IUA OF LONDON

INTERNATIONAL UNDERWRITING ASSOCIATION

# FINANCIAL LOSS.

## What is it, and when is it covered?

A report from a Working Party of the IUA's Liability Underwriters' Group in association with RPC

RPC

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# Preface

The area which this book covers is complex and uncertain for a number of reasons. First, there is a confusing range of expressions in common usage which do not have a uniform legal definition: financial loss, pecuniary loss, economic loss, pure economic loss and so on.

Secondly, the law about the recovery of such losses, in contract or in tort, can be tricky and confusing, as the examples in the book show. Not all decisions of the courts can be easily reconciled.

Thirdly, the strengths of the insurance market include its ability to adapt to changes in the law and the flexibility of the products offered, but the variety of terms offered can itself be a source of confusion and can impede the development of general market understanding.

This book provides a valuable guide for market professionals. It should help them to a better understanding of the ways in which an insured may be exposed to liability for financial loss and the effect of the forms of cover available. It does not attempt to provide answers to all the questions which may arise, but it should assist market professionals to identify potential pitfalls and to choose appropriate policy wording.

**Roger Toulson**

# Introduction

**It is important to understand liability for "financial loss" and when it is covered, particularly at a time when "financial loss" cover is increasingly given as an extension to general liability policies.**

English law divides situations into two:

- situations where there has been physical injury or damage, and
- situations where there has not.

"financial loss" as understood by insurers exists only in the second situation.

Therefore the way the law changes, and the insuring of "financial loss", are intimately bound up with each other.

It is in the law of **tort** that most of the legal changes have taken place, particularly the tort of negligence. Much of Part 1 of this guide is taken up with these changes, and how the two main strands have developed:

- physical injury or damage cases – the *Donoghue v Stevenson*[1] strand – **strand 1**
- special relationship cases – the *Hedley Byrne v Heller*[2] strand. – **strand 2**

Generally, in order for there to be a liability for "financial loss" in negligence, there has to be a special relationship – the facts have to come within strand 2.

The law of **contract**, under which liability for "financial loss" is regularly incurred, has developed less dramatically. However, where an insured has entered into a contract the question often arises of whether he or she has a liability in tort at the same time. This is known as **concurrent liability**, and this is something of a moving legal target. It is important, because

- many policies restrict cover for liability in contract.
- claims in contract usually become barred sooner than claims in tort, so claims can often only be advanced in tort.

There is also an ever increasing exposure to liability under **statute** in almost every area of commerce. Sometimes such liability arises where there has been physical injury or damage, and sometimes where there has not.

In order to understand how liability for "financial loss" arises, it is of course necessary to understand what is actually meant by "financial loss". There is plenty of scope for confusion here. For example, what are the differences between the following?

- economic loss
- pure economic loss
- consequential loss
- "financial loss"

The answers are in Box 1 .

"Economic loss" and "pure economic loss" have clear meanings in law – they are the phrases used by judges. Judges almost never refer to "financial loss", and yet, as mentioned in Box 1, that is the phrase usually used by insurers to refer to what the law calls "pure economic loss".

This guide will adopt the meanings in Box 1. Where appropriate, it will tend to use the more legally precise phrase "pure economic loss" in preference to "financial loss".

1 See [page 7/ Case 1]

2 See [page 14/ Case 12]

## Key questions

This guide aims to assist in finding the answers to five key questions. The right answers should lead to the right analysis of liability and coverage in relation to pure economic loss.

## Key questions – legal liability

1. Is there a legal liability for this kind of loss?

2. If so, is it just in contract, just in tort, in both concurrently, or under statute?

3. Is the liability for all of the loss or just part of it?

## Key questions – insurance coverage

1. Is the legal liability and the kind of loss within the scope of the insuring clause?

2. Is cover for the legal liability or the kind of loss limited by any exclusion?

## Format of this guide

This guide is in five parts

- what 'financial loss' is and how liability for it arises
- when 'financial loss' is covered
- 'financial loss' in certain other countries
- future trends
- frequently asked questions.

### Box 1: important definitions

**Economic loss**: pecuniary loss consequential on injury or damage.

**Pure economic loss**: pecuniary loss not consequential on injury or damage.

**Consequential loss**: often used to mean economic loss.

**'Financial loss'**: a term usually used by insurers to mean pure economic loss, but often loosely used to mean any of the above. Three example policy definitions:

- A pecuniary loss cost or expense incurred by any person other than the insured
- A pecuniary loss cost or expense incurred by any person other than the insured resulting from the sale or supply of Products
- A pecuniary loss cost or expense and not occasioned by injury or loss of or damage to property

Financial Loss Guide Part 1

# What is ‘financial loss’ and how does liability for it arise?

## Third party not first party loss

The first point to clarify is that this guide is concerned with liability to others – third parties – for their pure economic loss, and with cover under liability policies. It is not concerned with losses the insured itself suffers – first party losses – so will not consider property or business interruption insurance.

## Dependence on liability principles

The second point to make is that the reason insurers define 'financial loss' in the way they do (as, for example, in Box 1) is because it is closely linked to how the liability for such loss arises. 'financial loss', or as this guide will generally call it from now on, pure economic loss, cannot be properly understood without a good understanding of liability law. Box 2 outlines the main areas of liability law.

This guide now considers pure economic loss in the context of:

- the tort of negligence – strand 1
- the tort of negligence – strand 2
- contractual liability
- liability in tort and contract at the same time
- statutory liabilities
- the tort of nuisance and various other torts.

**Box 2: liability law**

**Tort**: a civil wrong for which the law imposes liability. This can be a liability to the public at large, or to another individual because of the nature of the relationship. The remedy is an award of damages which will so far as possible put the innocent party in the same position as if the wrong had not been committed. The most relevant tort so far as pure economic loss is concerned is negligence, closely followed by those often covered as standard in liability policies such as:

- nuisance
- trespass
- interference with rights such as rights of way, air, light or water

**Contract**: a private agreement or bargain whose terms the law will enforce. In the event of breach, the innocent party is, so far as money can do it, to be placed in the same position as if the contract had been performed.

**Statute**: statutes can impose civil liability where none would exist in tort or contract, for example liability for clean-up costs under environmental legislation, or under the Consumer Protection Act 1987 in relation to the supply of products. There are also statutes which imply terms into some contracts (for example the Sale of Goods Act 1979 implying terms as to fitness and quality) and the Unfair Contract Terms Act 1977 restricts the scope for parties to limit their liabilities in some contracts.

# The tort of negligence – strand 1 – physical injury or damage cases

Case 1 illustrates how decisions of fundamental legal importance can be based on the most mundane of circumstances. It sets out the neighbour principle that applies in cases where there is injury or damage.

**Case 1 – Donoghue v Stevenson [3]**

David Stevenson was a maker of ginger beer in Paisley near Glasgow. His ginger beer was on sale in the Wellmeadow Café in Paisley. On Sunday 28th August 1928, May Donoghue and a friend entered the café, and the friend bought ice cream and ginger beer for Mrs Donoghue. Mr Minchella, whose café it was, brought over the ice cream in a tumbler and poured on it some ginger beer from a brown opaque bottle. Mrs Donoghue drank some, and while her friend was refilling her glass, it is said that Mrs Donoghue saw floating out of the bottle what she believed to be the partially decomposed remains of a snail. She became ill suffering from severe shock and gastro-entiritis.

Since this was of course before the days of the *Consumer Protection Act 1987*[4], Mrs Donoghue could not sue Mr Minchella, as he had not been negligent, and she had no contract with him. Mr Minchella's contract (a contract of sale) had been with the friend. Her only option was to make new law and sue Mr Stevenson, the manufacturer. Until then, manufacturers could only be sued in contract. Indeed, there had just been two unsuccessful cases against another manufacturer involving decomposed mice in ginger beer. However, the lawyer in the mouse cases took on Mrs Donoghue's case free of charge.

The Scottish Appeal Court followed its decisions in the mouse cases, saying the only difference between those cases and Mrs Donogue's was the difference between a rodent and a gastropod, a difference which had no effect in law. Mrs Donoghue appealed to the House of Lords. In breaking new legal ground, Lord Atkin memorably stated:

"You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who then in law is my neighbour? The answer seems to be persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question."

This is the well known **neighbour principle**.

In applying this principle to the facts he set out the duty owed by manufacturers in cases where there is injury or damage:

"A manufacturer of products, which he sells in such a form as to show that he intends them to reach the ultimate consumer in the form in which they left him with no reasonable possibility of intermediate examination, and with the knowledge that the absence of reasonable care in the preparation or putting up of the products will result in an injury to the consumer's life or property, owes a duty to the consumer to take that reasonable care."


## Economic loss

In injury and damage cases, claimants will recover both compensation for the injury or damage, and consequential economic losses. For example:

- personal injury claimants will recover earnings lost during the period in which they are affected by the injuries, including earnings that will be lost in the future as the provable consequence of the injuries
- in a car damage case, the claimant will recover earnings lost (if for instance the claimant is a taxi driver) whilst the car is being repaired
- in a building damage case, loss of rent can be claimed whilst the property is being repaired.

## Economic loss and pure economic loss

As Box 1 explained, in this guide "economic loss" is consequential on injury or damage, while "pure economic loss" is not. This guide concentrates on pure economic loss, since, as already mentioned, that is what insurers usually mean by 'financial loss'.

## Where to draw the line

In many cases, not all the loss that is suffered following the injury or damage will be recoverable. The test in negligence for whether the damage is too remote is **whether the type of harm is reasonably foreseeable**.

The damage may be **too remote** from part of the loss, or (according to Lord Denning in *Spartan Steel & Alloys Ltd v Martin*, as an alternative way of looking at it) there may be **no duty** in respect of part of the loss.

3 [1932] UKHL 100

4 This Act imposes strict liability for injury or damage caused to consumers by defective products.

In *Spartan Steel* - Case 2 - the line was drawn between

- physical loss and the loss of profit consequent on it, and
- the loss of profit which was too remote from any physical damage which had been suffered.

**Case 2 – Spartan Steel & Alloys Ltd v Martin [5]**

Spartan Steel's factory's power supply was via a cable from a Midlands Electricity Board power station. Martin & Co, contractors, were working on a road and managed to damage the cable. Spartan Steel were without power for 14.5 hours. They suffered three kinds of loss:

- physical loss of the melt which had to be removed from the furnace: £368
- loss of profit on that melt: £400
- loss of profit from not being able to do four more "melts" they would have done: £1,768

Martin & Co accepted liability for the first, and was not seriously contesting liability for the second. Both resulted from the damage to Spartan's melt. The appeal was about whether Spartan Steel should recover the third, and the Court of Appeal decided it could not. It was too remote, alternatively there was no duty in respect of it.

It is also relevant to note that the damage which caused the third loss was the damage to the Electricity Board's cable, so not damage to anything owned by Spartan Steel. This is an example of the exclusionary rule, which is explained in Box 3.

In the Network Rail cases highlighted in Case 3, the pecuniary losses were held to be sufficiently closely associated with the physical damage to be recoverable.

**Case 3 – Network Rail v Conarken Group, Network Rail v Farrell Transport [6]**

Conarken Group's and Farrell Transport's lorries caused damage to Network Rail's property. Network Rail claimed

- the cost of repairing the damage, and
- compensation payments ("Schedule 8 sums") made to the affected Train Operating Companies under contractual arrangements between them and Network Rail, because of the resulting line closures.

The first of these was clearly recoverable. As regards the economic loss – the Schedule 8 sums - they were **"demonstrably consequential"** upon the physical damage. They resulted directly from Network Rail not being able to make the tracks available for the periods of delays, which in turn had been directly caused by the physical damage for which Conarken and Farrell were responsible.

Conarken and Farrell had accepted that the Schedule 8 sums were based on a reasonable assessment of the Train Operating Companies' losses flowing from the temporary closure of the lines. The fact that such sums were paid through a contract between the claimant and a third party was no bar to recovery.

Lord Justice Jackson took the opportunity to distil four principles from a long line of cases, as follows:

- Economic loss which flows directly and foreseeably from physical damage may be recoverable. The threshold test for foreseeability does not require the tortfeasor to have any detailed knowledge of the claimant's business affairs or financial circumstances, so long as the general nature of the claimant's loss is foreseeable.
- One of the recognised categories of recoverable economic loss is loss of income following damage to revenue generating property.

5 [1973] QB 27

6 [2011] EWCA Civ 644

- Loss of future business as a result of damage to property is a head of damage which lies on the outer fringe of recoverability. Whether the claimant can recover for such economic loss depends on the circumstances of the case and the relationship between the parties.
- In choosing the appropriate measure of damages for the purposes of assessing recoverable economic loss, the court seeks to arrive at an assessment which is fair and reasonable as between the claimant and the defendant.

Each case turns on its own facts, and knowing where to draw the line is not easy. There can also be problems with whose property is damaged, and the so-called **exclusionary rule**, which is considered next.

## Does it matter whose property is damaged?

Yes. If the claimant does not have a sufficient interest in the damaged property, even if it depends upon that property, the normal rule – **the exclusionary rule** – is that it cannot claim for any pecuniary loss it suffers.[7] This type of pecuniary loss is sometimes referred to as **relational economic loss**.

An example of such a situation is where a driver damages a bridge causing its closure. Many people who use the bridge are put to greater expense in having to use a different route. However, they cannot recover their losses from the driver if the bridge is not their property. For there to be a legal liability on the driver, there has to be some special relationship between the person suffering relational economic loss and the driver – mere dependence on the damaged property is not enough.

For the rationale behind this rule, see Box 3.

An illustration of the exclusionary rule is the foot and mouth case of *Weller* – Case 4.

**Case 4 – Weller v Foot and Mouth Disease Research Institute [9]**

In 1960, cattle on a farm near the Foot and Mouth Disease Research Institute in Pirbright in Surrey became infected with the disease, which was assumed to have escaped from the Institute. Movement of cattle in the area ceased, and cattle auctions had to be cancelled. The claim was made against the Institute by Weller, a firm of auctioneers which had lost income due to the cancellations.

While farmers whose cattle had been harmed could sue, the auctioneers' claim failed because they had no proprietary interest in anything which could be damaged by the escape of the virus - their claim was caught by the exclusionary rule and was for pure economic loss.

Widgery J explained the rationale: "The world of commerce would come to a halt and ordinary life would become intolerable if the law imposed a duty on all persons at all times to refrain from any conduct which might foreseeably cause detriment to another."

History repeated itself because Pirbright, the location of Case 4, was the scene of another escape of the disease in 2007, and the subject of another High Court decision, this time the claim being by farmers, some of whom were as far away as Cumbria.[10]

The farmers' cattle were not infected, but they became less valuable because they lost condition and had welfare problems, due to the movement restrictions imposed. It was held that their loss was pure economic loss because there was no physical damage to any of their property, so their claim failed.

**Box 3: the rationale for the exclusionary rule**

This rule may seem an unfair one, and one which denies justice to an additional group of claimants. The courts recognise this, but the rationale is:

Courts of justice should not "allow themselves, in the pursuit of perfectly complete remedies for all wrongful acts, to transgress the bounds, which our law, in a wise consciousness … of its limited powers, has imposed on itself, of redressing only *the proximate and direct consequences* of wrongful acts." [8]

This argument against expanding the bounds of liability has come to be known as the **floodgates argument**.

7 *Cattle v Stockton Waterworks Co* (1875) LR 10 QB 453

8 Coleridge J in *Lumley v Gye* 2 E&B at page 22, as quoted in Cattle, supra, as in turn quoted in *Shell UK Ltd v Total UK Ltd* [2010] EWCA Civ 180

9 [1966] 1 QB 569

10 *D Pride & Partners v Institute for Animal Health* [2009] EWHC 685

*Spartan Steel* can also be analysed as a case involving the exclusionary rule, with the loss of profit on melts which were not made being caught by that rule (see Case 2).

In these cases the claimants had no interest in any relevant damaged property. This leads to the next question.

What kind of interest in the damaged property is sufficient?

- Ownership of legal title? Yes.
- Possessory title (i.e. in possession or a right to possession)? Yes.
- Contractual interest? No – see Case 5.
- Beneficial interest? Yes – see Case 6.

**Case 5 – Leigh & Sillavan Ltd v Aliakmon Shipping Co Ltd [11]**

Leigh & Sillavan, the claimant, agreed to buy cargo shipped on the defendant's ship, the Aliakmon. Because of poor stowage the cargo was damaged. At the time of the damage, Leigh & Sillavan was not the owner of the cargo but under the purchase contract had assumed the risk of it.

As the property was owned by a third party at the time it was damaged, Leigh & Sillavan had no claim. Lord Brandon in setting out the exclusionary rule said:

"in order to enable a person to claim in negligence for loss caused to him by reason of loss of or damage to property, he must have had either the legal ownership of or a possessory title to the property concerned at the time when the loss or damage occurred, and it is not enough for him to have had only contractual rights in relation to such property which have been adversely affected by the loss of or damage to it."

The Buncefield explosion provided the occasion for clarification of the exclusionary rule, namely that a claimant with beneficial ownership was not caught by the rule – see Case 6.

**Case 6 – Shell UK Ltd v Total UK Ltd [12]**

Shell used tanks and pipelines at the Buncefield depot for storage and distribution of its oil. The explosion caused damage to the tanks and pipelines. Shell's losses were

- loss or damage to its own fuel in the relevant tanks and pipelines
- loss suffered through inability to supply fuel to customers at pre-explosion volumes or cost.

Total accepted liability for the first of these but not the second. Total said that only a legal owner of the damaged property or someone with an immediate right to possession has the right to claim damages for economic loss which is the consequence of damage to property.

Legal title to the tanks and pipelines was in two service companies which held them on trust for Shell and three other companies.

The Court of Appeal held that because Shell was one of four equitable co-owners of the two service companies, they had a beneficial interest in the property which the service companies held on trust for them. That was sufficient to get round the exclusionary rule and Shell was entitled to recover the second type of loss.

## What is "damage"?

The law treats the presence or absence of physical injury or damage as fundamental. It determines which of the two main strands applies – the injury or damage cases, or the special relationship cases (see the Introduction on page 3) – and hence whether there is a liability for the pure economic loss in question.

However, what the law means by "damage" is not easy to work out, and may not always seem logical.

## Damage to other property

Where physical damage is required, it has to be to property other than the thing which caused the damage.

## Does damage to the thing itself count as damage?

No. It may seem odd, but the cost of repair or replacement of the thing that caused the damage is regarded as a pecuniary loss. These principles are usefully set out in the leading case of *Murphy v Brentwood DC* - see Case 7.

11 *(The Aliakmon)* [1986] AC 785

12 [2010] EWCA Civ 180

**Case 7 – Murphy v Brentwood DC [13]**

Mr Murphy bought a new house which had been built on defective foundations. Cracks appeared, and it became an imminent danger to the health and safety of its occupants.

Mr Murphy sold the house in its defective state to a builder for £30,000. Its value free of defects would have been £65,000, so his loss (which he recovered from his insurer Norwich Union) was diminution in value of £35,000.

Norwich Union sought to recover the £35,000 from Brentwood District Counsel on the basis it had negligently approved the foundation design. The House of Lords held that the Council was not liable, because the cost of repairing the defective building was purely economic.

While *Murphy* was a building case, Lord Bridge in *Murphy* drew parallels with cases involving products. It is worth looking at what he said about negligence liability first in the products context and then in the building context.

## Negligence and damage in the context of products

In *Murphy* Lord Bridge paraphrased the principle derived from *Donoghue v Stevenson* (Case 1) which sets out the basis of a product manufacturer's duty to those harmed by the product (or "chattel" which is the word he uses for product):"If a manufacturer negligently puts into circulation a chattel containing a latent defect which renders it dangerous to persons or property, the manufacturer...will be liable in tort for injury to persons or damage to property which the chattel causes."

However, there are situations where the product has caused no damage to other property, or where it may be likely to cause damage to other property but has not done so yet. What Lord Bridge said about this is in Box 4.

## Negligence and damage in the context of buildings

Buildings are in effect just another kind of product. They may tend to be more complex, with many parties contributing to the completed building, but they are still "things". Accordingly it is helpful to know that the same broad legal principles apply to both buildings and products, and these are set out in Boxes 4 and 5.

### Box 4: negligence in the context of products

**Lord Bridge on products causing no injury or damage**: "...if a manufacturer produces and sells a chattel which is merely defective in quality, even to the extent that it is valueless for the purpose for which it is intended, the manufacturer's liability at common law arises only under and by reference to the terms of any contract to which he is a party in reference to the chattel; the common law does not impose on him any liability in tort to persons to whom he owes no duty in contract but who, having acquired the chattel, suffer economic loss because the chattel is defective in quality."

