



NARROWING EXCLUSION CLAUSES

Introduction

The High Court has recently considered whether an insurer can decline indemnity based on the operation of an efficacy clause in a product liability policy. The High Court was unanimous in overturning the decision of the Queensland Court of Appeal. In this respect, the decision comes as a useful reminder to the market of the need for rigorous assessment of declinatures.

Facts

The appellant, Selected Seeds, was a seed merchant. It purchased and on-sold Jarra seed. Jarra seed produces a hay crop widely used as quality stock feed. The Jarra seed was purchased, planted, harvested and on-sold several times prior to it ultimately being sold to a grazier (Mr Shrimp).

The Jarra seed was contaminated with Summer grass (a weed). With each progressive harvest, the presence of Summer grass seed increased. By the time that the Jarra seed was sold to Mr Shrimp, it was almost entirely composed of Summer grass. Mr Shrimp reaped only Summer grass. He brought proceedings to recover damages (ie the cost of eradicating the Summer grass from the land and the loss of the use of the land). Selected Seeds was eventually joined as a party to those proceedings. Mr Shrimp's claim was settled. Selected Seeds made a significant contribution to the settlement. Selected Seeds sought indemnity from its insurer, the respondent, in respect to the settlement of Mr Shrimp's claim. It was not disputed that the settlement was reasonable.

The insurer declined indemnity and relied upon an efficacy clause in the policy. That clause excluded liability caused or arising from the failure of any product to fulfil its intended use or function and/or meet the level of performance, quality, fitness or durability warranted or represented.

Selected Seeds had taken out a broad form liability policy (**policy**), which provided indemnity against public liability and product liability. In short, the policy provided cover to Selected Seeds for '*property damage*' which included '*physical damage to or loss or destruction of tangible property including any resulting loss of use of that property*'. The policy schedule contained endorsements which formed part of the policy. The efficacy clause was in the following terms:

'The following additional exclusion is added to the policy:

This policy does not cover any liability arising directly or indirectly from or caused by, contributed to or arising from:

the failure of any product to germinate or grow or meet the level of growth or germination warranted or represented by the insured; or

the failure of any product to correctly fulfil its intended use or function and/or meet the level of performance, quality, fitness or durability warranted or represented by the insured.'

At first instance

The trial judge¹ found for Selected Seeds and concluded that liability for damages arose, not from what the product failed to do (ie grow Jarra grass), but from the damage that the product caused to Mr Shrimp's land.

¹ McMurdo J (*Selected Seeds Pty Limited v QBEMM Pty Limited* (2009) 15 ANZ Insurance Cases 61-799).

The insurer appealed to the Queensland Court of Appeal.

Court of Appeal

The Queensland Court of Appeal² allowed the insurer's appeal. The Court of Appeal held that Selected Seeds' liability to Mr Shrimp arose because the seed supplied by it did not fulfil its represented or warranted quality as Jarra seed or fulfil its intended function by producing Jarra grass. The Court of Appeal read the exclusion clause independently of the balance of the policy. It formed the view that the liability excluded by the clause was all liability connected with the failure of a product to fulfil its purpose. Applying a broad and literal interpretation of the efficacy clause, the liability for which indemnity was sought was excluded.

Selected Seeds appealed to the High Court.

High Court

On 3 November 2010, the High Court handed down its judgment in respect to the appeal.³ In short, the High Court considered whether the Queensland Court of Appeal was wrong in adopting a literal construction of the efficacy exclusion clause, in the context of a broad form products liability policy.

The insurer's principal argument was that the Jarra seed's function was to produce a Jarra grass crop. The Jarra seeds did not fulfil that function and therefore the liability arose from its failure to fulfil its intended function. Accordingly, the efficacy clause was activated and cover was excluded. This was the argument that the Queensland Court of Appeal accepted. In short, the argument was the efficacy clause was to be read broadly, and as such it excluded any liability arising from the failure of the product to fulfil its use.

Selected Seeds argued that the Jarra seed did not merely fail to produce sheet Jarra grass. It said the Jarra seed did more than that. It produced a weed that had to be removed. This was characterised as property damage. Thus, the efficacy clause had no application based on that analysis.

The distinction between a failure of a product to fulfil its function and the failure of a product which causes actual damage has been considered in previous product liability cases.⁴

By unanimous decision, the High Court held that liability excluded by the efficacy clause should be interpreted as liability arising from property damage caused by contaminated seed. The damage to Mr Shrimp's land did not arise out of the failure of the Jarra seed to fulfil its function to produce Jarra grass. Instead, the damage was caused by the introduction of a weed (Summer grass) to Mr Shrimp's land. This caused Mr Shrimp to incur costs in removing the weed and loss caused by the loss of the use of the land.

The High court rejected the Court of Appeal's broad and literal approach to the construction of the exclusion clause. The High Court confirmed that the exclusion clause must be read in the context of the policy as a whole.

Observations

The High Court's decision brings further clarity to the construction of exclusion clauses. The Queensland Court of Appeal had considered that the exclusion clause should be construed independently of the balance of the policy. The High Court considered that the exclusion clause should not be read independently of the policy as a whole. In other words, it was incorrect to apply a broad definition of the liability excluded by the efficacy clause, in circumstances where the insuring clause stated that an insured was entitled to indemnity for claims arising from property damage.

This case emphasises the differing approaches to policy interpretation that can arise in a coverage disputes. This High Court's decision reinforces the basic principle that insurance policies are to be read as a whole, with exclusions being read in context. It provides a timely

² Holmes, Fraser JJA and White J (*Selected Seeds Pty Limited v QBEMM Pty Limited, QBE Insurance (Australia) Limited* [2009] QCA 286).

³ *Selected Seeds Pty Ltd v QBEMM Pty Ltd* [2010] HCA 37.

⁴ *John Wyeth & Bros Limited v Cigna Insurance Company of Europe SA/NV* [2001] EWCA CIV 175.

reminder that great care should be taken when determining the basis upon which to deny cover, especially in circumstances where reasonable minds differ in respect to how the exclusion may operate.

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