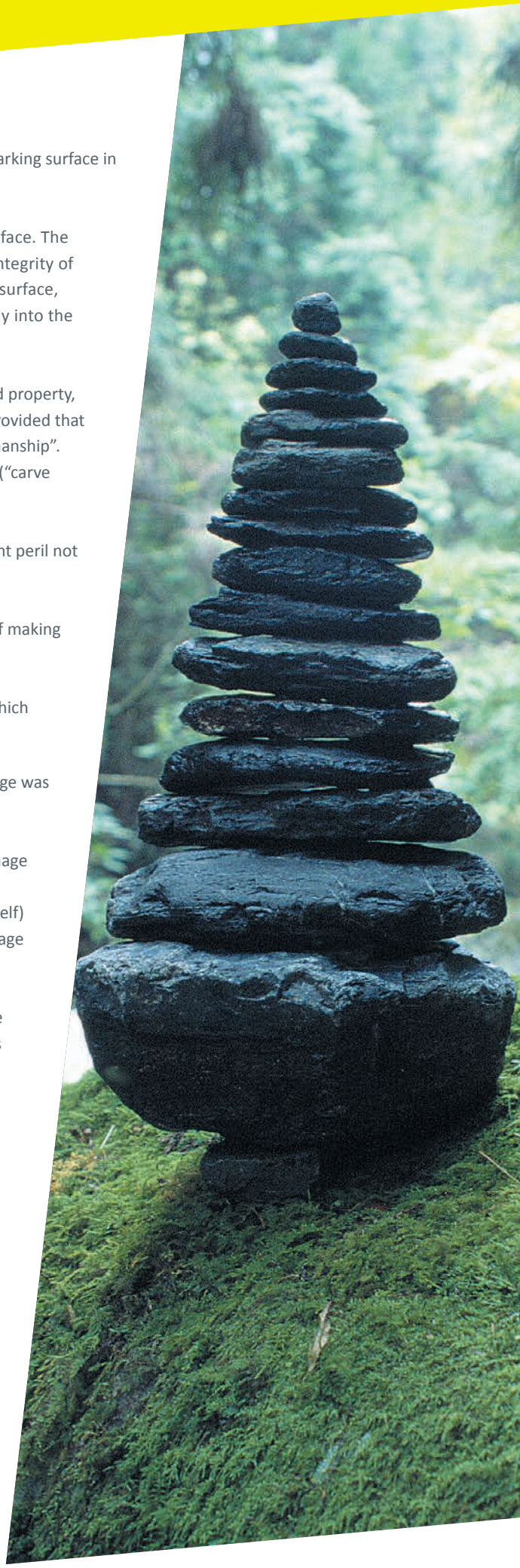
"This exclusion does not apply to loss or damage caused directly by a resultant peril not otherwise excluded…"

The Insurer had denied coverage on the basis of the exclusion for "the cost of making good faulty or improper workmanship" for the entire claim, being:

- the cost of the repair and remediation work to the parkade membrane (which costs the parties agreed were excluded from cover by the policy); and
- the damage caused to the structural integrity of the parkade (which damage was "not otherwise excluded" by the policy).

The issue was whether the loss suffered by the Insured as a result of the damage caused to the structural integrity of the parkade (as opposed to the damage caused by the Contractor's faulty workmanship to the parkade membrane itself) fell within the exception (carve back) to the exclusion clause for "loss or damage caused directly by a resultant peril not otherwise excluded".

The Contractor argued that the loss of structural integrity was a consequence of its actions, and had to be regarded as separate from the damage due to its faulty workmanship. The Insurer argued that such a separation was artificial, and that the negligent cutting and resultant damage to the parkade were all attributable to the Contractor's faulty workmanship and therefore fell within the exclusion clause.



The court held that any consideration of what constitutes faulty or improper workmanship was limited to the scope of the contract. The court accordingly interpreted the words "resultant peril" in this instance to mean "the loss of structural integrity to the parkade", in other words, the risk of structural collapse, and found that the resultant peril, or consequence (loss of structural integrity), was not excluded under the policy.

Comment and analysis

Importantly, the division between defective workmanship and the resultant damage was drawn with reference to the scope of the underlying contract. It should be observed that on the facts of this matter, the exact scope of work was easy to ascertain, but that is not always the case. A number of tests have been applied by the courts, but it is clear that there is no one extricable test or workable approach for all instances.

In terms of Canadian law, there are three interpretive principles:

- the reasonable expectation of the parties;
- the commercial reality; and
- that exclusion clauses are to be narrowly interpreted.

In relation to the application of these principles to the policy in the present matter, the court disagreed with the broad reading of the exclusion clause, as maintained by the Insurer, as such an interpretation "would exclude the cost of making good the consequences of faulty workmanship", and held:

> "We agree that the interpretation advanced by the Condo Corp [the contractor] fulfils the reasonable expectations of the parties: broad coverage for fortuitous or unexpected loss and damage. The cost of making good the faulty workmanship – in this case, a significant sum of approximately $500,000.00 - is excluded from coverage. This achieves the commercial purpose of ensuring that the contractor and engineer are not paid twice for their faulty workmanship. However, the property damage (loss to the structural integrity of the building) is covered. This is not a situation where this court's interpretation leads to coverage not otherwise contemplated by the terms of the policy read as a whole".

The interpretive principles in South African law are not dissimilar to those in the Canadian law. Accordingly, a South African court would be expected to take cognisance of a decision of a Canadian court, and might even be persuaded to follow a decision of a Canadian court.

A typical defective workmanship exclusion clause in the South African market might read as follows:

"The policy does not cover insured property which is in a defective condition due to a defect in workmanship of such insured property or any part thereof but this exception shall not apply to other insured property which is free of the defective condition but is damaged in consequence thereof".

Based on such a wording, and the facts in this matter, in our view, a South African court would be likely to come to a decision similar to that of the Canadian court.

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