**Lord Bridge on dangerous products where damage may be imminent**: "If a dangerous defect in a chattel is discovered before it causes any personal injury or damage to property, because the danger is now known and the chattel cannot be safely be used unless the defect is repaired, the defect becomes merely a defect in quality. The chattel is either capable of repair at economic cost or it is worthless and must be scrapped. In either case the loss sustained by the owner or hirer of the chattel is purely economic. It is recoverable against any party who owes the loser a relevant contractual duty. But it is not recoverable in tort in the absence of a special relationship of proximity imposing on the tortfeasor a duty of care to safeguard the plaintiff from economic loss. There is no such special relationship between the manufacturer of a chattel and a remote owner or hirer."

### Box 5: negligence in the context of buildings

**Lord Bridge on damage and buildings**: "I believe that these principles are equally applicable to buildings. If a builder erects a structure containing a latent defect which renders it dangerous to persons or property, he will be liable in tort for injury to persons or damage to property resulting from that dangerous defect. But if the defect becomes apparent before any injury or damage has been caused, the loss sustained by the building owner is purely economic. If the defect can be repaired at economic cost, that is the measure of the loss. If the building cannot be repaired, it may have to be abandoned as unfit for occupation and therefore valueless. These economic losses are recoverable if they flow from breach of a relevant contractual duty, but, here again, in the absence of a special relationship of proximity they are not recoverable in tort."

13 [1991] UKHL 2

What about where one part of a building damages another part? See Case 8.

**Case 8 – Linklaters Business Services v McAlpine [14]**

Pipework carrying chilled water in Linklaters' office corroded because of poorly applied insulating materials. Linklaters replaced the pipework and the insulation.

The insulation and the pipework were each components that went to make up one installation (the insulated chilled water pipework). Accordingly the corrosion damage, being to "the thing itself", was classified as pure economic loss, and was therefore not recoverable.

**Box 6: the complex structure theory**

This was first mooted in *D&F Estates v Church Commissioners for England*[15] and further considered in *Murphy v Brentwood*. The theory is that "in complex structures or complex chattels one part of a structure or chattel might, when it caused damage to another part of the same structure or chattel, be regarded in the law of tort as having caused damage to "other property" for the purpose of the application of *Donoghue v Stevenson* principles."[16]

## Damage and the complex structure theory

See Box 6. The complex structure theory has so far proved to be little more than a theory, but it is always mentioned when one part of a thing damages another part of the same thing.

The *Linklaters* case (Case 8) was a failed attempt to make this theory apply. To work, there would have had to have been damage by one thing (the insulation) to another thing (the pipework). Akenhead J decided that the insulated pipework was one "thing" for the purposes of the tort of negligence.

An American case[17] about defective turbine engines within ships was found by the Judge to be helpful. The American Court regarded each turbine as a single unit, saying that since all but the very simplest of machines have component parts, not to regard the turbine as one "thing" would result in a finding of damage – and hence liability in tort – in virtually every case where a product damages itself.

## Damage and the Bacardi case

This well known case caused a stir in insurance circles because of its unexpected result. Many had assumed that if you mix ingredients, one of which is contaminated, to produce a contaminated product, then there is damage and a standard product liability policy is triggered.

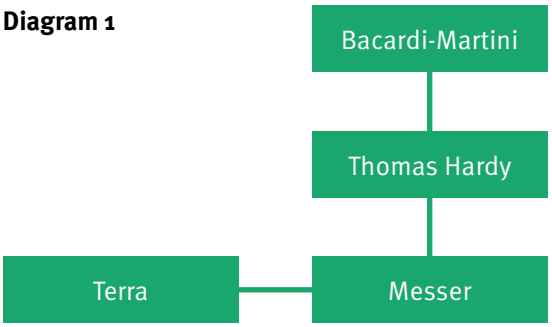
However, the finished product was treated as all one "thing" and it was held to be defective rather than damaged. Accordingly the loss was purely economic. Bacardi is not actually a negligence case, but it still turned on whether there had been damage because of the terms of a contract. This was because a clause in the contract between the parties limited liability for excluded liability for losses of a "purely financial or economic nature". See Case 9.

**Case 9 – Bacardi-Martini Beverages v Thomas Hardy Packaging [18]**

Thomas Hardy had a contract with B-MB to mix CO2 with Bacardi concentrate and water to make a drink called Bacardi Breezer. Unfortunately the CO2 was contaminated with benzene, a toxin. Consequently B-MB had to recall the drinks and destroy them.

Thomas Hardy was liable in contract to B-MB. Thomas Hardy sued Messer, who had supplied the contaminated carbon dioxide to Thomas Hardy under a contract. Messer had been supplied with the carbon dioxide by Terra. Diagram 1 shows the contractual set up.

**Diagram 1**



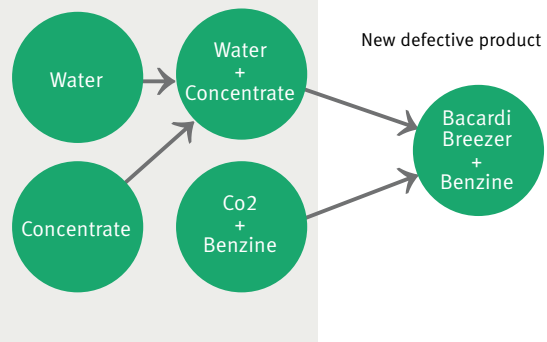

The contract limited Messer's liability for "direct physical damage to property" and limited liability for losses of a "purely financial or economic nature."

14 [2010] EWHC 2931 (TCC)
15 [1989] AC 177
16 Lord Bridge in Murphy v Brentwood [1991] UKHL 2
17 East River S.S.Corp v Transamerica Delaval 476 US 858 (1986)
18 [2002] EWCA Civ 549

The court therefore had to decide whether there had been "direct physical damage to property" and whether any of the losses were of a "purely financial or economic nature." The court analysed the situation as shown in Diagram 2:

Ingredients did not survive

**Diagram 2**




The claim was based upon the losses associated with the contaminated Bacardi Breezer. If it has been based upon the value of the ingredients, which had been contaminated in the mixing process, then there could well have been a finding that there had been damage to those ingredients. However, since the claim related instead to the Bacardi Breezer, it left it open to the court to decide that the contaminated Bacardi Breezer had not been damaged, and nor had it caused any damage - it was **a worthless end product which had been defective from the moment of its creation**. The loss was purely economic. There had been no damage.

So in the absence of damage ("direct physical damage to property") the limit of liability provision was irrelevant. The losses were of a "purely financial or economic nature," for which the contract sought to exclude liability.

There was a twist in the tail, because the court found that to exclude those losses was in the circumstances unreasonable (as per the Unfair Contract Terms Act 1977) so Hardy succeeded after all.

## A short history lesson

So far this guide has looked at what damage is for the purposes of negligence, and has flagged up that if there is no physical damage (and hence purely economic losses), there has to be a special relationship for there to be a liability in negligence.

Before looking more closely at special relationships, and the *Hedley Byrne* line of cases, it is worth having a reminder about how the courts spent the 1970s and 1980s deviating from mainstream negligence principles before they came back to the orthodox position which is represented by *Murphy v Brentwood*.

This deviation has been referred to as the **tort rollercoaster**, the high point of which was the infamous case of *Junior Books v Veitchi*, when the requirement for damage in negligence was virtually abandoned.

The leading cases are all House of Lords cases, and a good place to start is with *Anns v Merton London Borough Council* - see Case 10.

**Case 10 – Anns v Merton London Borough Council [19] – note: this is no longer the law**

Seven flats in a new two storey block in Wimbledon suffered from structural movement. Anns and others claimed that the local authority (Merton) had carried out its inspection duties under the building regulations negligently by not discovering the inadequacy of the foundations.

Lord Wilberforce, formulated a two stage test for negligence requiring just

- a sufficient relationship of proximity to give rise to a duty and
- the absence of any considerations which ought to negate that duty.

He found the local authority liable.

Despite the floodgates argument (see Box 3) this opened the floodgates to claims in negligence which did not depend on injury or damage, and the high water mark was represented by *Junior Books v Veitchi*.[20] There, the claimants persuaded a majority of the House of Lords that the defendant specialist flooring contractors owed them a duty of care to avoid pure economic loss and defects in the work itself – see Case 11.

19 [1978] AC 398
20 [1983] 1 A.C. 520


**Case 11 – Junior Books v Veitchi [21]– note: now regarded by the courts as unique and not to be followed**

Junior Books engaged a main contractor to build a factory in Grangemouth. Veitchi had been nominated by Junior Books' architect as subcontractors to lay flooring in the factory. The architect had relied on the fact that Veitchi were specialists in the laying of flooring. Unfortunately Veitchi did not take adequate care in laying it, with the result that it developed cracks. It was common ground that this was pure economic loss – damage to the thing itself.

There was no contract between Junior Books and Veitchi, so the claim was in the tort of negligence. The House of Lords applied Lord Wilberforce's test from *Anns v Merton* (Case 10). They decided that both stages of the test had been satisfied.

Given that these cases caused a significant extension to the potential liability of commercial insureds, who previously would only have been liable in negligence if their work or product caused injury or physical damage, insurers responded by adding "tort only" 'financial loss' extensions – sometimes known as "*Junior Books* extensions" – to their public and products liability policies.

## Back on track

The House of Lords in *Murphy v Brentwood* reversed their earlier decision of *Anns v Merton*, and overruled the decision of the Court of Appeal in *Dutton v Bognor Regis Urban District Council*[22] as well as all cases subsequent to Anns which were decided in reliance on it. Junior Books was also categorised as a truly unique case.[23] As a result, "tort only" 'financial loss' extensions appeared to lose much of their *raison d'être*. Whether they still provide an element of cover is considered in Part 2 of this guide.

It is worth noting that there are however some common law countries where *Anns* and *Junior Books* remain good law – see further Part 3.

## The present position – two strands

As a result of these legal convulsions, the law of negligence reverted broadly to

- the formulation in *Donoghue v Stevenson* where there is physical injury or damage – **strand 1** – and
- cases where there is a special relationship (with a narrower test than in Anns) giving rise to a duty of care to safeguard a claimant from pure economic loss – the *Hedley Byrne* strand – **strand 2**.

# The tort of negligence – strand 2 – special relationship cases

While having somewhat less human interest than *Donoghue v Stevenson*, the decision in *Hedley Byrne v Heller* was also a momentous one. See Case 12.

**Case 12 – Hedley Byrne v Heller [24]**

Hedley Byrne, a firm of advertising agents, had placed on Easipower's behalf substantial orders for advertising time on television and advertising space in newspapers. Hedley Byrne became concerned about Easipower's credit-worthiness. It therefore asked its bank, National Provincial Bank, to seek a reference from Heller & Partners, a merchant bank, about Heller's customer, Easipower.

Heller made a representation about the financial soundness of Easipower, including the words, "Without responsibility on the part of this Bank or its officials". Hedley Byrne relied on the reference and continued to extend credit to Easipower. Easipower went into liquidation, and Hedley Byrne lost over £17,000 as a result.

The Judge at first instance and also the Court of Appeal considered that Heller owed no duty of care to Hedley Byrne, because there was no contract or fiduciary relationship between them. The House of Lords disagreed. Lord Morris said:

"If someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for

21 [1983] 1 A.C. 520
22 [1972] 1 Q.B. 373
23 See *Nitrigin Eireann Teoranta v Inco Alloys* [1992] 1 WLR 498
24 [1963] UKHL 4

the assistance of another person who relies upon such skill, a duty of care will arise….Furthermore, if in a sphere in which a person is so placed that others could reasonably rely upon his judgment or his skill or upon his ability to make careful inquiry, a person takes it upon himself to give information or advice to… another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise."

Heller were therefore found to owe a duty of care to Hedley Byrne. This was a new development in the law, establishing "negligent misstatement" as a new basis of claim.

However, the court also upheld the "without responsibility" disclaimer and so, ultimately, Hedley Byrne did not get compensated by Heller.

In *Hedley Byrne* much was said about whether the law treated deeds differently from words. The starting point was that there is no general duty not to make careless statements, just as there is no general duty to be careful in action. Whether there is a duty depends on whether there is a sufficient relationship of **proximity**. Lord Devlin said there was such a relationship in *Donoghue v Stevenson*, and the question was whether there could be such a relationship in the *Hedley Byrne* situation.

Given how well the nature of the relationship is understood in situations where physical injury or damage are caused (as per *Donoghue v Stevenson* and subsequent cases), this guide has reserved the phrase "special relationship" for the sort of relationship which is required where loss is recoverable in the absence of physical injury or damage.

## When is there a special relationship?

The courts have gradually added to the situations where such a relationship arises, and no doubt will continue to do so in future. The key component is that one party needs to have assumed some responsibility to the other. This happens particularly where the relationship is sufficiently close to be virtually the same as a contractual one, but without there actually being a contract.

Box 7 contains a chronology of some of the cases.

It is interesting to note that all of the situations in Box 7 involved the provision of services of some kind, rather than "things", in contrast with the case of Junior Books which involved the provision of a "thing" namely the flooring.

### Box 7: special relationship cases

**1914 Fiduciary relationships**. Lord Ashburton relied upon advice from his solicitor Nocton in relation to certain lending transactions. The fiduciary duty owed to Lord Ashburton gave rise to a special relationship in which Nocton owed a duty to Lord Ashburton to be careful.[25] A similar fiduciary duty (and hence a duty of care) arises between a trustee and his beneficiary.

**1963 Making statements**. *Hedley Byrne v Heller* – see Case 12.

**1979 Failure to act**. Solicitors Hett, Stubbs and Kemp failed to protect their client's option to purchase property by registering it at the Land Registry.[26] This extended the principle to omissions.

**1990 Surveyor and mortgagor**. Eric S Bush, a surveyor instructed by a building society, failed to spot a serious defect in a house. The surveyor was held to owe a duty to Mrs Smith, the prospective mortgagor, to take reasonable care when inspecting and reporting.[27]

**1994 Performance of a service**. Henderson v Merrett:[28] Managing agents held themselves out as possessing a special expertise to advise Lloyd's Names on underwriting, reinsurance and claims. The Names, as the managing agents knew, relied on that expertise. This case extended the principle beyond negligent statements or omissions to negligent acts such ax1s the performance of a service.

**1994 Giving a reference**. Guardian provided an employment reference about Mr Spring to Scottish Amicable. It was not compiled carefully and he was not offered employment. Mr Spring established that Guardian owed him a duty of care in negligence.[29]

**1995 Solicitors and beneficiaries**. Mr Jones accepted instructions to draw up a new will for Mr Barrett, naming Mrs White and her sister as beneficiaries. However, he failed to do so before Mr Barrett died. Neither Mr Barrett nor his estate had suffered a loss. However, the disappointed beneficiary succeeded against Mr Jones. This created an extension to the *Hedley Byrne* principle. The *Hedley Byrne* requirement of reliance arose from *Hedley Byrne* being a negligent misstatement case, where reliance was essential; White v Jones established that reliance was not necessary in all situations - there had been no reliance by the beneficiaries on Mr Jones; however he had clearly assumed responsibility in relation to them.[30]

**2001 Employee assuming personal responsibility**. Mr Babb, a valuer employed by a firm (not a limited company), personally signed a mortgage valuation. As in *Smith v Eric S Bush* (the 1990 case above) the mortgagor claimed, but this time against Mr Babb personally. He was held liable by a majority in the Court of Appeal.[31] This decision does not sit well with Williams v Natural Life Health Foods[32] where a company director was held not to have assumed a personal responsibility (see Case 13).

**2011 Negligent misstatement by former employer**. Swindon College, sent – unsolicited – an untrue and harmful email about a Mr McKie, whom they used to employ, to the University of Bath, Mr McKie's then current employer. As a result, the University dismissed Mr McKie, and Swindon College was held liable to Mr McKie in negligence for the pure economic loss flowing from the dismissal.[33] See Case 15.

25 *Nocton v Lord Ashburton* [1914] A.C. 932
26 *Midland Bank Trust Co v Hett, Stubbs and Kemp* [1979] Ch. 384
27 *Smith v Eric S Bush* [1990] 1 A.C. 831
28 [1994] 3 WLR 761
29 *Spring v Guardian Assurance* [1994] UKHL 7
30 *White v Jones* [1995] UKHL 5
31 *Merrett v Babb* [2001] EWCA Civ 214
32 [1998] UKHL 17
33 *McKie v Swindon College* [2011] EWHC 469 (QB)

Generally the courts are wary about finding that there has been an **assumption of personal responsibility**, particularly where the individual is an officer of a company and the claimant has dealt with the company. The main example is the case of Williams v Natural Life Health Foods – see Case 13. It has been suggested that it would be desirable for the tension between this decision and the surveyors' cases (Merrett v Babb – the 2001 case in Box 7) to be resolved the next time the courts have the opportunity.

**Case 13 – Williams v Natural Life Health Foods [34]**

Mr Mistlin was managing director and principal shareholder of Natural Life Health Foods Ltd. His company, through an employee, encouraged Mr Williams to enter into a franchise agreement and open a shop in Rugby. Prior to signing a franchise agreement the Claimants were provided with a brochure and detailed financial projections, prepared by Mr Mistlin. Mr Mistlin was not, however, personally involved in the pre-contractual negotiations.

After trading at a loss for 18 months Mr Williams ceased trading and brought an action against Natural Life for economic loss suffered as a result of the negligent advice provided.

Natural Life was subsequently dissolved and Mr Mistlin was joined to the proceedings. The House of Lords held that Natural Life would have been liable on ordinary *Hedley Byrne* principles, but Mr Mistlin was not personally liable for the Claimants' economic loss. In order for a director to be liable personally there must be an **assumption of personal responsibility** so as to create a special relationship between the parties and the Claimant must reasonably rely on that assumption of responsibility.

Accordingly, while it is possible that there will be situations where a director is found personally liable for pure economic loss based on assumption of responsibility and reliance, they are likely to be rare.

The last case in Box 7, *McKie v Swindon College*, illustrates how the courts are still capable of imposing liability for pure economic loss in new situations. See Case 15 for a fuller account.

## Pure economic loss – different tests for duty

In the *Hedley Byrne* line of cases, the guiding principle for whether there was a special relationship of proximity was whether there had been

- an assumption of responsibility, and
- (in most instances) reliance.

This has been called the assumption of responsibility test.

A different test – a three-stage test – was developed in *Caparo v Dickman*[35] in the context of auditors' duties to shareholders. The three stages were

- foreseeability
- proximity and
- fairness, justice and reasonableness.

This test has tended to give more room for policy factors to be brought into play, and has been relied on particularly where it is sought to extend liability to a novel relationship.

However, these tests should not be viewed as alternative but complementary. The leading textbook, Clerk & Lindsell, suggests that the assumption of responsibility test should be seen as a means of confirming that the requirements of proximity and fairness have been met. They are flexible tools which assist the courts to decide whether, on particular facts in individual cases, there is a duty to avoid causing the kind of loss in question (including where there has been pure economic loss). There is an emphasis on providing "practical justice", and the law of tort, in its gap-filling role, provides a way for the courts to do this.

It also seems clear that the further the parties are away from a relationship which is similar to a contractual one, the less likely it is that a duty of care will exist. For an example see Case 14.

34 [1998] UKHL 17

35 [1990] 2 AC 605

**Case 14 – Customs & Excise v Barclays Bank plc [36]**

The Commissioners of Customs and Excise had obtained a freezing injunction over accounts held by a debtor at Barclays Bank. The debtor asked Barclays to pay money out of those accounts in breach of the court order. Barclays did so.

Although what Barclays did was contrary to the injunction, Barclays was held not to owe a duty of care to the Commissioners not to allow payments out of the accounts. It had not voluntarily assumed such a responsibility. Barclays and the Commissioners were also a long way from anything approaching a contractual type relationship.

A recent example of the application of the three stage *Caparo* test is *McKie v Swindon College* – see Case 15 – where a duty of care not to cause pure economic loss was found in a novel situation.

**Case 15 – McKie v Swindon College [37]**

Rob McKie was employed by Swindon College in January 1995 as "Contextual Studies Co-Ordinator". In 2002 he left his employment at Swindon College for a role at Bath City College. At the time, he received a strong, positive reference from Swindon College. After also working at Bristol City College for a short period, he was employed as "Director of Studies" at the University of Bath's Life Long Learning Department in May 2008. As part of his new role, Mr McKie was required to liaise with local colleges in the area which offer degree courses, including Swindon College.

Swindon College became aware of Mr McKie's new role and, on hearing that he would be required to attend at the College to meet with students, Robert Rowe, Human Resources Manager at Swindon College sent an email to the University of Bath. In his email, Mr Rowe stated that Swindon College had "real safeguarding concerns" for its students and that "there were serious staff relationship problems during his employment". Following receipt of the email, the HR Department at the University of Bath invited Mr McKie to attend an internal disciplinary hearing after which he was summarily dismissed.

