How far does product liability indemnity for economic loss extend?

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AT A GLANCE

- At the heart of a typical product liability policy is the embedded concept that the policy responds to injury to tangible property and its consequences.
- Typically, a recoverable product liability claim under the standard wording involves the legal liability for the physical loss caused by a product to a third party.
- However, recent claims have tested whether product liability indemnity extends to damages for loss of profit arising from the loss of contracts.
- This remains an unresolved question in Australian law.

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STANDARD PRODUCT LIABILITY POLICIES

A product liability policy usually involves an insuring clause and a definition of 'property damage'. For example:

> *"The Insurers will pay to or on behalf of the Insured all sums which the Insured shall become legally and liable to pay by way of damages … in accordance with any law of any country or issued under contract or agreement by reason of or arising out of Personal Injury or Property Damage … arising out of an Occurrence … in connection with the Insured's Business or Products."*

Property damage is usually defined to have two aspects:

- physical injury to tangible property, including resulting loss of use of that property, and
- loss of use of tangible property that is not physically injured, provided the loss of use is caused by physical damage to other tangible property.

In the clause above, physical damage to property is the trigger for the operation of the policy. For example, if an industrial enterprise catches fire because of machinery breakdown, the policy indemnifies for the physical consequences of the fire and the time it takes for the enterprise to reach its previous level of business.

The compensation for the period of time is usually reflected in a claim for economic loss or a loss of profits. The measure of any loss is bounded by legal liability and the usual principles of proof of loss. In the example, the industrial enterprise was able to recover its economic loss until the business was re-established.

THE EXTENT OF INDEMNITY FOR ECONOMIC LOSS QUESTION

An unresolved question in Australian law is how far does the indemnity for economic loss extend? In other words, what do the words *"by reason of or arising out of … property damage"* mean and are there restrictions in the insuring clause of the extent of indemnity?

In a claim handled by this office, an insured manufacturer made products out of fibreglass. A fibreglass ingredient was defective, which meant the manufacturer had to repair swimming pools it had supplied. Under the policy, these repairs were admissible on the specific technical facts of the claim. However, the manufacturer further claimed that it had lost other contracts because of the failures of pools. The insured argued the loss of the contracts was going to have an impact on its long-term business, so it sought a loss of profit claim over many years.

This raised the question of whether the loss was recoverable in contract (as a loss that flowed from the contract breach), or whether it was a loss covered under the product liability policy.

RECENT GUIDANCE ON THE ISSUE

Construction of insurance policies begins with an objective analysis of the words in the context of what the policy is intended to secure. In commercial insurance, it is often said that the policy must reflect the insured's business requirements.

The UK Courts have clearly indicated in several decisions[1] that claims for loss of future contracts are not covered under the standard wording of a product liability policy (in the absence of an extension for financial loss).

For example, in *Redoxan International Ltd v CGU* [1999] Lloyd's Reports IR 495, the claim involved a supply of soap powder in cartons that were defective. The matter included a claim for the loss because the soap powder needed to be replaced, as well as a claim for loss of profits, due to the loss of a customer. In *Redoxan*, the insured argued it would have continued supplying soap powder to the customer over a lengthy period of time had there been no claim.

In the Court of Appeal, Lord Justice Hobhouse's leading judgment said:

> *"The liability of the Assured in damages will have to be expressed in terms of money, but that liability must be in respect of the consequences of the physical loss or damage to physical property.*
>
> *Items 3 and 4 in the claim of Newbright were not of such a character. They relate to the future non-performance of obligations of Redoxan towards Newbright. They do not relate to any quantification of the loss which Newbright suffered as a result of the relevant physical occurrence, the staining of the cartons."*

The Court accepted that there was a limitation on the scope of a product liability wording that operated to indemnify an insured for economic loss regarding liability arising out of property damage caused by a product. The Court indicated that the liability was limited to the indemnity for the actual physical loss, and to the resulting economic loss for the period of that loss – and no more. Economic loss resulting from the property damage beyond the time taken to remediate it was excluded.

THE ISSUE FOR INSURERS DOING BUSINESS IN AUSTRALIA

There is a legitimate distinction to be drawn between liability for causing physical harm and a liability for breaching a contract.

Product liability policies have not traditionally been a proxy for guaranteeing commercial rights, such as fitness for purpose. Rather, they are designed to respond to loss or damage caused by a product.

If this issue arises in Australia, insurers should take comfort from the body of law that is favourable to confining the loss to the economic loss in the period in which the physical loss occurred for the time it takes to remediate the loss.

That approach is consistent with the standard definition of 'property damage' provided earlier. As the wording refers to "physical loss", it is reasonable to argue that the limit to the loss is confined to the "physical event".

References

[1] *James Budgett Sugars* [2002] EWHC 968
A.S. Screenprint v British Reserve [1999] Lloyd's Reports IR 430

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Need to know more?

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