Mr McKie brought a claim against Swindon College alleging that it owed him a duty of care when sending the email. Unlike in *Hedley Byrne v Heller*, the person asking for or receiving the information was not the person who suffered a loss but the Claimant, as subject of the email, did suffer an economic loss, his loss of earnings as a result of his dismissal.

Judge Denyer QC held that the email should not be construed as a reference, thereby distinguishing this case from *Spring v Guardian Assurance*. Applying the Caparo three stage test, the Judge determined that Mr McKie had suffered economic loss which had been **foreseeable**. The lapse in time since Mr McKie worked for Swindon College did not damage the relevant degree of proximity. He considered it was **fair, just and reasonable** to impose a duty of care on Swindon College.

Before moving onto the next topic, it is worth quoting some judicial comments that are particularly relevant – see Box 8.

**Box 8: judicial soundbites of the '90s**

Lord Bridge: "It is one thing to owe a duty of care to avoid causing injury to the person or property of others. It is quite another to cause others to suffer purely economic loss." [38]

Lord Oliver: "The infliction of physical injury to the person or property of another universally requires to be justified. The causing of economic loss does not." [39]

Brennan J (Australian case): "If liability were to be imposed for the doing of anything which caused pure economic loss that was foreseeable, the tort of negligence would destroy commercial competition, sterilise many contracts and, in the well-known dictum of Chief Judge Cardozo, expose defendants to potential liability 'in an indeterminate amount for an indeterminate time to an indeterminate class'." [40]

McHugh J (Australian case): "Anglo-Australian law has never accepted the proposition that a person owes a duty of care to another person merely because the first person knows that his or her careless act may cause economic loss to the latter person. Social and commercial life would be very different if it did." [41]

36 [2006] UKHL 28
37 [2011] EWHC 469 (QB)
38 *Caparo v Dickman* [1990] 2 AC 605
39 *Murphy v Brentwood DC* [1991] UKHL 2
40 *Bryan v Maloney* (1995) 182 CLR 609
41 *Hill v Van Erp* [1997] HCA 9

**Box 9: Why does the law approach pure economic loss and physical loss differently?**

It will be obvious from what has been said in this section that it is a general principle of English tort law that a person has a duty to take care to avoid causing his neighbour physical injury or damage, but no duty (except in certain limited circumstances) to avoid causing pure economic loss.

The rationale for this distinction is often questioned particularly as it is a distinction which is not so clear cut under other legal jurisdictions and leads to situations that may seem to some to be unfair, unjust or just plain nonsensical; the same negligent act of one person causing physical loss to some people (that is recoverable) and pure economic loss to others (that is not).

Sometimes the justification is that such pure economic loss is said to be too remote, unforeseeable or, possibly most convincingly, likely to lead to a flood of claims (the fear of **indeterminate liability to an indeterminate class for an indeterminate time**) which would either swamp the courts or the defendant, or most probably both.

Sometimes, it is said that as a **matter of public policy**, it is necessary to draw a line in the sand, arbitrarily, to define the limits of recoverable harm.

In some cases the **economic argument** is used, that ''the philosophy of the market place presumes that it is lawful to gain profit by causing others economic loss'' (Goff LJ in The Aliakmon[42]).

Again, it has been argued that the reason for the English law's approach to pure economic loss can be found in the historical development of the common law of tort centred on the **primacy of property interests not economic ones**. In other words purely economic interests are perceived as in less need of protection than interests in tangible property.

Another aspect is the difficulty in distinguishing **deliberate** from **unintended** economic loss. With property damage or injury, it is never permissible to seek the harm of another. Pure economic loss is not so clear cut as mentioned above under the economic argument.

English law is not unique in its attitude to this area of the law and most common law countries have a similar reluctance to allow compensation for pure economic loss and most have developed similar 'logic' to rationalise the approach.

A few (notably France and other EU 'code' countries) have developed a different, **more liberal approach** to the recovery of pure economic loss. See Part 3 of this guide.

As society develops, changing notions of justice and fairness will inevitably affect the courts' view of what sorts of pure economic losses should be recoverable and how often the rationale set out above will be challenged.

Finally, a philosophical look at why the law is as it is may be helpful – see Box 9.

Having explored the tort of negligence in the context of pure economic loss, this guide now considers relevant aspects of contractual liability.

42 *Leigh & Sillavan Ltd v Aliakmon Shipping Co Ltd (The Aliakmon)* [1986] AC 785

# Contractual liability

**The law of contract provides the main cause of action for claims for pure economic loss.**

A contract is a private agreement or bargain whose terms the law will enforce. In the event of breach, the innocent party is, so far as money can do it, to be placed in the same position as if the contract had been performed.

Pure economic loss is recoverable in contract, provided the contract terms permit it. This is because the parties have struck their own bargain, have established their own "special relationship". Accordingly they are not subject to the restrictions on recoverability which govern the general law of tort.

In fact, there is no restriction on the kind of loss which is recoverable, whether it is pure economic or economic loss that is consequent on injury or damage, or whether it is for the injury or damage itself, unless it is "too remote". The leading case is *Hadley v Baxendale* – see Case 16 – the kind of loss has to be within the **reasonable contemplation of the parties**.

*Hadley's Mill*

**Case 16 – Hadley v Baxendale [43]**

Hadley owned the City Steam Mills in Gloucester. A steam engine normally provided the power, but it had a broken crankshaft. Hadley ordered a new crankshaft from W. Joyce & Co in Greenwich, who needed to have the old one to copy from. Hadley contracted with the famous firm of Pickfords (which had been saved from bankruptcy in 1816 when Baxendale and others bought it from the Pickfords family) to carry the old crankshaft to Greenwich. Hadley made clear to Pickfords that it was urgent, but not that the profits of his company were at stake. Pickfords took longer to deliver it than they had promised, with the result that Hadley received the new crankshaft several days later than planned, losing profits in the interim.

Hadley sued Baxendale (the owner of Pickfords) and was awarded £25 for loss of profits. Baxendale appealed and won.

The Appeal Court Judge, Baron Alderson, said: "Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered as arising naturally, i.e. according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it."

He went on to explain that if Hadley's special circumstances (that it would lose profit if Pickfords were to delay) had been communicated, then he would have been able to recover the lost profit. For all Pickfords knew, Hadley may have had a spare crankshaft, or some other part of the mill might have been out of order so that delay would not have made any difference.

Accordingly, Pickfords / Baxendale were not liable for the loss of profit. This does not detract, however, from the general principle that pure economic loss may be recoverable where there is a contractual relationship.

Subsequent cases have refined the rule, for example a recent one has confirmed that it will not be too remote if it is a loss from which the party in breach may reasonably be taken to have assumed a responsibility to protect the other party. [44]

Suffice it to say, for the purposes of this guide, that in the majority of contract cases, some pure economic loss at least will very likely be recoverable.

43 (1854) 9 Exch. 341

44 Lord Justice Toulson in *Supershield Ltd v Siemens Building Technologies FE Ltd* [2010] EWCA Civ 7 at 40, summarising the principle underlying *Hadley v Baxendale* (1854) 9 Ex 341) and subsequent cases on remoteness including *Transfield Shipping Inc v Mercator Shipping Inc* [2008] UKHL 48.

**Box 10: implied terms of satisfactory quality and fitness for purpose**

**Sale of Goods Act 1979**

Quality: Where the seller sells goods in the course of a business, there is an implied term that the goods supplied under the contract are of satisfactory quality.....goods are of satisfactory quality if they meet the standard that a reasonable person would regard as satisfactory, taking account of any description of the goods, the price (if relevant) and all the other relevant circumstances.[45]

Fitness: Where the seller sells goods in the course of a business and the buyer, expressly or by implication, makes known...any particular purpose for which the goods are being bought, there is an implied term that the goods supplied under the contract are reasonably fit for that purpose....[46]

**Box 11: implied term to use reasonable care and skill where services are provided**

**Supply of Goods and Services Act 1982**

Contracts for services: In a contract for the supply of a service where the supplier is acting in the course of a business, there is an implied term that the supplier will carry out the service with reasonable care and skill.[47]

Contracts for the supply of goods and services: as regards the goods, they have to be of satisfactory quality or fitness;[48] as regards the services, it is implied that they will be carried out with reasonable care and skill.[49]

Part 2 of this guide looks at how liability policies may give or exclude contractual liability cover, so first it is necessary to consider some of the ways in which contractual liability can arise.

## Contractual terms

There are two main types of contractual terms:

- Express terms – ones the parties have actually stated and agreed, whether in writing or verbally
- Implied terms – ones which are part of the contract even though they have not been mentioned by the parties.

## Express terms

These will set out most if not all the obligations of the parties, who as a general principle are free to contract on any terms they wish. One party will frequently include terms seeking to limit or exclude certain liabilities (also known as **exemption clauses**). Putting aside the question of whether such terms are actually incorporated in the contract (often giving rise to a "battle of the forms") there are rules about the extent to which liability can be limited or excluded. For example, the Unfair Contract Terms Act 1977 restricts the use of some types of exemption clause (as happened in the *Bacardi* case – see Case 9). These rules are designed to protect the weaker party where there is inequality of bargaining power, typically where a consumer is contracting with a business, but also to an extent in business to business contracts. Clearly when considering an insured's liability in contract, the effect of any such terms needs to be assessed.

## Implied terms

Where the parties make an imperfect agreement, or one lacking in detail, the law often steps in either to make it fairer or more workable, and it does this by implying terms. Normally the express wishes of the parties will prevent the implication of a contradictory term, but there are some terms which the parties cannot override, for example in the context of **sale of goods**:

- A business dealing with a consumer cannot exclude the implied term that the goods will be of satisfactory quality and reasonably fit for the purpose (see Box 10 for the relevant extracts from the Sale of Goods Act 1979).
- In non-consumer sales, an exclusion of the implied terms as to quality and fitness may be enforced but only if it satisfies the requirement of reasonableness contained in the Unfair Contract Terms Act 1977.

Where **goods** are supplied, the implied terms are concerned with the quality and fitness of the goods. Goods of the right fitness and quality have to be supplied – the obligation is strict. It is not enough just to take reasonable care that the goods will be of the right fitness and quality.

It is by the implication of these terms that purchasers of goods can be confident of a remedy in contract against those they buy them from if the goods do not do what they ought to do. As has been made clear earlier in Part 1, the seller has breached no duty of care in tort to the purchaser if the goods simply do not work or are not of the right quality.

It is different when it comes to the supply of services under a contract. Here, the law implies a different type of term, one that is similar to a duty of care in the tort of negligence. See Box 11.

45 From Section 14(2)

46 From Section 14(3)

47 Section 13, Supply of Goods and Services Act 1982

48 Section 4, Supply of Goods and Services Act 1982, equivalent of Section 14, Sale of Goods Act 1979

49 Section 13, Supply of Goods and Services Act 1982

However, it is possible that in specific circumstances, the supplier of a service might, by implication, warrant that his services will provide a specified result or that the product of his service will be reasonably fit for the required purpose, as opposed to simply using reasonable care and skill (which would not guarantee a particular result). Whether the supplier has taken on such an onerous contractual obligation will depend on the facts.

### Collateral warranties

Insureds may take on express contractual obligations to others, alongside their main contract. Often known as collateral warranties, their purpose is to provide a contractual remedy to someone who would otherwise have either just a remedy in tort or no remedy at all. Example situations:

- Subcontractor on a building contract to developer / building owner / funder of the building project
- Supplier of crucial component in a machine to the purchaser of the assembled machine (leapfrogging the machine's assembler)
- Architect to future lessee of a building he is designing
- Sub-subcontractor to main contractor (leapfrogging the subcontractor).

### The rule of privity of contract

The general rule is that only a party to a contract can sue on it. This is a complicated area of the law, and one which the Law Commission considered in need of some change. As a result the **Contracts (Rights of Third Parties) Act 1999** was enacted, designed to enable a third party to acquire rights under a contract between others, but only if the parties to the contract intend that he should.

This statute was expected by some to remove the need to draft collateral warranties. However, it is narrowly drafted and appears to have had very limited effect so far. It is mentioned here just for completeness.

The next topic combines both tort and contract, and looks at situations when liability in both can arise at the same time.

**Box 12: limitation periods**

Cases must be commenced within a fixed period from the date when the **cause of action accrued**. This is the date when the claimant first had satisfied all the requirements needed to sue. Otherwise they are said to be **time-barred** or **statute-barred**. The fixed period is known as the **limitation period**. There are different periods for different situations.

There are major differences between claims in negligence and contract:

- In contract, the cause of action accrues when the contract is breached, and it can be a long time before any loss or damage is suffered
- In negligence, the cause of action accrues when the loss or damage occurs.

This is why in many cases the limitation period in contract expires earlier than the limitation period in negligence.

## Liability in tort and contract at the same time

This is usually referred to as **"concurrent liability"**.

Inevitably the existence of a contract makes a difference to the legal relationship between the parties, and affects whether one can be liable to the other in tort at the same time. It has already been seen how a contract creates its own kind of "special relationship" between the parties and that where breach of the contract causes pure economic loss, recovery of that loss is permitted so long as it is not too remote. Can that relationship also be a "special relationship" for the purposes of recovery of pure economic loss in tort?

As mentioned in the Introduction, this is important because

- Many policies restrict cover for liability in contract
- Claims in contract usually become time barred sooner than claims in tort so often claims can only be advanced in tort (see Box 12 about time-barring of claims).[50]

Much has been written about whether, when there is concurrent liability, there is any difference in principle between the remedy available in tort and the remedy available in contract. For example, the rules on remoteness are different:

- Tort - is the type of harm reasonably foreseeable?
- Contract – is the kind of loss within the reasonable contemplation of the parties?

50 The Limitation Act 1980 is the starting point for the relevant law.

In practice it appears that the courts try to assimilate the rules so that there is no difference.

## The leading case

The leading case on concurrent liability is *Henderson v Merrett*.[51] It involved managing agents and Lloyd's Names, and features in Box 7, the 1994 entry. It not only has its place in the development of the *Hedley Byrne* strand, but also established that a party to a contract may bring an action based on a tort committed by the other party, as long as doing so is not inconsistent with the express or implied terms of the contract.

## Conflicting cases on concurrent liability in the construction industry context

In the construction industry context, it is established that providing a defective building, or part of a building, which causes no damage to "other property" constitutes pure economic loss. However, it is less clear when there may be a duty in tort on a contractor to his employer not to cause such loss. In the case of *Barclays Bank v Fairclough Building* there was such a duty – see Case 17.

**Case 17 - Barclays Bank v Fairclough Building (No 3)** [52]

Barclays engaged Fairclough as main contractor to maintain and repair its warehouses. Fairclough sub-contracted roofing works to Carne. Carne sub-subcontracted roof cleaning work to Trendleway. This work involved high pressure water jetting to clean an asbestos cement roof. In the process Trendleway caused widespread contamination to the property of the owner, Barclays. Carne's loss was purely economic, having had to compensate Fairclough in contract, who in turn compensated Barclays, again in contract.

The Court of Appeal held that Trendleway owed a concurrent duty in tort to Carne to avoid causing [pure] economic loss by failing to exercise the care and skill of a competent contractor. Beldam LJ said:

"A skilled contractor undertaking maintenance work to a building assumes a responsibility which invites reliance no less than the financial or other professional adviser does in undertaking his work. The nature of the responsibility is the same though it will differ in extent."

It was relevant that on the facts of the case, the scope of Trendleway's concurrent liability in tort was no greater than the scope of Trendleway's liability in contract.

It was thought that this could be extended to support the general principle that a builder who is in a contractual relationship with his client can concurrently owe a duty of care in tort to his client in relation to economic loss.

However, in *Robinson v P.E.Jones* the Court of Appeal reached the opposite result (Case 18).

**Case 18 – Robinson v PE Jones (Contractors) Ltd** [53]

Jones, a builder, agreed to sell 5 Magnolia Drive to Mr and Mrs Robinson when he had built it. The Robinsons wanted an extra chimney, which he agreed to install. The contract limited Jones' liability in respect of defects.

Some years after the house was built, British Gas was testing a gas fire and found that the extra chimney was defective. Mr Robinson claimed the repair cost from Jones. His claim in contract was statute barred.

The Court of Appeal could see nothing to suggest that Jones assumed responsibility to the Robinsons outside the contract. Further, the parties had decided that the contract would govern the allocation of risk, and there was no room for a concurrent liability in tort to arise. The claim failed completely.

51 [1994] 3 WLR 761

52 (1995) 44 Con LR 34. Interestingly a differently constituted Court of Appeal had shortly before refused to find a concurrent duty in tort in the same case – see [1995] QB 214.

53 [2011] EWCA Civ 9

While in *Barclays* the court found there was an assumption of responsibility to avoid causing pure economic loss, in *Robinson* the court (which was not referred to *Barclays*) found there was not. The decisions conflict on this point. In *Robinson* the claim could in any event not succeed, because the terms of the contract were not consistent with a concurrent duty in tort (whereas in *Barclays* there was no such inconsistency).

This guide will now briefly consider certain statutory liabilities which are relevant to pure economic loss.

## Statutory liability

Having explored how liability for pure economic loss can arise in negligence, in contract and in both of them together, it is necessary to consider if any statutes impose liability for pure economic loss.

There is a wide range of different liabilities created by statutes, some criminal and some civil. This guide is concerned only with civil liabilities. Below is a non-exhaustive list of statutes and regulations which expressly give rise to civil liability (including liability for pure economic loss).

### Civil Liability (Contribution) Act 1978

Section 1 states, in effect, that person A, who is liable in respect of any damage suffered by person B, may recover contribution from person C if C is liable to B in respect of the same damage. “Damage” here includes pecuniary loss. As between A and C, this is a separate statutory cause of action, so would not be caught by a contractual liability exclusion.

### Data Protection Act 1998

Section 13 sets out when an individual is entitled to compensation from a data controller who contravenes any of the requirements of the Act, causing the individual to suffer damage or (in some circumstances) distress. “Damage” includes purely economic loss or physical injury. It is a defence to show that reasonable care to comply with the relevant requirement was taken.

### Defective Premises Act 1972

Section 1 imposes a duty to build dwellings (including extensions to dwellings) properly, so that they are ‘fit for habitation’. The duty is owed to developers and to anyone who acquires an interest in the dwelling. There is no need for damage to “other property” and the obligation is to rectify defects. The cost of rectification is pure economic loss (being damage to “the thing itself”).

### Employment legislation

Breaches of employment legislation will typically give rise to a liability for pure economic loss.

## Environmental legislation

For example, the Environmental Civil Sanctions (England) Order 2010, which permits the Environment Agency and Natural England to impose civil sanctions in relation to the offences specified in Schedule 5 to the Order. The civil sanctions are fixed monetary penalties, variable monetary penalties, compliance notices, restoration notices and stop notices, and enforcement undertakings. Also, the Environmental Damage (Prevention and Remediation) Regulations 2009 give regulators the ability to require extensive remediation, including "complementary" and "compensatory" remediation.

## Human Rights Act 1998

A person who is a victim of a public authority which has acted in contravention of any of the rights and freedoms guaranteed under the European Convention on Human Rights may in some circumstances be entitled to damages.

## Misrepresentation Act 1967

A misrepresentation in this sense is where one prospective contracting party makes a representation to the other, who in reliance on it enters into the contract, and the representation turns out to be untrue. Section 2 states that in this situation the representee is entitled to damages, unless the maker of the representation reasonably believed the facts represented were true. The damages will normally be for pure economic loss.

## Package Travel, Package Holiday and Package Tours Regulations 1992

These Regulations, which enacted EU Directive on package holidays 90/314/EEC, provide consumers with statutory rights against their holiday Organiser, being the company *"who organises packages and sells or offers them for sale, whether directly or through a retailer"*. In particular, the Regulations enable dissatisfied holidaymakers to pursue their case with the Organiser instead of with individual suppliers such as airlines or hoteliers. Where an Organiser is in breach of its contractual obligations to its customer, it may be liable to pay compensation, or in the words of the Regulations, *"compensate the consumer for any loss which the consumer suffers in consequence"* (4.(2) – 1992/3288).

## Protection from Harassment Act 1997

Section 3 provides a civil remedy for victims of harassment. "On such a claim, damages may be awarded for (among other things) any anxiety caused by the harassment and any financial loss resulting from the harassment." References to harassing a person include alarming the person or causing the person distress. It will be a question of fact whether what has happened amounts to an injury, in which case resulting 'financial loss' will be economic loss, or not, in which case the resulting 'financial loss' will be pure economic loss.

# Further torts

The main cover under general liability policies is for legal liability for bodily injury and property damage.

In addition, most general liability policies include cover for liability for the following, irrespective of whether they are associated with bodily injury or property damage:

- nuisance
- trespass
- interference with rights such as rights of way, air, light or water

Accordingly, each of these can give rise to liability for pure economic loss. They are summarised below.

There are in addition other torts which can also give rise to liability for pure economic loss, which can (unless excluded) fall within the scope of cover of a 'financial loss' extension. Some of them will also be summarised below.

## Nuisance

Nuisance splits into two types, public and private, and private nuisance is the most relevant in terms of civil liability. It is **a condition or activity which unduly interferes with the use or enjoyment of land**. *Rylands v Fletcher*[54] is an extension of the law of nuisance to cases of isolated escapes. These concepts are summarised in Box 13.

**Box 13: public nuisance, private nuisance and Rylands v Fletcher defined**

**Public nuisance** is a crime. It is an act or omission which endangers the life, health, property, morals or comfort of the public, or obstructs the public in the exercise or enjoyment of their common rights. It is a civil wrong only when a private individual has suffered particular damage over and above the general inconvenience and injury suffered by the public, for example through the obstruction of a highway (this could also be a private nuisance).

**Private nuisances** are of three kinds:

- encroachment on a neighbour's land (e.g. by tree roots)
- direct physical damage to a neighbour's land or building or vegetation on it (e.g. from a blocked drain, or by vibrations from building works)
- undue interference with a neighbour's quiet enjoyment of his land (e.g. by creating smells, vibrations, noise, dust – damage to the neighbour's land is not necessary).

The classic rule in **Rylands v Fletcher**: a person, in the course of a non-natural use of his land, who brings on his land and collects and keeps there anything likely to do mischief if it escapes must keep it at his peril, and if he does not he is answerable for all the damage which is the natural consequence of its escape. Recent cases have required the harm suffered to be foreseeable, and have restricted the application of the rule.

There are also various statutory nuisances, such as under

- The Environmental Protection Act 1990 (relating to waste disposal and pollution control)
- The Clean Air Act 1993
- The Noise Act 1996

See Case 19 for a noise pollution example in which pure economic loss was recovered.

54 [1868] UKHL 1

**Case 19 – Watson v Croft Promo Sport Ltd [55]**

Croft occupied and managed the Croft Motor Circuit near Darlington on the site of a former aerodrome in a rural area. The Watsons lived 300m away, and sought an injunction and damages because they said the circuit was too noisy and constituted a nuisance.

After going through the planning and usage history of the site, as well as noise levels, the Court of Appeal confirmed that there was a nuisance, and upheld the Judge's decision to award damages to two households totalling £149,600 based on diminution in value of their properties and loss of amenity. It also ordered an injunction to restrain the use of the circuit for the noisiest activities to 40 days per annum.

## Trespass

There are three types of trespass: trespass to the person, trespass to land and trespass to goods.

Trespass to the person occurs where there is any interference, even if slight, with person's right to "security of the person" by false imprisonment, assault or battery. An assault takes place where a person believes that they are to subject to immediate and unlawful force; battery occurs where that force is applied; false imprisonment is unlawfully restricting a person's freedom of movement. A person can claim damages for all direct consequences of the trespass, even if they are unforeseeable by the other party.

Accordingly there can be trespass to the person unaccompanied by bodily injury.

Trespass to land is perhaps the most widely known form of trespass. It consists of unjustifiable entry onto land owned or possessed by another person. The person who owns or possesses the land is entitled to damages, even though they have suffered no actual loss.

Therefore trespass to land can take place unaccompanied by physical damage.

Trespass to goods is direct physical interference with goods. The person in lawful possession is entitled to damages. The item in question does not need to be physically damaged or removed, but deliberate physical contact with the item by the wrongdoer is required. An example of this would be the looting in London, Manchester, Liverpool and Birmingham following the riots in August 2011. Where a person unlawfully entered a shop during one of the riots and interfered with another person's property by using or removing the item in question from the shop, this would constitute trespass to goods.

Sometimes overlapping with trespass to goods is the tort of conversion. A person in possession of an item is entitled to damages where another person deliberately takes, receives, buys, sells or uses that item. However, conversion is more far-reaching and concerns not only interference with a piece of property but also with a person's right to use or own that property.

So trespass to goods and conversion do not require physical damage either.

## Interference with rights such as rights of way, air, light or water

Such interference can constitute a nuisance, but can also arise through specific property rights such as easements. Again, losses will tend to be purely economic and, as with Case 19, the remedy could include an injunction.

Further torts which do not involve the causing of physical injury or damage include the following:

## Defamation

Defamation is concerned with the protection of reputations. A person is entitled to damages where another person communicates to a third party information which is not true and is likely to harm or affect the subject's reputation. Losses are purely economic.

## Breach of confidence and privacy

In the case of *Guardian Newspapers,*[56] Lord Goff referred to a breach of confidence occurring where a person has knowledge of confidential information, and that person has agreed or is aware that the information is confidential so that to share the information with others would be breaching a duty. The remedies available include damages.

It is widely accepted that there is no tort of privacy. However, a person is entitled to have a "reasonable expectation of privacy". Information about health, personal relationships and finances are obviously protected. Lord Hope in *Campbell v MGN Ltd*[57] stated that where it is not clear if information is protected, the test is whether "in respect of the disclosed

55 [2009] EWCA Civ 15

56 *Att Gen v Guardian Newspapers Ltd* (No.2) [1990] 1 AC 109

57 [2004] UKHL 22

facts, the person in question had a reasonable expectation of privacy" i.e. what a person of ordinary sensibilities would feel if the same information was placed in the public domain. The test is an objective one.

## Breach of statutory duty

On page 23 there are examples of statutory provisions which expressly impose civil liabilities. Where a statutory provision is silent about whether there is a civil liability, the courts have to decide whether or not Parliament intended there to be one. Accordingly, there are a number of such situations that have been established, particularly in the field of industrial safety, and someone who breaches the relevant provisions commits the tort of breach of statutory duty.

The duties concerned are owed by public bodies, who can breach them in the course of exercising their powers and duties under the relevant legislation. Examples:

- Breach of legislation to promote industrial safety (often overlaps with a claim in negligence)
- An education authority was liable to a child injured through breach of their statutory duty to maintain the school premises
- A local authority with statutory responsibility for maintaining drains was liable to a farmer whose land was flooded.
- A local authority with a duty to maintain roads and highways, was liable to a pedestrian who tripped on a pothole and fell causing injury.

The courts are less ready to infer a right of action where the harm suffered is pure economic loss.

## Interference with intellectual property rights

Intellectual property collectively refers to copyright, patents, trade marks, design rights and confidential trade information. Intellectual property owners, usually businesses owning and developing products and services with a brand identity, have the benefit of a tort called passing off. Where a party, X, intentionally leads others to believe that its business, goods or service are those of another, Y, then Y is entitled to bring a claim for passing off.

In order to establish interference with intellectual property rights, a claimant must demonstrate the following:

1. there is goodwill and / or a reputation in respect of the goods / services associated with the brand name / image being copied;

2. misrepresentation by the wrongdoer to the public, intentional or unintentional, which leads the public to believe that the goods / services offered by the wrongdoer are those of the claimant; and

3. damage suffered as a result of the wrongdoer's misleading conduct.

There are also various statutes relating to intellectual property rights, breach of which may also give rise to a cause of action.

## Deceit

Where a wrongdoer makes a false representation, intentionally or recklessly, with the intention that another party will rely on the same representation, where that party does rely on the representation and subsequently suffers a loss, the wrongdoer will be liable.

The tort of deceit, in its current form, was established following the case of *Pasley v Freeman*[58] in 1789. Freeman had falsely represented to Pasley that a third party was creditworthy when Freeman had knowledge that the same third party was not creditworthy. Pasley suffered a loss and Freeman was held liable for deceit.

## The "economic torts"

These require deliberate intent, and include:

- Conspiracy – this requires an agreement or an understanding by two or more people and can be (a) a conspiracy to do a lawful act by unlawful means[59] or (b) a "conspiracy to injure", which requires a predominant purpose to injure.
- Intimidation – where a party threatens or makes threats to another that he will commit an act, or use unlawful means against that person, which prevents the innocent party from doing something he is entitled to do, and which causes loss to the innocent party or to a third party.[60]

58 (1789) 3 T.R. 51

59 *Crofter Hand Woven Harries Tweed Co v Veitch* [1942] A.C. 435

60 *Rookes v Barnard* [1964] A.C. 1129 HL

- Inducement of breach of contract / procuring a breach of contract – knowingly to bring about or induce an innocent party, for example by active persuasion or enticement, to breach an agreement, causing loss to the other contracting party, without reasonable justification.
- Injurious or malicious falsehood – the Court of Appeal held in *Ratcliffe v Evans*[61] that "an action will lie for written or oral falsehoods, not actionable per se, or even defamatory, where they are maliciously published, where they are calculated in the ordinary course of things to produce, and where they do produce actual damage….".
- Unlawful interference with economic or other interests – where a wrongdoer uses unlawful means with the object and result of causing loss and / or damage to another. Interference does not need to amount to contracts being broken, it will suffice for an innocent party to have suffered loss brought about by the wrongdoer's unlawful means.
- Trade disputes / industrial action – Although permitted, in certain circumstances, under statute,[62] industrial action is tortious and could give rise to a cause of action, save for the statutory immunities in place. These immunities cover conspiracy to injure, picketing, interference with trade, unlawful interference with contracts and inducement to break a contract.

61 [1892] 2 Q.B. 524

62 Trade Union and Labour Relations (Consolidation) Act 1992; Trade Union Reform and Employment Rights Act 1993, the Employment Relations Act 1999 and the Employment Relations Act 2004.

# Summary

Part 1 has sought to explain what 'financial loss' is (namely pure economic loss – pecuniary loss not consequential on injury or damage), and how liability for it can arise.

Most claims in tort arise from situations where there has been injury or damage, and are claims in the tort of negligence. Damages by way of compensation for the injury, or the cost of repair or replacement of the thing damaged, are commonly recoverable, together with the reasonably foreseeable economic losses consequent upon the injury or damage.

Where there is no injury or damage, it is necessary to find a special relationship between the claimant and defendant for a claim in negligence to succeed. This may not be straightforward. Accordingly, deciding whether or not there has been injury or damage is an important step.

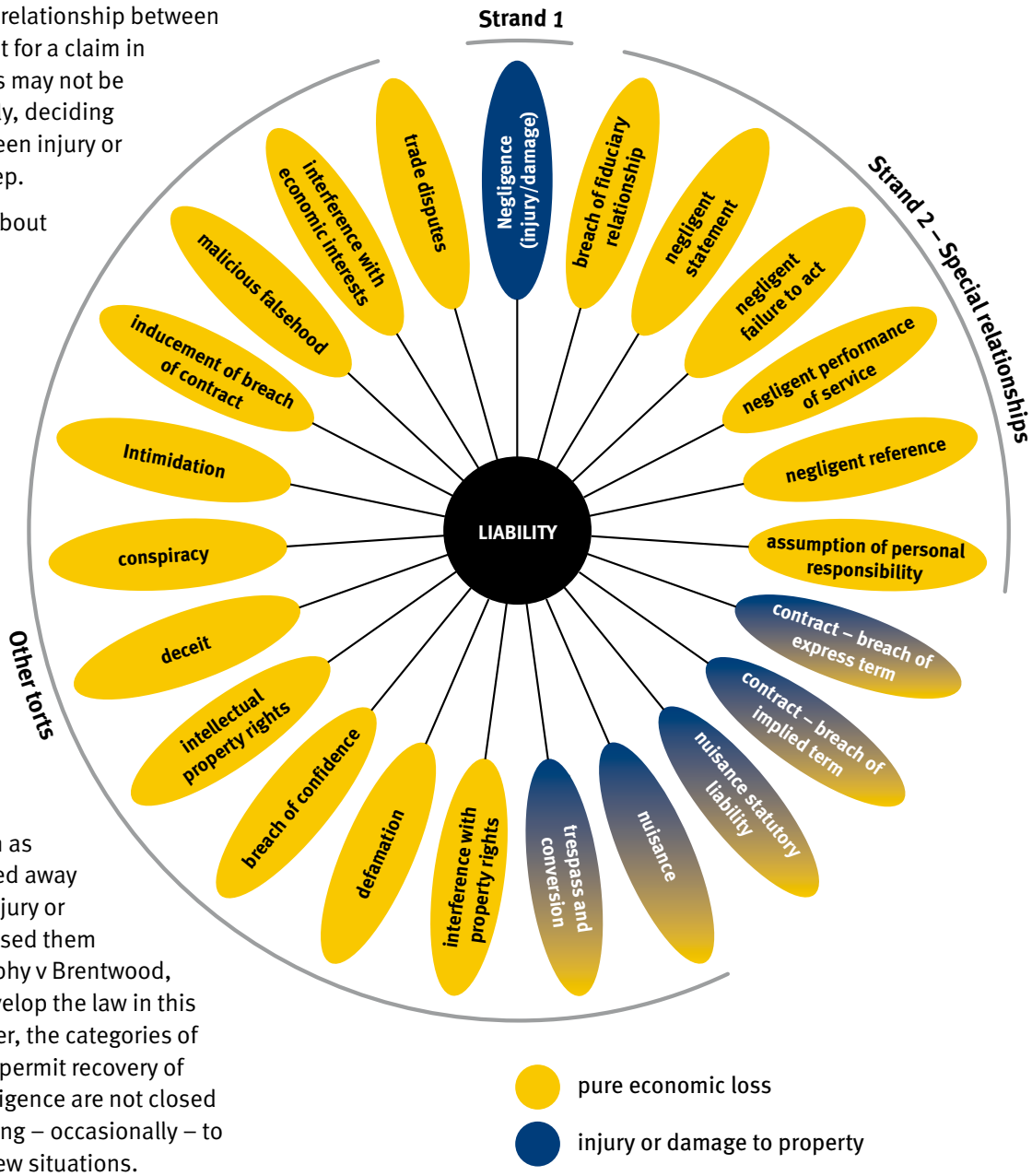
There are court decisions about whether there has been damage which have had results which some find surprising, for example the Bacardi case, but the principle is that a product or building that is merely defective has not been damaged. The cost of repairing or replacing it is pure economic loss, as is any further pecuniary loss that has been caused.

The courts opened the floodgates in the 1980s and early 1990s to claims for pure economic loss in negligence with cases such as Anns v Merton, which moved away from the requirement for injury or damage. However, they closed them again with the case of Murphy v Brentwood, and the trend now is to develop the law in this area incrementally. However, the categories of special relationship which permit recovery of pure economic loss in negligence are not closed and the courts are continuing – occasionally – to find defendants liable in new situations.

In contrast with the tort of negligence, it is routine to recover pure economic loss for breach of a contract. In addition, there are various statutes, as well as various torts other than negligence, which impose liability for pure economic loss.

The diagram below illustrates some of these types of liability.

This guide considers next the extent to which any of these liabilities for pure economic loss may be covered by insurance.



Financial Loss Guide Part 2

# When is ‘financial loss’ covered?

# Introduction

Having explored in Part 1 what 'financial loss' is (namely pure economic loss) and when liability for it may arise under English law, Part 2 looks at when such liability is covered in English law policies. However, those insuring UK businesses which may also have exposures to liabilities for such loss under foreign legal systems need in addition to understand those exposures, and when they might fall within the scope of cover of their English policies. Accordingly there is a very brief introduction to such exposures in certain other countries in Part 3.

To return to Part 2, the somewhat ambitious aim (given the different perceptions there currently appear to be about this area of insurance) is to enable anyone considering, or drafting, a wording or extension to reach a view, with a fair degree of confidence, of the extent of cover it provides for liability for pure economic loss.

The starting point is to consider the extent to which such cover may already be provided by the different types of liability policy an insured may purchase, and hence what gaps in cover may remain to be plugged by a 'financial loss' extension.

Once those gaps have been identified, it is then possible to go on to look at

(a) whether the 'financial loss' extension being considered does what it is supposed to do or

(b) how to tailor an extension to give the required level of further cover.

With these steps in mind, this Part is structured as follows:

- **Overview of cover for pure economic loss under different liability policies and types of cover**
- **Two concepts particularly relevant to cover for 'financial loss'**
- **Which policies are 'financial loss' extensions usually attached to and why?**
- **Public liability policies – insuring clause**
- **Product liability policies – insuring clause**
- **Public and product liability policies – exclusions**
- **'Financial loss' extensions – generally**
- **'Financial loss' extensions – insuring clause**
- **'Financial loss' extensions – exclusions**
- **Summary**

So first, a comparison of the relevant features of various different liability policies.

# Overview of cover for pure economic loss under different liability policies and types of cover

In going through the list below the way 'financial loss' cover is given should be borne in mind, namely as an "all risks" liability cover – all risks of liability for pure economic loss are covered apart from those which are specifically excluded. However, many 'financial loss' extensions are restricted to where the loss is caused by products, thus cutting out straight away many of the risks. As regards those that are not restricted to products, on the other hand, if the relevant exclusions are not inserted, they would provide cover for (for example) land disputes, competition issues, intellectual property disputes, employment issues, wrongful advice, and so on. Accordingly it is important to bear all of these different risks in mind, to identify those that are, or ought to be, covered under a more appropriate policy, and then to decide which of the rest should be covered under the extension. Whilst listed as separate risks for the purposes of explanation, it needs to be borne in mind that many insurers may integrate or combine some of these covers within a package type policy wording.

## Public liability

As its name implies, **public** liability insurance is normally directed at covering the insured's liability to members of the public. To a large extent this kind of liability arises in tort. It may also pick up **private** liabilities, namely ones which arise from breach of a contract (a private agreement), so long as the breach has caused injury or damage. However (and this will be explored further) the cover for pure economic loss under a public liability policy is quite limited.

## Product liability

A product liability policy has a different context. While it will respond to liability to members of the public in tort caused by a product (*Donoghue v Stevenson*[1] is the prime example of such a liability), product liability claims also frequently arise within a contractual setting – the buyer claiming breach of contract by the seller. If the breach of contract causes injury or damage, then it is likely to be covered, if there is no applicable exclusion. If there is no injury or damage then it is a claim for pure economic loss, which is likely to succeed only as a breach of contract claim. As will be explained, that claim is unlikely to be covered in the absence of a 'financial loss' extension.

## Product guarantee

A product guarantee policy in its basic form is a legal liability policy that "guarantees" the performance of the product – if the insured is liable for the product's failure to perform its intended function, the policy will pay for the cost of its removal, repair, replacement etc., and other consequential losses of the customer. It is a safety net for when the insured's quality control fails. Because it exists as a specialist line of insurance, the cover it provides is typically excluded from other policies, including from 'financial loss' extensions.

## Product recall

A product recall policy provides cover for pure economic loss, such as the cost of recalling products that are dangerous but which have not yet caused any injury or damage. Some recall policies provide only first party cover (the insured's own costs of recalling its product) and are therefore not relevant to this guide; others also provide cover for the legal liability of the insured in respect of losses incurred by others as a result of having to recall the insured's products. Those are pure economic losses. Again, as it is a specialist line of insurance, mainstream liability policies (and 'financial loss' extensions) usually – but not always – exclude cover for recall costs.

## Employers' liability

Employers' liability policies relate to the insured's legal liability for injury to its employees. The employee has to suffer injury, disease or death for the cover to be triggered. Accordingly these policies do not provide cover for pure economic loss.

## Professional indemnity

As for professional indemnity insurance, most claims against professionals are brought by their clients in contract, and by their nature tend to be for pure economic loss. It is therefore normal for professional indemnity policies to cover a significant amount of contractual liability, including liability for pure economic loss. Further, as was explained in Part 1, professionals can

1 See Case 1

also incur liability in tort to both their clients and others for pure economic loss, and they require cover for such liability as standard as well. Accordingly, it is inappropriate to have a 'financial loss' extension to a professional indemnity policy (it would be replicating part of the cover already provided by the operative clause).

## Directors and officers

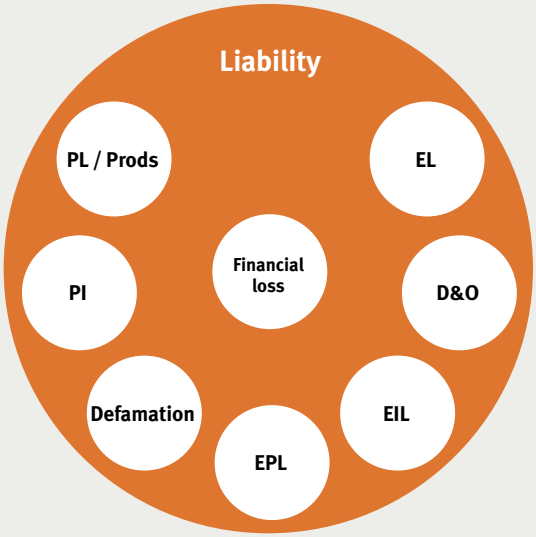
Directors and officers operate within a statutory framework, and face various different liability exposures, many of them involving pure economic loss. A D&O policy, like professional indemnity insurance, provides a significant amount of cover for such loss, and there is again unlikely to be any 'financial loss' extension in such a policy.

## Advertising liability and intellectual property rights

Advertising liability and intellectual property infringement policies (or extensions) can provide a measure of cover for liability for defamation, intellectual property right infringements and invasion of privacy rights, amongst other things, directly related to mistakes in the advertising material or activities of the insured. Given that such liabilities give rise to pure economic losses, and given the existence of these specialist covers, these kinds of liability are routinely excluded from mainstream liability policies, and also from 'financial loss' extensions.

**Box 14 – How is an insured's liability covered?**

This illustrates how various types of policy cover different types of liability, ideally without overlap, with a 'financial loss' extension carving out its own territory; the turquoise shaded area represents all those liabilities which remain uninsured.




## Defamation

Much broader than the cover given under an advertising liability wording, these can be either specialist covers for publishers and printers or extensions to public liability policies for those with a small or incidental publishing activity or potential defamation risk. The policy will cover liability against actions for libel or slander arising out of the published or printed or broadcast material or the general business. The policy may also cover the cost of withdrawing the libellous material. Again these are liabilities for pure economic losses and would not be covered under mainstream liability covers.

## Employment practices liability

Another specialist type of policy covers employment practices liability. It provides protection for employers against claims by past, present and potential employees based on discrimination, wrongful termination of employment, harassment, and other employment-related claims. Such claims will often be for pure economic loss, and are normally excluded from mainstream liability policies and from 'financial loss' extensions.

## Environmental impairment liability

An environmental impairment liability policy is designed to provide wider cover for pollution than may be given by public or products liability policies (where cover, if given, is typically limited to sudden pollution incidents). To avoid the risk of providing overlapping cover, 'financial loss' extensions often exclude all pollution exposures.

The IUA has published a paper on environmental risks, 'Environmental Risks – insured or not?, which is freely available from the Non-Marine Environmental Committee section of the IUA website, www.iua.co.uk. It examines the key environmental risks in light of recent legislative developments and considers the interaction between environmental impairment liability and traditional liability policies in providing cover for environmental risks.

# Two concepts particularly relevant to cover for 'financial loss'

## The presence or absence of injury or damage

As was shown in Part 1, the law distinguishes between situations where there has been injury or damage and those where there has not in order to control who should be liable to whom. The way insurance provides cover reflects this to a large extent. By way of example, 'financial loss' is defined as not being consequential on injury or damage.

## The extent to which cover for contractual liability is given

The law also distinguishes between situations where relationships are governed by the "public" law – namely tort – and where they are governed by "private" law – namely contract. Insurance policies accordingly need to control the extent to which they cover contractual liability. Since liability for pure economic loss (or 'financial loss') most commonly arises out of contractual relationships, the extent to which 'financial loss' extensions provide contractual liability cover is important.

In fact, a very valid question is the following: **What cover does a 'financial loss' extension give if it excludes cover for contractual liability?**

These concepts, as well as the question just posed, are now considered in more detail.

**1. The importance of the link to injury or damage**

'Financial loss' (pure economic loss) is pecuniary loss not consequential on injury or damage (see Box 1). The cover under public and product liability policies is normally given for the consequences of injury to another party, or damage to another party's property.

Many public / product liability policies state that the cover is "in respect of" injury or damage. However, some say (for example) that the cover is "arising out of" injury or damage. There is a big difference, which is considered in more detail in several noteworthy cases including the *Screenprint* and *Horbury Building Systems* cases highlighted in case summaries 22 and 23 respectively.

The first restricts the cover to losses directly caused by the injury or the damage; the second covers all losses that arise as a consequence of the injury or the damage (assuming that the insured is legally liable for them).

**2. The importance of contractual liability**

As just discussed, the main control mechanism in policies which are not supposed to cover pure economic loss is to link all loss tightly (or in some cases, not so tightly) to injury or damage. This results in a range of possible outcomes as follows:

a) providing cover for liability in tort where the tort depends on injury or damage

b) providing cover for liability in contract where there has been injury or damage

c) providing cover for liability under statute where there has been injury or damage

d) providing no cover for pecuniary losses which are not closely enough linked to the injury or damage, and

e) by definition, where there has been no injury or damage, providing no cover.

Both (d) and (e) flag up potential gaps in cover. Scenario (d) has been discussed under the last heading. An example of this gap is in Case 22 – the Maltesers case – where the loss of profit for which the insured was liable was not covered because even though there had been damage, the loss in question was not "in respect of" that damage.

Scenario (e) arises whether or not the liability in question is based on tort, contract or statute. As was explained in Part 1, liability in **tort** in the absence of injury or damage can arise in several ways, whether in negligence where there is a special relationship (see Box 7) or under various other torts. Similarly, liability under **statute** can also be incurred in the absence of injury or damage. However, the biggest gap in cover for pure economic loss, in the sense of the one where commercial insureds are likely to have the most exposure, is for liability in **contract** which is not based on injury or damage.

Since scenario (e) illustrates a gap which can be plugged by an appropriately designed 'financial loss' extension, it is vitally important – because it is potentially of most benefit to commercial insureds – to know whether the extension does provide any contractual liability cover, and if so, how much.

The fact that 'financial loss' cover is given on an "all risks" basis means that the precise terms of any contractual liability exclusion are crucial. There are various ways of approaching such exclusions, and some of the variants currently in use will be considered on page 57.

This brings us to the question: **if a 'financial loss' extension excludes contractual liability, what cover is left?**

Since many 'financial loss' extensions do try to exclude contractual liability, this is a question which inevitably arises, because there are always many further exclusions which can appear to exclude all other potential types of liability. The result can be an extension which seems to provide no cover at all.

This anomaly is actually the result of the way the law changed. With the line of cases leading up to *Junior Books*[2] came the birth of "tort only" 'financial loss' extensions (which by definition did not provide any contractual liability cover) and when the law in the UK swung away from *Junior Books*, the insurance market ought perhaps to have swung away from those *"Junior Books"* extensions, at least as regards UK exposures. There is potentially still cover for exposures in those jurisdictions where pure economic loss is still recoverable in tort (see Section 3 generally) and there is also cover in the perhaps unlikely event that the law changes direction and makes pure economic loss more freely recoverable in tort again. Despite this, even after nearly 30 years these extensions have remained in use. In parallel, over the same period variations have gradually developed which do provide valuable cover.

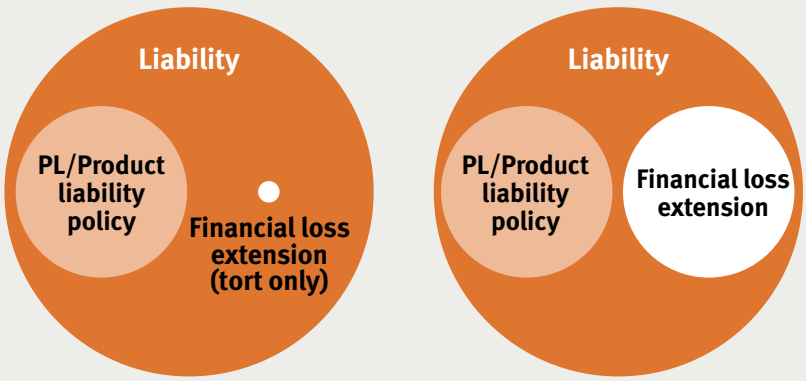
Accordingly there is in use a whole range of 'financial loss' extensions, from those which provide arguably almost no cover at all at one end of the range, to those which provide significant contractual and other cover at the other.

Later in this Part, the characteristics of current 'financial loss' extensions will be examined, with a view to making it clearer where within the range any particular extension will sit.

Before then, however, it is necessary to examine which types of cover are suitable for extending to cover pure economic loss.

**Box 15 – how wide is your 'financial loss' extension?**

The difference is likely to be largely due to either (a) the ambit of the contractual liability exclusion or (b) a drafting mistake (e.g. forgetting to put an exclusion in).




2 See Case 11

## Which policies are 'financial loss' extensions usually attached to and why?

The answer is **public and products** liability policies, because cover is normally restricted to just legal liability for injury and/or damage to property. Therefore there is no cover for pure economic loss (which is loosely referred to as 'financial loss').

There is no intrinsic need for the public and products liability policy to give cover for pure economic loss (i.e. via a 'financial loss' extension) but quite often a broker will request it and an extension may then be given by the insurer.

There are differing practices amongst underwriters as to how these 'financial loss' extensions are priced. They are often given at the request of the broker, for no extra premium. The broker may have 'financial loss' cover on his shopping list, and be more concerned about ticking that item off than about the precise extent of the cover offered by the extension in question. In such circumstances the fact it is included by the underwriter at no extra cost may reflect the belief of both underwriter and broker that the cover provided is minimal.

However, where the extension does provide more valuable cover, then it may attract an additional premium. This guide will hopefully enable underwriters and brokers to assess better what is within the scope of their extensions, and to agree on the appropriate additional premium. Until this becomes the norm, the wide differences in cover that are available will (as often seems to be the case) continue to go unnoticed, and those extensions which provide wider cover will be undervalued by both parties to the policy.

## Public liability policies – insuring clause

The aim of public liability policies is, broadly, to provide cover for tort liability arising from accidental injury or damage to persons or property or interference with their property rights. These are **public liabilities**. Box 16 contains an insuring clause from such a policy (which happens to be a project policy but the principles are the same). In Box 16, (a) and (b) relate to injury and damage. However, (c) does not depend on injury or damage but can give rise to pure economic losses. Accordingly there is in most public liability policies an element of pure economic loss cover already in the standard cover.

A pure economic loss extension to a policy with such an insuring clause should have an exclusion of cover arising out of any of (c), in order to avoid duplicating this cover.

The clause in Box 16 was the subject of the decision in *Tesco Stores Limited v Constable and Others* (Case 20). The issue was whether the policy, as a typical example of public liability cover, provided cover under (c) where the liability for the obstruction etc. was solely a contractual one. In reaching their decision (that there was no contractual liability cover), the Court of Appeal made some useful observations about aspects of the insuring clause.

It should be borne in mind that the more usual expression for this type of cover in UK policies would be on the lines of "nuisance, trespass or interference with any easement of air, light, water or way" but the essential point so far as concerns liability for pure economic losses remains the same.

**Box 16: Public liability policy insuring clause**

The insurers will indemnify the insured against all sums for which the insured shall be liable at law for damages in respect of:

a) death of or bodily injury to or illness or disease of any person

b) loss or damage to material property...

c)obstruction, loss of amenities, trespass, nuisance or any like cause happening or consequent upon a cause occurring during the Construction Period or any extension thereof and arising out of and in connection with the Project.

**Case 20 – Tesco Stores Limited v Constable and Others[3]**

Tesco wished to enclose a section of the railway which ran through a cutting near Gerrards Cross, and to build a supermarket on top. The track and surrounding land was owned by Network Rail, and Chiltern operated the trains under an agreement with Network Rail. The rail regulator required Tesco to take out public liability cover of £155m, and Tesco also entered into a deed with Chiltern which granted Chiltern a very wide contractual indemnity up to £155m.

On 30 June 2005 a section of the tunnel collapsed, damaging the property of Network Rail, but no property belonging to Chiltern was damaged. However, Chiltern suffered losses, including loss of passenger revenues, for which Tesco were liable to Chiltern under the deed. Tesco claimed indemnity for this contractual liability for pure economic loss under the insuring clause in Box 16.

Tesco argued that using the ordinary meaning of the words, Chiltern had suffered "obstruction, loss of amenities, trespass, nuisance or any like cause" for which Tesco was liable, and therefore within the insuring clause. Tesco said it did not matter that it was a contractual liability.

However, the Court of Appeal disagreed for the following reasons:

- Public liability insurance provides cover against liability to the public at large, unlike private liability which arises from contracts entered into between individuals. Public liability in this sense arises in tort; it cannot arise only in contract. The insuring clause here is consistent with this.
- While the words "liable at law for damages" are wide enough to include liability in contract, the restrictive words "in respect of" make clear that the cover is against liability in tort. This is because the classes of liability that follow are all tortious ones:
- Interference with a third party's person
- Interference with a third party's property, or
- Interference with a third party's property rights.
- Regarding those property rights, "nuisance" is a well recognised tort, where the claimant must have an interest in the land affected; "trespass" is also a recognised tort requiring an interest in land; "obstruction" and "loss of amenities" in this context refer to obstruction of the highway or a private right of way, and to loss or impairment of such amenities as the quiet enjoyment of possession of land, and easements such as rights of way, rights to ancient lights, rights of support, water rights etc., all of which give rise to a right to compensation in tort.
- The words "or any like cause" in this context are describing types of harm for which compensation will lie in tort.

Accordingly, as Tesco's liability to Chiltern was solely in contract, that liability was not covered. It was a private liability arising out of the private contractual arrangements between Tesco and Chiltern, rather than out of any general tortious liability.

Since *Tesco v Constable* was decided, underwriters have occasionally been asked to provide "*Tesco extensions*" under which Tesco's liability to Chiltern would have been covered. However, this liability does not need to give birth to a new kind of extension – all that is needed is a suitably worded 'financial loss' extension which provides the right level of contractual liability cover. See page 57 for more about such cover.

The use of the word "**damages**" in the insuring clause of a typical public liability policy is also important. Its effect is illustrated in the *Bartoline* case (Case 21), which also emphasised the way public liability policies generally cover just liabilities in tort.

**Case 21 – Bartoline Limited v Royal Sun Alliance plc[4]**

Bartoline manufactured adhesives at its premises in East Yorkshire. In 2003 a fire broke out at the premises, and the neighbouring watercourses (the Swinemoor and Barmston Drains) allegedly became contaminated with fire fighting materials and chemicals. The Environment Agency carried out emergency cleaning up work using its powers under the Water Resources Act 1991. It claimed the cost of doing so from Bartoline. It also served notices requiring Bartoline to do further work. Bartoline claimed under its public liability policy an indemnity for the expenses claimed from it by the Agency, and also for the costs it had incurred in complying with the notices.

The issue was whether these were capable of being a "legal liability for damages…in respect of damage to property" within the insuring clause.

The judge decided that a liability to repay expenses incurred by the Agency and a liability to pay damages in tort were different. The indemnity did not extend to money payable pursuant to statute. It extended only to legal liability for damages to a third party which had suffered actual loss and damage caused by a tortious act. Bartoline's own costs incurred in complying with the notices were not covered either.

Note that many UK wordings refer to liability to pay "compensation" rather than "damages" (e.g. see Case 25 later on). It is unlikely that the variation in wording would have made any practical difference to the outcome of the case.

3 [2008] EWCA Civ 362

4 [2007] Lloyd's Rep IR 423

As a result of the *Bartoline* case, so-called "Bartoline Extensions" started to be available as extensions to public liability policies to provide the cover which Bartoline had argued it was entitled to. An alternative way to buy such cover is under a specialist environmental impairment liability policy.[5]

The words **"in respect of"** in the insuring clause were interpreted in *Tesco* in a restrictive way, and the same interpretation has been applied in the context of product liability policies whose insuring clause also contains that phrase to link the liability to injury or damage. This is important, because those who manufacture or supply products will inevitably enter into contracts, and as will have been seen from Part 1, damages for breach of contract can include pecuniary losses which would not be recoverable in tort.

Accordingly, where an insured is liable for breach of contract, his product liability policy may well not cover all of that liability, leaving some pecuniary losses uninsured. This is considered next.

## Product liability policies – insuring clause

Product liability cover is written in either of two ways:

- In the same section as public liability, sharing the same insuring clause, or
- In a separate section, with its own insuring clause.

Both product liability cover and public liability cover are given on the same basis, both requiring injury or damage, hence their ability to share the same insuring clause. Where they are in separate sections there are two drafting points:

- the public liability section has to have an exclusion of liability caused by products (where they are in the same section, no such exclusion is necessary), and
- the product liability insuring clause needs to include words such as "and caused by products".

It is interesting to speculate whether the decision in *Tesco v Constable* (namely that the typical public liability insuring clause is intended to cover just tort liability) would have been the same if the insuring clause been shared with product liability and if the loss had been caused by a product. It would have been possible to argue that since many, if not most, product liability claims are brought either under statute (the Consumer Protection Act) or in contract (by the buyer against the seller), it cannot be the intention of the insuring clause not to cover such statutory or contractual liability.

Certainly the current practice in the insurance market in relation to product liability is that such statutory or contractual liability, so long as it is sufficiently linked to injury or damage, is covered (in the absence of any relevant exclusions). It remains to be seen whether any insurer will seek to challenge that practice, relying on *Tesco*.

5 For further details see the IUA publication, Environmental Risks – insured or not?, available from the Non-Marine Environmental section of the IUA website, www.iua.co.uk.

**Box 17: Product liability insuring clause**

….will indemnify against all sums which the insured shall become legally liable to pay **in respect of** death, bodily injury, illness, loss or damage…happening anywhere in the world…during the period of insurance and caused by goods (including containers) manufactured, sold, supplied, repaired, altered, installed or treated in the course of the Business from any premises within Great Britain…

An example of an insuring clause in a separate product liability section is in Box 17.

There is a string of product liability cases which were concerned with whether there was cover for the insured's contractual liability to its customers for certain pecuniary losses which accompanied damage to property. In each case the phrase **"in respect of"** was of vital importance. It transpired that there was no cover for liability for pecuniary loss which was not sufficiently closely connected with the damage.

It is worth looking at some of these cases because of the way they draw the line between covered losses and those which are outside the scope of cover. The first case, Case 22, features the insuring clause in Box 17.

**Case 22 – AS Screenprint Limited v British Reserve Insurance Co Limited[6]**

AS Screenprint received an order from LMG Folding Cartons Limited to print 52,000 Maltesers gift boxes. Once printed, LMG supplied the gift boxes to Mars to be packed with Maltesers chocolates.

Mars subsequently complained to LMG that the Maltesers had been contaminated by the packaging and claimed damages from LMG for the losses it had suffered as a result of the contamination. LMG settled Mars' claim for £282,243. LMG then claimed from Screenprint:

- the £282,243 it had paid to settle its liability to Mars. and
- £980,244 for loss of profits on anticipated further orders which were not placed by Mars following the contamination.

Screenprint sought an indemnity for both these sums under the product liability section of the combined policy they held with British Reserve (BRI), which contained the insuring clause in Box 17.

BRI did not dispute that they were liable to indemnify Screenprint for the £282,243. They clearly accepted that LMG's liability to Mars was in respect of damage (the contamination of the packaging and the Maltesers) and therefore within the scope of cover. They declined indemnity, however, for the claim for LMG's loss of profits of £980,244.

Screenprint sought a declaration that they were entitled to an indemnity for the sum representing LMG's loss of profits.

**"In respect of"**

The Court of Appeal held that to determine whether the loss of profits was covered, it was necessary to look closely at the wording of the insuring clause. The indemnity provided was for sums that Screenprint became legally liable to pay **"in respect of"** loss or damage happening somewhere in the world during the period of insurance. Whilst there was no reference to damage to property, the words loss and damage had to be construed in this context as something that related to a physical event

The printed material supplied or treated by Screenprint had caused both the contamination of the packaging and contamination of the Maltesers. They could therefore show that the goods they had supplied or treated had caused damage to the packaging and the Maltesers - a physical event. However, this damage was the limit of what could be proved as a matter of physical causation.

The Court of Appeal went on to consider whether Screenprint's legal liability to pay LMG's loss of profits was **"in respect of"** the contamination of the packaging and the Maltesers. They decided that it was not. The liability for the loss of profits claim was not caused by the contamination, but by Mars choosing not to place further orders with LMG. It was an economic loss arising from a loss of goodwill. A liability to pay compensation in respect of a pecuniary loss arising from a loss of goodwill was not a liability "in respect of" a physical loss or damage physically caused. Accordingly, the loss of profits claim was not covered.

So, in *Screenprint* the cover did not extend to the liability for loss of profits. Accordingly, in a standard products liability policy which uses the words "in respect of" there is a gap in cover.

## The Screenprint gap in cover – how to fill it

The loss of profit was not covered because it was not a liability "in respect of" a physical loss or physical damage. It was found to have been caused by a loss of goodwill instead. Some may view this as an artificial distinction, since the loss of profit would not have happened if there had been no damage, but it is the result of the very direct link that is required by the words "in respect of". Ways of expanding the cover include the following:

**a) Amending the product liability policy**

If one were to substitute a different linking phrase, such as "accompanied by" or "occasioned by" or even (to make it a very loose link) "directly or indirectly resulting from", then liability for such a loss is more likely be sufficiently closely linked to the damage for it to

6 [1999] Lloyd's Rep IR 430

be covered.[7] If one expands the cover by going down this route, one is moving away from the product liability cover being restricted to only the close consequences of injury or damage to, instead, a wider cover which picks up more of the financial consequences of the injury or damage (provided of course the insured is legally liable for them).

**b) Providing a sufficiently wide 'financial loss' extension**

An alternative solution would be via a 'financial loss' extension. This would require careful drafting for the reasons given below. Cover under such an extension would almost certainly be on a claims made basis (see Box 18).

A drafting issue arises because of the way 'financial loss' extensions require the loss not to be linked to injury or damage. As will be seen on page 52, there are various linking phrases that are used, such as:

- not occasioned by injury or damage
- not consequent upon injury or damage
- not accompanied by injury or damage

The aim is to keep well away from liabilities for losses linked to injury or damage. Other words could be added to keep even further away from such liabilities. Although the connection between the damage and the loss of profit in *Screenprint* was not close enough for the loss to be "in respect of" the damage, it may have been close enough to be "occasioned by" or "accompanied by" the damage, for example, in which case it would still be outside the scope of an extension using such phrases. Therefore one is likely to have to amend the extension if it is to fill the *Screenprint* gap, care being necessary in the drafting in order to avoid providing more cover than intended.

## The Screenprint gap in cover – whether to fill it?

In *Screenprint* the loss of profit was over three times as much as the covered loss. In other similar cases the non-covered losses were also substantial. Such losses have the potential to be large; they depend upon the parties' commercial arrangements and their value is likely to be less predictable than the value of physical losses and their immediate financial consequences.
If an underwriter is considering extending the cover by loosening the control mechanism, or by providing an appropriately worded 'financial loss' extension, to enable him to assess the increased exposure he will require additional relevant information, not least the potential liabilities of the insured's trading partners in the event that the insured's products cause damage to the property of a party further up the contractual chain.

To return to where the line is drawn in a product liability policy, the next case illustrates the meaning of "in respect of" in a construction context.

7 This is not a drafting guide and should not be relied upon as such – for specific situations, specific advice should be sought.

## "In respect of" continued

**Case 23 – Horbury Building Systems Limited v Hampden Insurance NV [8]**

Horbury Building Systems Limited was sub-contracted to provide partition walls and ceilings for a 16 cinema complex being built by Galliford for AMC. The ceilings in the cinemas were suspended from the roof by hangers. Shortly after the complex opened, the ceiling of one of the cinemas, cinema 6, collapsed. Although the damage caused by the collapse of the ceiling did not physically prevent the use of the rest of the complex, AMC immediately closed the entire complex for several weeks to allow an investigation to take place. In the course of the investigation, it was discovered that Horbury had used the wrong washers to fix the ceilings in five of the other cinemas and these had to be replaced.

AMC claimed damages from Galliford for

- loss of revenue for the whole complex whilst it was closed
- the costs of physical repair and
- additional marketing and advertising costs.

Galliford passed AMC's claims on to Horbury.

Horbury sought indemnity from its product liability insurer Hampden, whose policy provided cover for:

*"... liability at law for damages ... **in respect of** ... loss of or damage to Property [defined as material property] ... caused by any Products."*

Hampden denied liability and Horbury issued proceedings seeking a declaration as to whether Hampden were liable to indemnify them if they were held liable for AMC's loss of profits for the period during which the complex was closed.

**"In respect of"**

The Court of Appeal considered the insuring clause and held that the words **"in respect of"** had a limiting effect on the extent of the cover. The words did not merely identify the causal event that had to give rise to the insured's liability. It was not sufficient that the liability simply had some connection with that causal event.

The loss of profits resulting from the closure of the rest of cinema complex was not itself physical damage. Horbury's case therefore depended on such loss of profits having been caused by the collapse of the ceiling in cinema 6. The Court therefore had to look at the concept of causation.

As far as causation was concerned, whilst in one sense the collapse of the ceiling in cinema 6 "caused" the closure of the rest of the complex, in the context of the policy the cause of the widespread closure was the concern of AMC about the possibility of similar defects in the ceilings of the other cinemas, not physical damage to those other cinemas. The mere fact that the collapse of cinema 6 triggered those concerns was not sufficient to bring losses flowing from the closure of the entire complex within the terms of the policy.

The Court of Appeal concluded that the policy provided cover for liability for the physical consequence of the collapse of the ceiling in cinema 6 and such economic losses as were caused by that physical damage. This did not embrace the loss of profits resulting from the closure of the rest of the complex.

## Damage or defect, in the context of insurance policies

In addition to considering the words in the policy linking the liability with the injury or damage, the question of whether there actually is **damage** or only a **defect** is important in assessing whether what has happened is covered. Part 1 page 10 looks at how the law decides what damage is for the purposes of the tort of negligence and (in the *Bacardi* case) for the purposes of a contractual exclusion clause. Since public and products policies depend on damage, it is necessary to know when there has been damage for the purposes of the policy.

The next case considers the "defect or damage" issue for the purposes of a global liability policy. It is also interesting because the words in the policy linking what happened to the liability were not "in respect of" but "on account of".

**Case 24 – Tioxide Europe Limited v CGU International plc[9]**

Tioxide manufactured and supplied white titanium dioxide pigment for use in the manufacture of u-PVC compounds, which were in turn used in the manufacture of u-PVC window and door frames. The pigment was designed to give a white colour to the end product and to help maintain whiteness in outdoor weather conditions. However, due to a defect in the pigment, the pigment caused discolouration or "pinking" of window and door frames in certain environmental conditions.

8 [2004] EWCA Civ 41

9 [2004] EWHC 2116 (Comm)

Claims for the costs of repairing or replacing the window and door frames that had pinked were made by consumers against the retailers and manufacturers of the window and door frames. The retailers and manufacturers, in turn, issued proceedings against Tioxide to recover damages in respect of

- the claims by consumers for the costs of repair or replacement, and
- the loss of goodwill, business and profits they had suffered as a result of the pinking problem.

The proceedings were settled by Tioxide on confidential terms.

Tioxide sought an indemnity for the settlement sums and any future proceedings that may be brought against it under the global liability policy it held with CGU, which provided an indemnity for sums:

*"which the Insured shall be obligated to pay by reason of the liability … for damages on account of … Property Damage … resulting from each Loss"*

Property Damage was defined as:

*"(a) physical injury to or destruction of tangible property including the loss of use thereof resulting therefrom;*

*(b) loss of use of tangible property which has not been physically injured or destroyed."*

CGU declined indemnity and Tioxide issued proceedings.

The Judge considered the insuring clause and held that Tioxide had to show that a claim had been made against it for damages on account of property damage as defined.

Had there been damage?

The Judge accepted Tioxide's case that the change in colour of the u-PVC products amounted to property damage as defined. "Physical injury to tangible property" extended to **any unwanted physical change in the relevant subject matter**, even if the change was not permanent or irreparable, **provided that the change impaired the value or usefulness of the subject**. That being so, the physical injury was to the products manufactured using u-PVC compounds containing the pigments, not to the compounds themselves, and it occurred at the earliest when those products were installed in environmental conditions that made pinking liable to occur.

**"On account of"**

"On account of" were words intended to provide a causal link between the damages sought in the claims made against Tioxide and the property damage. The wording did not require, as it could have done, that the claims were made against Tioxide "for" or "in respect of" property damage.

The claims against Tioxide were brought, not by the consumers whose property had suffered the physical injury, but in contract by the retailers and manufacturers who were allegedly liable to indemnify those persons. Although the claims against Tioxide were therefore for pure economic loss, and not for damage to property, the wording of the insuring clause did not focus on such distinctions. The fact that the claims were for pure economic loss did not necessarily mean that damages were not sought "on account of" physical injury to the u-PVC products. The words "on account of" were sufficiently wide to encompass claims for the cost of repair or replacement of those products that had pinked.

Claims for damages for loss of business or profits said to have resulted from the pinking problem could not, however, be said to be claims for damages "on account of" physical injury to the finished products. The words "on account of" required a more direct connection between the loss claimed and the physical injury sustained.

Accordingly, unlike *Screenprint*, there was cover for some pure economic losses because "on account of" let them in while "in respect of" would probably not have done; "on account of" did nonetheless result in other pure economic losses not being covered.

A further issue arising in relation to "*damage*" is what constitutes damage where the defective property has been incorporated within other property but remains distinct from it.

This is particularly relevant to the construction industry where defective products (for example, panelling, windows and ceilings) may be installed in the structure of a building. The question then becomes whether the building as a whole, or any other components of the building, have been damaged by the incorporation of the defective product.

The issue of whether *"damage"* arises in this situation was considered in the case of Pilkington v CGU Insurance, detailed in Case 25.

**Case 25 – Pilkington UK Limited v CGU Insurance plc[10]**

Pilkington manufactured and installed 3,000 heat-soaked toughened glass panels in the roof and vertical panels of the former Eurostar terminal at London Waterloo. Pilkington were subcontractors to Tarmac, who had a contract with Eurostar, the owners and operators of the terminal.

Thirteen of the panels were defective in that they fractured once installed. Although no personal injury was caused and there was no damage to the fabric of the terminal other than the fractures in the panels

10 [2004] EWCA Civ 23

themselves, Eurostar were concerned that passengers or staff may be injured if further fractures occurred, and commissioned an investigation. In the event, Eurostar chose not to remove and replace the panels but instead installed safety nets under the panels designed to prevent fractured glass from falling and causing injury.

Eurostar brought proceedings against Tarmac for damages for the costs of the investigation, management time and the costs of the remedial scheme. Tarmac, in turn, claimed an indemnity from Pilkington. The proceedings were settled with Tarmac and Pilkington contributing to the settlement. Having made a partial recovery from their professional liability insurers, Pilkington sought indemnity from their global liability insurers, CGU.

The insuring clause of the CGU policy provided an indemnity against:

*"all sums which the Insured shall become legally liable to pay for compensation and claimants' costs and expenses in respect of any Occurrence to which this Policy applies as stated in the Specification and in connection with the Business."*

The product liability section of the specification referred to:

*"... loss of or physical damage to physical property not belonging to the Insured or in the charge or under the control of the Insured .... caused by any commodity article or thing supplied installed erected repaired altered or treated by the Insured and happening during the Period of Indemnity elsewhere than at the Insured's premises."*

CGU denied liability on the basis that, on the plain and ordinary meaning of the words of the cover, the mere installation of the panels and their incorporation into the building did not, simply because of a risk of future fracture, amount to physical damage of the terminal.

Pilkington issued proceedings claiming a declaration that the sums it had paid in settlement of Eurostar's claims were covered under the global liability policy. Pilkington argued that the need to repair the terminal meant that the terminal was physically damaged by the installation of the defective glass panels. They said that the costs of taking precautions to allow the building to be used safely were covered as they related to that physical damage.

**No damage**

The Court of Appeal held that in order to establish cover under a products liability cover, the insured had to demonstrate some physical damage caused by the product, for which a defect or deterioration in the product was not itself sufficient, and that the loss claimed must be a loss resulting from that physical damage. As it could not be shown that physical damage had occurred within any part of the terminal other than a small number of the panels themselves, the appeal could only succeed if the incorporation of a potentially dangerous and defective product into the physical structure of a building in itself constituted loss of or physical damage to physical property.

Where a product is supplied for incorporation into a building and it is so incorporated without damage of any kind and in a condition such that it and the other components of the building function effectively, subject only to the possibility of some future failure or malfunction, that does not in the ordinary sense give rise to physical damage in those other components or the building as a whole. At best, it creates the possibility of some fracture or malfunction occurring in the future. To take precautions at that stage is simply to anticipate future injury or damage that may be covered by the policy and the costs of those measures do not fall within the cover provided by a product liability policy without a specific term making that clear.

The Court of Appeal noted that in English law damage usually referred to a changed physical state, the relevant alteration being harmful in the commercial context. This plainly covered a situation where there was poisoning or a contaminating effect upon the property of a third party as a result of the introduction or intermixture of the product supplied. It did not, however, extend to the position where the product supplied was installed in or juxtaposed with the property of a third party in circumstances where it does no physical harm and the harmful effect of any later defect or deterioration is contained within it.

As Pilkington could not show physical damage to physical property, other than the defects in the glass panels themselves, its claim failed.

*Tioxide* was a case where there was damage rather than a defect; *Pilkington* illustrated a defect rather than damage. The facts of a more recent insurance case, *Omega Proteins v Aspen* (see Case 28, where it is considered primarily in relation to a contractual liability exclusion) has similarities to *Bacardi* (though *Bacardi* was not an insurance case) as it involved mixing of products (contaminated meat products with sound ones). However, in *Omega* the insurer had accepted that damage had been caused so the court did not have to consider the point.

Finally, a case which considered what can constitute damage at a microscopic level – although a property insurance case, the principle is likely to apply more widely.

**Case 26 – Quorum A S v Schramm[11]**

A pastel painted by Degas in 1881 called *La Danse Greque* was in a strong room in a warehouse when there was a fire in the warehouse. This caused it to be exposed to rapid increases in heat and an increase in humidity. Fortunately, apart from some minor paper tears and bowing of the backboard, no change was visible to the pastel itself, apart from a loss of brilliance, which was however visible only to the highly expert eye. In fact, the pastel itself had been affected at a sub-molecular level, with resultant greater fragility of the pigment. However, the extent of the sub-molecular change could not be determined without testing, which could not be carried out because of its effects on the pastel.

The defendant underwriters provided cover for "direct physical loss or direct physical damage of whatsoever nature". They contended that apart from the paper tears and bowing of the backboard, there was no other direct physical damage.

The judge accepted that depreciation in value because of the suspicion of possible physical damage would not have been covered, and nor would indirect physical damage have been. However he considered that the sub-molecular change constituted damage – direct physical damage resulting from the fire. It gave rise to the shortening of the life of the pastel and the risk of deterioration. Accordingly the loss was covered.

11 [2001] EWHC 494 (Comm)

# Public and product liability policies – exclusions

In order to ascertain the scope of cover, in addition to the insuring clause it is of course necessary to look at the exclusions. It is appropriate to look at exclusions to both public and product liability policies together, given the similarities of both kinds of cover.

The examples below are not an exhaustive list.

| Exclusion of liability: | Comments |
|---|---|
| for advice, design specification, inspection, testing, for a fee, and not connected with the insured's products | Although the pure professional indemnity risk is not within the scope of the insuring clause, provided the latter is closely tied to injury and damage, this exclusion is commonly included. It confirms that advice about products which is not charged for is covered, if it is otherwise within the insuring clause. This is consistent with the fact that many definitions of "product" include labels and instructions supplied with the product. Also, wrong advice by, say, a shop assistant selling a product is also intended to be covered, but only if it results in injury or damage.<br><br>Note that for many insurers this exclusion is here not just for the PI risk but also to exclude injury etc. where that arises purely out of design etc. |
| for loss or damage to goods sold, supplied, installed, erected, repaired, altered, treated, tested by the insured | This liability will arise only in contract. |
| for the costs of making good, removal, repair, rectification, replacement, or recall of any goods sold, supplied, etc., or the cost or reduction in value of any such goods, or of any defective work executed by or on behalf of the insured | See above comment. See also Case 27 – *Rexodan*. |
| for injury to employees arising out of and in the course of their employment | To avoid providing employers' liability cover. |
| For contract works or risks to be insured under JCT contract clause 6.5.1 or similar | These liabilities arise under specific contract conditions. |
| (in relation to products) which attaches solely under the terms of an agreement other than any warranty of goods implied by law | This is an example of a contractual liability exclusion – see further page 57. |
| (again in relation to products) arising under any contract or agreement unless such liability would have attached in the absences of such contract or agreement | This is another example of a contractual liability exclusion – this one is the subject of Case 28 – *Omega Proteins*. |
| (for where there is a separate public liability section) liability arising from any products | As already mentioned – in order to ensure the products risk is picked up by the products section |
| (in relation to products) for injury loss or damage caused by or arising out of the failure of any goods to perform their intended function | This is an "efficacy exclusion" – see Case 29 *(Nittan)* which decided what the effect of this was. It tends not to be applied as standard, but rather where the insurer does not wish to insure the consequences of a particular efficacy risk (for example a fire alarm). |

There are of course further typical exclusions but the ones above are sufficient to illustrate the relevant principles.

The next case is another "in respect of" case, but it is included because of the effect of the exclusions in the policy.

**Case 27 – Rexodan International v Commercial Union Assurance Co plc[12]**

Rexodan supplied to the imaginatively named Newbrite 100 tons of soap powder in one ton bags. The soap powder was delivered to a packaging company for packing in Newbrite branded cartons to be supplied by Newbrite to the retail trade. After a while, Newbrite began to receive complaints from customers that the cartons had become stained and the soap powder in the cartons was becoming caked.

Newbrite issued proceedings for breach of contract against Rexodan. In those proceedings, the judge held that the soap powder was not of satisfactory quality. It had not been properly formulated, with the result that its liquid constituents migrated into the cartons causing them to stain. The liquid constituents also attracted moisture from the atmosphere that penetrated into the powder so that it became caked. Newbrite recovered damages against Rexodan made up of the following four items:

1. The difference between the market value of sound cartons of soap powder and the reduced price achieved for the defective cartons of soap powder.

2. Expenses incurred by Newbrite in recalling the defective cartons of soap powder.

3. The wasted cost of the purchase of 300,000 cartons by Newbrite in anticipation of taking delivery of more soap powder ordered from Rexodan. Following the delivery of the defective soap powder, Newbrite decided not to proceed with the orders.

4. Loss of profits which Newbrite would have made over the following 18 month period. Newbrite claimed that its brand name had been destroyed and that it would take 18 months to re-establish a similar brand name using a different supplier of soap powder.

As Rexodan was liable for all four types of loss, they claimed an indemnity in respect of all of them under the product liability policy they held with Commercial Union ("CU"). The policy covered:

*"all sums which the Insured shall become legally liable to pay for compensation and claimants' costs and expenses **in respect of** any Occurrence to which this cover applies …"*

"Occurrences" were defined as follows:

*"Loss of or physical damage to physical property not belonging to the Insured or in the charge or under the control of the Insured caused by any commodity article or thing supplied installed erected repaired altered or treated by the Insured …"*

Cover was expressly excluded for liability in respect of:

*"… recalling, removing, repairing, replacing, reinstating or the cost of or reduction in value of any commodity, article or thing, if such liability arose from any defect or from the article's unsuitability or harmful nature"*

CU declined indemnity and Rexodan issued proceedings. At first instance the Judge held that all four items listed above fell within the insuring clause as being recoverable as damages for breach of contract. However, items 1 and 2 were subject to the exclusion and no indemnity was therefore available for them. Both Rexodan and CU appealed.

**The occurrence**

The Court of Appeal held that it was first necessary to identify the Occurrence. The defects in the powder supplied by Rexodan caused the staining damage to the cartons which in turn caused the damage to the powder contained in the cartons. The Occurrence was the physical damage to Newbrite's property – the staining of the cartons. The damage to the soap powder – the caking – was a consequence of this. The caking of the powder was not sufficient to amount to an Occurrence. Such a construction would mean that the policy could cover deterioration in the product itself and the insuring clause clearly contemplated that the defective product would cause damage to other property.

**"In respect of"**

The next step was to consider which, if any, of the items of damage were referable to a legal liability *"in respect of"* the Occurrence. The Court of Appeal noted that the Judge at first instance had incorrectly treated *"in respect of"* the Occurrence as meaning *"arising out of the same cause of action as gave rise to the assured's liability for the Occurrence"* (ie breach of contract). The phrase *"in respect of"* carried a requirement that the liability related to the identified Occurrence, that was to say the damage to physical property. It was not sufficient that there should simply be some loose connection with the Occurrence. If this were not the case, the product liability policy would be transformed into a policy covering general contractual liabilities. A product liability policy in these terms covered only liabilities relating to the physical consequences caused by the defective product – generally, the value of the property that has been damaged and any economic losses flowing from that damage.

12 [1999] Lloyd's Rep IR 495

**The result – no cover at all**

The Court of Appeal then applied this to the four items claimed by Newbrite. They held that items 3 and 4 were not "in respect of" the Occurrence, the staining of the cartons. Instead, they related to Newbrite's decision not to accept further orders of washing powder from Rexodan following discovery of the defect. As they were related to the future non-performance of obligations of Rexodan towards Newbrite and did not relate to any quantification of the loss which Newbrite suffered as a result of the relevant physical occurrence, they were not covered by the policy.

As to item 1, the majority of the Court of Appeal held that, as the caking of the washing powder was caused by the staining of the cartons and there was no reason to distinguish between the container and its contents, it could be said that the defective powder had caused physical damage to the "cartons of powder". Item 2 was consequential economic loss arising from that physical damage. The items were therefore both "in respect of" the Occurrence. However, items 1 and 2 fell within the exclusion for liability in respect of recalling, repairing or replacing and the reduction in value of any product supplied and, accordingly, no cover was available.

Case 28 shows how a particular contractual liability exclusion worked. Anyone having to draft or interpret contractual liability exclusions should study the judgment.

**Case 28 – Omega Proteins Limited v Aspen Insurance UK Limited[13]**

Omega's business was the processing of by-products from animal carcasses. Northern Counties Meat Limited was a meat processing company, selling animal material which had to comply with the E C Regulation which was brought in following the bovine spongiform encephalopathy (BSE) crisis.

Northern Counties supplied animal material to Omega. As it contained the vertebral column of cattle aged over 24 months, contrary to the Regulation, it should have been disposed of instead.

As it was, Omega, not knowing it was unfit for use, mixed it with other material. The resulting contaminated bulk was sold by Omega to J K Pears (Newark) Limited. Pears on-sold the material as meat and bone meal to pet food manufacturers and as tallow to Webster Thompson Limited. DEFRA discovered the breach of the Regulation and required all the contaminated material to be disposed of.

Webster Thompson sued Pears who sued Omega who sued Northern Counties. All of the claims were for breach of contract. Webster Thompson obtained judgment against Pears, who obtained judgment against Omega, who obtained judgment against Northern Counties.

Northern Counties had been in breach of an express term that the material should comply with the Regulation; they had also been in breach of the implied terms of satisfactory quality and fitness for purpose.

No claim or allegation was made in the proceedings that Northern Counties had been negligent or that it was liable to Omega by virtue of any non-contractual duty or obligation.

This was the backdrop to Northern Counties' claim under its product liability policy for indemnity from Aspen. Because Northern Counties was in liquidation, the action was brought against Aspen by Omega under the *Third Parties (Rights Against Insurers) Act* 1930.

**The policy**

The insuring clause of the product liability section was as follows:

"*The Company will indemnify …. against all sums which the Insured shall become legally liable to pay for damages and claimants' costs and expenses arising out of or in connection with*

*(i) accidental Bodily Injury to any person*

*(ii) accidental loss of or damage to tangible property …..caused by any Product…*"

There was the following exclusion:

The Company will not indemnify the Insured against any liability arising…under any contract or agreement unless such liability would have attached in the absence of such contract or agreement…

**Aspen's arguments**

Aspen's primary argument was that the judgment in the earlier action was all one was entitled to look at in order to determine whether the policy responded. Since that judgment was solely in contract, the claim was excluded.

Aspen also contended that if their primary argument was wrong, then Northern Counties had not in any event been negligent, because they had been excusably ignorant of a recent change in the law that rendered their product unfit for sale. This was in effect another way of arguing that Northern Counties had been liable solely in contract.

**Omega's counter-arguments**

- The primary argument would involve re-writing the exclusion so as to read, "*unless the judge in the trial which established liability had expressed the view that liability would arise in the absence of contract*" or something to that effect.
- The parties cannot have intended that the judge's failure to answer a hypothetical question he was not asked should conclusively determine whether or not Omega could recover.
- The parties cannot have intended the extent of the cover to depend on whether the third party chooses to base his claim on contract or tort.

13 [2010] EWHC 2280 (Comm)

- Aspen's primary argument did not address the position if the third party and the insured agree a settlement of a claim; there was no reason why there should be a distinction in approach between settlement and judgment.
- As regards the secondary argument, Omega maintained that it could be inferred from several factors apparent from the judgment that Northern Counties should have known of the change in the law and had been negligent.

**Decision**

Omega was correct – the judgment established that Northern Counties had suffered a loss. It was then open to the insured to seek to show that the loss was caused by a peril insured against and to the Insurer to seek to show that it was not. The judgment did not say that Northern Counties had been liable solely in contract.

On the secondary argument, the judge agreed with Omega. Since Northern Counties had been negligent, the exclusion did not apply.

The judge also commented on the nature of the exclusion. He said that deciding whether the exclusion applied required the court "to consider what liability there would have been if there had been no contract between Omega and Northern Counties but the facts were otherwise as they were." He also said, "The nature of [the exclusion] is that each and every liability which arises under any contract is excluded unless it would have attached anyway."

It followed that Omega could only recover from Aspen the sums that Northern Counties would have been liable for in negligence. This is significant, since there was a significant amount that Northern Counties had been liable for in contract which they would not have been liable for in negligence (for example the value of the contaminated product they had originally supplied to Omega).

**Comparison with Bacardi**

The question of whether the mixing of the contaminated material with other material resulted in a defective product rather than damaged product was not raised in *Omega*. It was inferred by the judge that Northern Counties had failed to take reasonable care to see that their product could be used without damaging any product with which it was mixed. This was different from the way the Court of Appeal approached *Bacardi*, which they considered concerned a defective / contaminated ingredient that, in the course of manufacture, was then incorporated into and formed part of a new product, rendering the new product defective.

Contractual liability exclusions are considered further in Box 19.

The next case deals with the effect of an efficacy exclusion. In it, the consequences of the failure to perform included physical damage, which was sufficient to bring that part of the loss within the product liability insuring clause. Such exclusions may also be found in 'financial loss' extensions, given that failure of a product to perform can easily give rise to a contractual liability for pure economic loss.

**Case 29 – Nittan (UK) Limited v Solent Steel Fabrication Limited and Cornhill Insurance[14]**

Nittan made smoke detectors in its factory in Woking. The process involved testing them in a cabinet in which they were exposed to heat and humidity. Nittan bought an electric timer from Solent Steel which was used to regulate when the heat in the cabinet was switched on and off.

Unfortunately the timer malfunctioned, and 500 smoke detectors were damaged, as was some other equipment. Nittan sued Solent Steel, who settled the claim. Solent Steel claimed indemnity under their policy with Cornhill, which contained an exclusion of

*"…injury loss or damage caused by or arising out of the failure of any such goods to perform their intended function…"*

Solent Steel argued that to give effect to this exclusion would deprive the cover of any content in relation to the electronics business of Solent Steel.

**Decision of the Court of Appeal**

The intended function of the equipment was a control function – the control of the process of testing the smoke detectors. That processing included the application of heat. The equipment did not correctly control the application of heat. Therefore the equipment failed to perform its intended function. There was no ambiguity, the words were clear.

This conclusion was not thought to deprive the insurance cover of any content (if it had done it would not have made commercial sense). It left the cover intact as an indemnity against liability to pay compensation for injury, loss or damage which was not caused by and which did not arise out of the malfunction of equipment. For all the court knew, and for all Cornhill knew, there may have been a number of non-functional hazards in such electronic apparatus. Therefore the exclusion applied, and Cornhill was not liable under the policy.

The emphasis of this Part so far has been on the extent to which cover for liability for pure economic loss may already be available in – or excluded from – various types of insurance policy. It is necessary now to look at how liability for such loss may be covered by – or excluded from - a 'financial loss' extension.

14 [1981] 1 Lloyd's Rep 633

# 'Financial loss' extensions – generally

Having considered the extent to which cover for pure economic loss may be found in various types of insurance policy, it is possible to identify

(a) what gaps may remain which could usefully be plugged by a pure economic loss extension and

(b) the extent to which the range of pure economic loss extensions which have evolved plug those gaps.

## Claims made basis

'financial loss' extensions are normally written on a claims made basis, in much the same way as professional indemnity policies, for example. This contrasts with public and product liability policies, which are normally written on an occurrence basis.

**Box 18: claims made basis**

Insurance written on this basis is triggered by a claim being made against the insured during the period of insurance. A retroactive date is often stipulated, resulting in there being cover only for claims relating to events happening after that date.

It contrasts with policies written on an occurrence basis, where the policy responds to any occurrence happening in the period of insurance, regardless of when the claim is made.

Claims made policies usually have a "deeming" provision which increases the cover: if during the period of insurance the insured notifies the insurer of circumstances which might give rise to a claim against him, then if such a claim is made after the period of insurance, it is deemed to have been made within the period and will therefore be covered.

The above is the position in the UK. By contrast, in France, for example, by law all liability policies have to have a "discovery period", and retroactive dates are not allowed. This has the effect of making the cover under the French equivalent of claims made policies very much greater.

## Two main sorts

'financial loss' extensions have to date tended to fall into two types – those which are restricted to losses resulting from the sale or supply of a product, and those which are not. Clearly if there is no such restriction, the scope of cover is much greater (subject of course to the exclusions). The diagram below illustrates this.

## The way this guide approaches 'financial loss' wordings

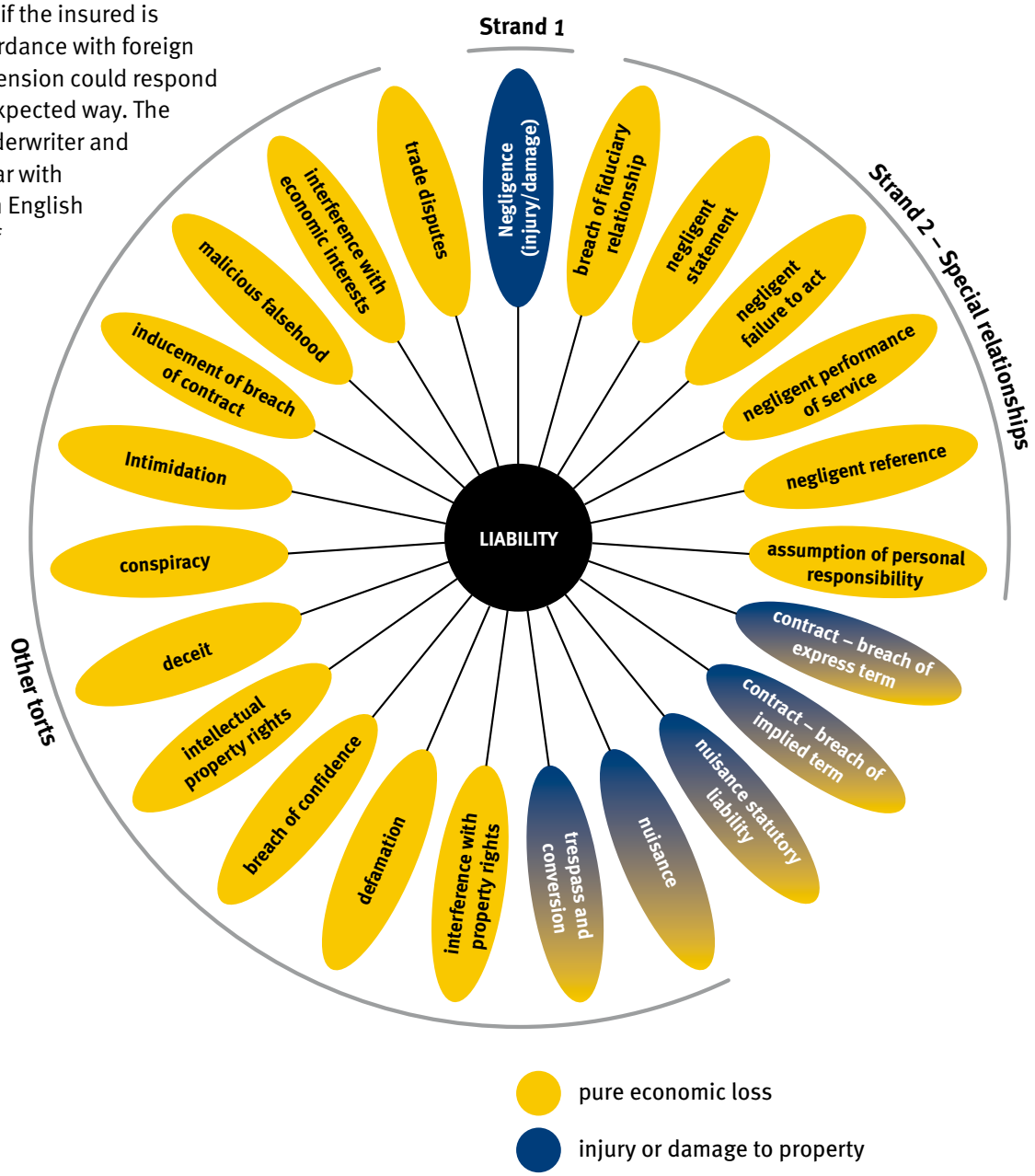
An examination of many of the available wordings has revealed some characteristics these extensions have in common, but there are more differences than similarities. Accordingly, rather than reproduce any wordings, this guide will instead consider all the various features that have been found in the extensions considered. This approach should provide some guidance to those who need to know when drafting a wording the effect of including or omitting certain provisions, and also to those who need to interpret a policy or extension which may provide cover for the pure economic loss in question.

As a general point, It should be borne in mind that all of these clauses are grounded in English law concepts, which are different from foreign law concepts; accordingly, if the insured is exposed to liability in accordance with foreign law, the 'financial loss' extension could respond in an unpredicted and unexpected way. The ideal solution is for the underwriter and broker both to be as familiar with foreign law as they are with English law, where there is a risk of foreign exposure.

## A reminder of potential liabilities

Since 'financial loss' cover is written on an "all risks" basis, all the liabilities will be covered unless they are excluded. The diagram below from Part 1 is a reminder of what most of those liabilities are. It can be seen as a menu, from which various combinations may be created to provide the desired level of cover.

The rest of Part 2 concentrates on which liabilities tend to be covered and which tend to be excluded. It may be helpful to be reminded of the diagram from the Summary at the end of Part 1 which contains virtually all potential civil liabilities, so this is reproduced to the right.



# 'Financial loss' extensions – insuring clause

Below are two columns, the main elements of each clause on the left, and comments on the right. A hopefully representative selection of 'financial loss' extensions has been considered.

Where "standard" appears as a comment, the element appeared in some form in all the extensions considered; where "non standard" appears, it did not appear in all of them.

| Main elements | Comments |
|---|---|
| indemnity against legal liability | Standard |
| in tort | Not standard – this makes it a tort only extension, which, depending on the exclusions applied, potentially results in there being little identifiable cover. It dates back to the time of the first *Junior Books* extensions. However, as can be seen from the case of McKie (Case 15), new liabilities for pure economic loss in tort do still arise and could be covered under a tort only extension (though only one which was not limited to products). If the real intention behind giving as narrow as possible an extension is to protect just against changes in the law then both parties should be explicit about that, and any premium should be commensurately small. |
| other than arising under contract | Not standard. This is an alternative to using a contractual liability exclusion, and shifts the onus of proof to the insured to bring himself within the insuring clause. See also the various options for excluding contractual liability under the Exclusions heading below. |
| to pay damages / compensation | Contrast a debt resulting from statute – see the *Bartoline* decision (Case 21). |
| for / in respect of | Words linking the indemnity to the Financial Loss. |
| accidental | Not standard. It is arguably unnecessary, given the inherent requirement of insurance law for fortuity, and it is not always clear exactly what has to be accidental. See also the exclusion of deliberate acts which is perhaps more frequently used, sometimes even where "accidental" is already in the insuring clause. |
| Financial Loss | Standard, however, there are variations in how it is defined, as follows. |
| - a pecuniary loss, cost or expense | Standard in definitions of Financial Loss. |
| - incurred / sustained by any person other than the insured | Not standard. Whether it is needed may depend on the definition of insured, and the Insurer's intention as regards claims between different entities comprising the insured. Any "cross claims" exclusion in the main policy would also need to be checked. |

| | |
|---|---|
| - not occasioned by / consequent upon / accompanied by injury or loss of or damage to property | Not standard; however given the importance of ensuring that the loss is not linked to injury or damage, a provision of this kind should probably be standard (and see also page 40). |
| - arising from a fortuitous occurrence unintended and unexpected by the insured | Not standard. See above comment about "accidental". |
| - resulting from the sale or supply of Products | Not standard. This is the provision which makes the cover a "products only" extension; if it is omitted, then it extends the cover more widely. |
| [alternatively] due to a defect in or the harmful condition of products supplied or failure to perform their intended function sustained by a customer of the insured or a user of products supplied | Not standard. This is a very different way of linking the cover to products; it also includes cover for the efficacy risk (which is seen by some as covering the business or enterprise risk and often instead expressly excluded - see under the Exclusions heading below). |
| [alternatively] due to any contingency not caused by products | Not standard. This turns the cover into an "anything except products" extension. |
| [alternatively] as a result of (i) defects in products or (ii) work carried out negligently by or on behalf of the insured | Not standard. This links the extension to products and work carried out. |
| Claimant's costs and expenses, and insured's costs and expenses | Standard to include cover for these. |
| Potential triggers<br><br>what has to happen in the period of insurance? | |
| – the incurring of the liability | Not standard. It may not always be easy to identify when the liability was incurred. In contract it is the time of breach, in tort the time the loss was incurred, which can be years later. This introduces an extra layer of complexity. Further, unlike most injury or damage situations, which happen at a specific time, 'financial loss' may be caused over a long period. For reasons such as these, 'financial loss' extensions are normally written on a claims made basis. |
| – the first making of a claim | Virtually standard. See Box 18 where the claims made basis is described. |
| Retroactive date | Virtually standard. If the cover is on a claims made basis, the insurer may stipulate a retroactive date. If there is such a provision, It is important to check what has to happen after that date for there to be cover. Two examples:<br><br>– the loss has to be sustained after the retroactive date<br><br>– the occurrence giving rise to the claim has to happen after the retroactive date. |

## General comment on the variety of insuring clauses

From the above it will be seen that there are currently many different approaches to the insuring clause. Accordingly it is crucial to read the insuring clause in question very carefully as the extent of cover will vary considerably.

The next step is to examine some of the exclusions found in the 'financial loss' extensions which have been considered.

# 'Financial loss' extensions – exclusions

Because of the large number of exclusions inevitably found in 'financial loss' extensions given the "all risks" basis of the insuring clause, they have been grouped below into the following categories:

1. Risks covered under the General Liability policy
2. Risks covered under other available covers
3. Contractual liability
4. Intentional acts
5. Business or enterprise risks
6. The retro date and known claims/ circumstances
7. Geographical limits
8. Other risks

By their nature, there is some overlap and some could fit into more than one category. It is not an exhaustive list, and there are many variations on a theme.

## 1. Excluding risks covered under the General Liability policy

| Main elements | Comments |
|---|---|
| FL resulting from bodily injury or damage to material property | This should not be necessary in view of the normal definition of Financial Loss. |
| FL resulting from:<br>– obstruction trespass or nuisance<br>– interference with any easement right of air light water or way<br>– interference with pedestrian road rail air or waterborne traffic<br>– loss of amenities | These need to be excluded if covered in the General Liability policy |
| FL<br>– incurred by an employee<br>or<br>– sustained by any employee arising out of or in the course of his employment by the insured | To remove risk of overlap with Employers' Liability, although such risk should be minimal or non-existent as Employers' Liability policies require injury; as regards other liabilities to employees, there will normally be an EPL exclusion (see further below). |

## 2. Excluding risks covered under other available covers

| Main elements | Comments |
|---|---|
| The cost of recalling removing repairing or replacing, or rectifying or reinstating, or inspecting, or recovering, or altering, demolishing, breaking out, dismantling, delivering, rebuilding , supplying or installing products [or any commodity, article or thing in which such products are incorporated] if products are withdrawn from sale or use because of any known or suspected defect or deficiency | Potentially covered by product recall and product guarantee policies. |
| Liability arising from a decision by the insured or a requirement by any Government or Public Authority that products supplied should be recalled or modified or withdrawn from sale or use. | Also potentially covered by a product recall policy. |
| Professional indemnity exclusion:<br>• FL resulting from advice provided for a [specific] fee<br>• breach of professional duty<br>• liability arising from or in connection with advice, design, specification<br>• arising from design formula or specification for a [specific] fee | Potentially covered by a professional indemnity policy. Included to dovetail with specialist cover elsewhere, or to exclude a risk that the 'financial loss' underwriter does not wish to cover.<br>This could exclude much of the liability arising under Strand 2 – special relationships on page 14.<br>Some exclusions, when referring to a fee, also exclude cover for advice where no fee is actually charged, but where the circumstances are such that a fee would normally have been charged. |
| Negligent misstatements | Since this is an important part of the main strand of law under which liability for pure economic loss may be incurred in tort, an exclusion of negligent misstatements will remove one of the most likely areas of risk. For example, the liability in the *McKie* case would not be covered. |
| FL in respect of property belonging to the policyholder or in the custody or control of the policyholder or any employee or agent of the policyholder | This is not necessary insofar as it relates to a first party risk. However, liability in relation to property belonging to others may arise, for example where the insured is in a bailor – bailee relationship. |
| FL resulting from fraud / dishonesty by the insured / any director / any employee / any partner | This may be covered under a fidelity guarantee policy. |
| Libel / slander (defamation) | Specific cover may be obtained. |

| | |
|---|---|
| FL resulting from<br>• passing off<br>• infringement of patents, copyrights, trade marks, trade names, merchandise mark, registered design, design rights<br>• breach of confidence actions<br>• unauthorised use of systems or programmes of others<br>• infringement of other rights to intellectual property | Specific cover may be given for intellectual property risks. |
| FL resulting from<br>• data input<br>• electronic data<br>• any reciprocal agreement for the storage or processing of computer data or use of computer facilities<br>• transmission or impact of any virus<br>• unauthorised access to a system<br>• interruption of or interference with electronic means of communication used in the conduct of the insured's business including but not limited to any diminution in the performance of any website or electronic means of communication<br>• failure of a system<br>• damage to data including but not limited to any loss or destruction or corruption of data whether in whole or in part, unauthorised appropriation use access to or modification of data, unauthorised transmission of data to any third party, misinterpretation use or misuse of data, operator error<br>• Internet liability | Specific cover against technology risks may be obtained. |
| Employment Practices Liability | Specific EPL cover may be obtained. It is not necessary to exclude this from a "products only" 'financial loss' extension. |
| Breach of trust, breach of duty owed to shareholders by any director or officer | This may in part exclude the D&O risk. |
| Liability arising out of the Data Protection Act 1998 | This may be specifically covered elsewhere. |

## 3. Excluding contractual liability

As contractual liability potentially provides the greatest exposure most insureds will have to liability for pure economic loss, the extent to which a 'financial loss' extension excludes such liability is extremely important. There are many varieties of contractual exclusion clauses, and there is no standard approach.

## Contractual liability exclusions – basic principles

There are many ways one contracting party can incur liability to another contracting party. For example:

- Complete failure by one party to perform (e.g. not to supply the goods or to perform the service contracted for).
- Wrong performance by one party (e.g. wrong goods supplied, or goods supplied late).
- Breach of implied contract terms (e.g. breach of terms implied by the Sale of Goods Act 1979 such as: that seller has title to the goods; the goods correspond with their description if applicable; the goods are of satisfactory quality; the goods are fit for their intended purpose; in a sale by sample, that the bulk corresponds with the sample; or breach of terms implied by the Supply of Goods and Services Act 1982 such as: the service will be carried out with reasonable care and skill; the service will be carried out in a reasonable time).
- Breach of express contract terms (which will go beyond and normally be more onerous than implied terms).

### Box 19 – the theoretical range of contractual liability exclusions

So what sort of liability are underwriters seeking to exclude by the contractual liability exclusion? Clearly different underwriters have different contractual exposures and legal risks in mind when constructing wordings and tailoring clauses accordingly. But the following seem to be among the main possibilities in the light of the various wordings in use in the market, starting with the exclusions which exclude most, and ending with no exclusion at all.

**1. liability to any claimant with whom there is a contractual relationship**

This would exclude cover for all liability, whether or not it was based on that contractual relationship.

**2. liability to any claimant with whom there is a contractual relationship unless it can be established that the liability exists independently of that contract and does not arise out of the facts resulting from that contract**

This would need to be a variation on the *Omega* exclusion, in order for it to be interpreted more widely than *Omega* was.

**3. liability to any claimant with whom there is a contractual relationship unless it can be established that the liability would have attached in the absence of that contract**

This is the *Omega* clause.

**4. liability that arises from a breach of contractual duty that differs from a breach of concurrent tortious duty**

While the quantum may be the same in both, the liability threshold is likely to be higher in tort. Contractual liability requires just proof of breach of a term, while tortious liability normally requires proof of the existence of a duty as well as breach of that duty (i.e. proof of fault).

**5. liability that arises from breach of the express terms of the contract**

This does not exclude liability for breach of implied terms.

**6. liability that arises from breach of certain of the express terms of the contract**

In addition to not excluding liability for breach of implied terms, it will also not exclude liability for breach of the express terms other than those specified.

**7. no exclusion at all**

Since 'financial loss' cover is normally written on an "all risks" basis, what is not excluded is covered, so the omission of any kind of contractual liability exclusion will result in there being cover for all contractual liability. This is subject, of course, to any other relevant exclusions there may be – particularly, for example, any relating to the business or enterprise risk, or the efficacy risk (see further sections 5 and 6 below) or any exclusion that applies across the entire policy.

It is helpful to bear in mind the various ways in which contractual liability may arise when considering precisely what contractual liability to cover – if any – and hence what the remaining contractual liability is that needs to be excluded.

As for exactly how to exclude that remaining contractual liability, the example exclusions that have been considered (see table below) show that there are several different approaches. It should be borne in mind that the burden is on the insurer to show that the exclusion applies.

| Main elements | Comments |
|---|---|
| liability assumed under any contract and/or agreement unless such liability would have attached in the absence of such contract or agreement | This is similar to the clause considered in *Omega* (Case 28). On one reading, if there had been no contract or agreement, there could have been no supply of the faulty product, and hence no liability of any kind would have arisen. However, the court interpreted it more liberally. It considered liability **would have attached in tort** on the basis of the facts as they were (i.e. the facts resulting from the contract) and so the exclusion did not operate. |
| contractual liability other than liability arising out of a condition or warranty of goods implied by law | This will result in cover being provided for liability due to breach of terms implied by the Sale of Goods Act, for example (see third bullet point above). It is intended to exclude cover for liability due to breach of express terms. |
| in respect of legal liability which attaches by virtue of an express warranty indemnity or guarantee entered into by the insured and which would not have attached in the absence of such warranty indemnity or guarantee | This will not exclude cover for breach of implied terms, or for breach of express terms other than warranties indemnities or guarantees. Accordingly it will not exclude cover for breach of other types of express terms relating for example to time for delivery, non-compliance with specification, or failure to provide a service. The different meanings of "warranty" could give rise to debate (e.g. a warranty provided by a manufacturer is different from the class of contract terms known as warranties, breach of which gives rise to an entitlement to damages as opposed to a right to repudiate the contract). |
| for liability which is assumed by the insured solely because of a contract or agreement | This similar to the first exclusion in this table. |
| liability which attaches by virtue of a contract or agreement or arises out of or by reason of a contractual relationship | The second half potentially broadens this exclusion beyond the *Omega* exclusion (see first exclusion in this table) but it remains to be seen whether the court would interpret it in the same way. |
| any liability which attaches to the insured by reason of any express term of any contract unless such liability would have attached to the insured notwithstanding such term | This will not exclude cover for liability for breach of implied terms. It probably excludes less than the second exclusion in this table as it permits the court to consider the situation as though the relevant express term were absent, leaving room to find liability for breach of a term which would be implied in its place. |

## 4. Excluding intentional acts

As a general point, intentional acts of the insured are not insurable, due to the legal requirement of fortuity for the insurance to be valid. However, where someone other than the insured intentionally commits an illegal act, in some situations the insured may be liable, hence the presence of such exclusions. Most of the liabilities excluded are "intentional torts".

| Main elements | Comments |
|---|---|
| FL resulting from trade disputes: strikes, lock-outs or [labour] disturbances in which the policyholder and/or their employees are involved | Trade Unions, Employment Relations legislation. At common law, effective industrial action is invariably tortious. Legislation provides immunities in the form of special defences to common law liability. |
| FL resulting from<br>• deceit<br>• injurious / malicious falsehood | An overlap with defamation is possible. |
| Arising from<br>• any deliberate act or omission by or on behalf of the insured<br>• any deliberate act or omission by or on behalf of the insured where the 'financial loss' could reasonably have been foreseen by the insured having regard to the nature and circumstances of such act or omission | |
| Conspiracy | An economic tort. |
| Intimidation | Ditto. |
| Unlawful interference with economic and other interests | Ditto. |
| Inducement of breach of contract | Ditto. It is also known as procuring a breach of contract. |

## 5. Excluding business or enterprise risks

| Main elements | Comments |
|---|---|
| FL resulting from<br>• late delivery or non-compliance with a delivery order<br>• non-completion of works or operations by or on behalf of the insured or any employee<br>• misdirection of products supplied<br>• failure to meet delivery deadlines<br>• failure to complete any work on time<br>• failure to return property in the custody or control of the insured or any employee | Those risks which, in effect, constitute a guarantee of the performance of work carried out or of a product supplied are not normally regarded as appropriate risks for a 'financial loss' extension. There are three main potential reasons:<br>(a) they may not constitute unforeseen risks over which the insured has no control – they may therefore not be fortuitous; or<br>(b) underwriting such risks could amount to – in some way – underwriting or guaranteeing the profitability of the insured business; or<br>(c) where appropriate such cover may be available in specialist financial or other markets.<br>Therefore the insured will normally make provision for these risks in the way the business (and the production process etc.) is structured or managed, or, where appropriate, by arranging cover under specialist financial instruments available through the very specialist markets.<br>See also below under 8. Excluding Other Risks – Failure to Perform, and above under Financial Loss Exclusions – Insuring Clause.<br>However, at the end of the day each insurer will decide the range of risks appropriate for them, depending on their own expertise and corporate underwriting strategy. If an insurer does wish to cover liability resulting from its insured's breach of express contractual terms, then the insurer needs to understand the full consequences of such breaches, as well as the consequences in terms of the severity and the frequency of losses that might arise. |
| The cost of rectifying defective work | Ditto. |
| Liability<br>• for reimbursement of the purchase price of the products<br>• in respect of the cost or value or refund for any product supplied | Again, part of the business risk. |
| the cost of improving or guaranteeing the performance of products or any work carried out by or on behalf of the insured | |
| arising out of any products supplied that are in the custody or control of the insured or which have not been accepted by a customer or user | |
| Liability arising from financial default or insolvency | |

## 6. Exclusions relating to the retro date and to known claims/circumstances

| Main elements | Comments |
|---|---|
| Cause / loss [or other happening] prior to retroactive date | |
| Circumstances / incidents / claims known prior to inception and / or notified (or should have been notified) to previous insurers | Unlike occurrence wordings, claims made wordings (and hence FL extensions) need to include specific provision for the notification of circumstances. Claims which arise later out of such circumstances are deemed to have been made during the policy period when the circumstances were notified, hence the need for this provision. |

## 7. Exclusions relating to geographical limits

| Main elements | Comments |
|---|---|
| Examples:<br>• FL incurred outside of the European Union<br>• FL sustained outside GB, NI, Channel Islands, Isle of Man<br>• Liability arising out of any occurrence happening outside Great Britain the Channel Islands or the Isle of Man<br>• FL arising from or in connection with any product supplied which to the knowledge of the insured is for delivery or use in the USA or Canada<br>• arising out of any products supplied that are directly or indirectly exported to the USA or Canada<br>• Liability arising from products knowingly exported from X countries or from work carried out by or on behalf of the insured outside X countries<br>• Claims made in the courts of the USA [its territories or dependencies] or Canada / liability arising out of any occurrence in respect of which legal proceedings are brought in X countries or where legal proceedings are brought outside X countries to enforce an award, whether by way of reciprocal agreement or otherwise | As regards the first two examples, it can be difficult to identify where FL is incurred or sustained. Accordingly, the approaches adopted in the other examples may be preferable. |

## 8. Excluding other risks

| Main elements | Comments |
|---|---|
| Failure of products to perform the function for which they were supplied | In a UK PL/Products policy the "inefficacy" clause is sometimes used to exclude the risk of insuring inevitable damage as against incidental damage (e.g. fire alarms) and its legitimacy has been tested in various cases, e.g. *Nittan v Solent Steel* (Case 29). However, in the context of FL covers, all products that are defective or fail to work may lead to third party loss. The underwriter must decide whether in some circumstances the "failure to perform" or "inefficacy" risk is such that it amounts to a business or enterprise risk (see also above). In such cases the underwriter must also decide whether – after the exclusion – there is enough "incidental" risk left to pass the *Solent Steel* test.<br><br>It needs also to be borne in mind that several insurers specifically give cover for this risk as they refer to it within the insuring clause. |
| FL resulting from the sale or supply of products | |
| Unsuitability of products directly or indirectly traceable to any defect in the design formula specification or QA system of such products | |
| Liability suffered as a result of prototype goods which are supplied on an experimental or trial basis | |
| FL resulting from<br>• fines, liquidated damages, punitive damages<br>• aggravated exemplary or punitive damages awarded by any court outside GB, NI, Channel Islands, Isle of Man<br>• compensation ordered or awarded by a Court of Criminal Jurisdiction<br>• payments due under any statutory regulation or byelaw | |
| Statutory payments<br>• liability to pay any statutory authority arising out of the enforcement of statutory requirements or the performance of statutory duties | This excludes cover for liability for breach of statutory duty. It would also exclude cover for the liability that arose in *Bartoline*, for example. |

| | |
|---|---|
| Conversion | This is another tort - unauthorised dealing with the claimant's chattel so as to question or deny his title to it. It includes loss by a bailee in breach of his duty to the bailor, and need not be intentional. |
| The abandonment or postponement of any exhibition meeting function or other event organised by the insured | |
| Breach or alleged breach of anti-trust laws / competition law | |
| Diminution in value of any property | |

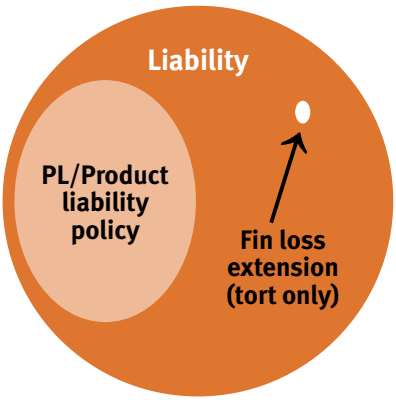
## Summary

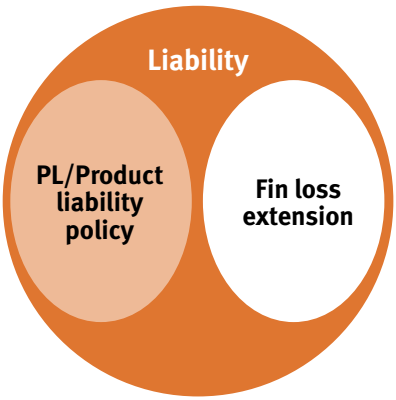
In Part 1 the trajectory of the law of tort was traced on its way up to the high point of *Junior Books* and down again. In Part 2 the reason why this gave rise to 'financial loss' extensions has been considered, as has how, after losing much of their initial raison d'être, there has now grown up a wide range of such extensions providing almost no cover at one end and very wide cover at the other.

In order to understand the purpose of a 'financial loss' extension, one has to begin with where pure economic loss may already be covered under other policies, in order to avoid overlapping with them. A particularly good understanding of the extent of cover provided by public and products liability policies is needed, so that any 'financial loss' extension will work as intended alongside them. Part 2 has sought to provide that understanding.

Finally, Part 2 has examined the elements that make up a 'financial loss' extension, with the aim of enabling those concerned with this kind of cover to reach a view, with a fair degree of confidence, of the extent of cover being provided for liability for pure economic loss.

Accordingly, readers will hopefully now be able to decide which of the diagrams opposite most nearly represents the extension they may be considering!



Financial Loss Guide Part 3

# Financial loss in certain other countries

Given that many UK-based businesses are exposed to potential liabilities abroad, it is worth considering briefly the approach of some foreign jurisdictions to liability for pure economic loss and the insurance of that liability. The following jurisdictions are considered in this Section:

- Australia
- Canada
- China
- France
- Germany
- United States

These jurisdictions have been selected to illustrate how pure economic loss is treated in some developed jurisdictions, and in a more recently emerging market (China). They also include both common law jurisdictions, in which the development of the law is based on decisions of the Courts which set legal precedent, and civil law jurisdictions, which have a codified system in which the law is set out in rules or codes. Some of the common law jurisdictions, in particular Australia, the United States and Canada, may on occasion influence the approach to economic loss taken by the Courts in England and Wales.

For the purposes of consistency, the terms "pure economic loss" and "economic loss" in this section are used with the same meaning as in the rest of this guide, even though terminology in the following jurisdictions varies.

## Australia

### (i) The legal position

Australia is a common law jurisdiction.

In Australia it is well established that a Claimant can seek recovery for economic loss where it has suffered injury or damage, as in England & Wales. The law in relation to pure economic loss is less clear. The basic position is that pure economic loss is recoverable only in certain, limited circumstances.

**Case 30 Perre & Ors v Apand Pty Ltd (1999), High Court of Australia**

This is the leading case on recovery for pure economic loss in Australia.

The Perre family were potato growers whose major source of profit was lucrative contracts to supply potatoes to Western Australia. Apand supplied seed potatoes to the Sparnons' farm, which was near the Perre's land.

The seed potatoes which Apand supplied introduced a disease onto the Sparnons' property. Because the Perre's land was within 20km of infected land (and despite it not being infected) Western Australian law prohibited Perre from exporting their potatoes to Western Australia for five years. This caused Perre to suffer pure economic loss, in respect of which it sued Apand.

All seven judges of the High Court of Australia held that Apand owed a duty of care to Perre which extended to requiring Apand to compensate Perre for pure economic loss.

In order to determine whether a duty of care arises which allows for the recovery of pure economic loss, the following should be considered:

1. Was it reasonably foreseeable to the wrongdoer that harm would be caused to the person who has suffered loss or damage as a result of a particular act or omission?

2. Is there a relationship of proximity between the wrongdoer and the person who has suffered harm?

3. Is it just and reasonable for the law to impose a duty of care on the wrongdoer?

The vulnerability of the claimant to the type of harm was relevant (the Perre's were powerless to prevent their loss) as was the fact that Apand already had a duty not to infect the Sparnons' land. The Australian Competition and Consumer Act 2010, previously known as the Trade Practices Act 1974, permits a claim for pure economic loss arising out of misleading and/or deceptive conduct. This is a frequent source of claims for pure economic loss.

### (ii) The insurance position

Liability policies often exclude cover for pure economic loss. However, cover for pure economic loss can be provided through an appropriately worded policy.

Professional indemnity policies do not exclude claims under the Competition and Consumer Act 2010 and, in many circumstances, include an express extension for claims under the Act.

# Canada

## (i) The legal position

Canada is a common law jurisdiction (with the exception of the province of Quebec, which is outside of the scope of this Section).

As in England and Wales, the Canadian courts permit recovery of economic loss where there has been injury to a person or property.

Canadian courts are more receptive to claims for pure economic loss than the courts in England and Wales. The widely differing judgements in the case of *Norsk* (Case 31) contain lengthy analyses of the principles involved, including comparisons between civil law and common law jurisdictions, so are well worth reading as background.

**Case 31Canadian National Railway Co. v. Norsk Pacific Steamship Co. (1992), Supreme Court of Canada**

Norsk negligently damaged a railway bridge owned by Public Works Canada and used by Canadian National Railway ('CNR'). CNR incurred pure economic loss in re-routing its traffic while the bridge was being repaired. By a 3 – 2 majority the Supreme Court held that CNR could recover from Norsk.

The Court departed from what it saw as the traditional exclusionary rule which restricted recovery of economic loss to cases where the claimant had suffered physical damage (as reinstated by *Murphy v Brentwood*, with the only exception being the *Hedley Byrne* reliance cases). Instead it preferred the non-exclusionary *Anns v Merton* approach.

In the particular circumstances, there was sufficient proximity necessary to find liability.

Extension of recovery to this type of loss (a claim for pure economic loss where there was a clear proximity between the parties) was desirable from a practical point of view, and allowing CNR to recover did not (to use the famous expression of Judge Cardozo) open the floodgates of indeterminate liability (Norsk knew that its negligence would cause a loss of precisely this type to just the small number of companies that used the bridge, one of which was CNR).

Finally, it is interesting that in this case the court was knowingly departing from the approach that had recently been established in the English courts (*Murphy*).

An earlier case, *Rivtow*, illustrates how in Canada pure economic loss can be recovered from a negligent manufacturer or supplier who fails to warn of a dangerous defect.

**Case 32 Rivtow Marine v. Washington Iron Works (1974), Supreme Court of Canada**

A crane had to be taken out of service after a similar crane supplied to another customer collapsed as the result of a design defect which the manufacturer and supplier had both known about but had given no warning of.

Both the manufacturer and supplier had (in Canadian law) a duty to warn of dangerous defects, so were liable for the loss caused by their failure to warn. Had they given timely warning, Rivtow would have arranged repair at a less busy time of year. Accordingly Rivtow recovered their increased losses through having to repair at a busy time. They did not recover the cost of repair, though one judge would have awarded this too, against the manufacturer.

In a subsequent case involving a faulty structure, ***Winnipeg Condominium Corporation No. 36 v. Bird Construction Co., (1995)***, the Supreme Court extended the principle to include the cost of all repairs required to eliminate real and substantial dangers posed by poor quality goods or structures.

The more recent case of *Design Services Ltd. v. Canada (2008)*, was an example of the Supreme Court of Canada being reluctant to create a new category of pure economic loss. It involved a tender process where subcontractors suffered loss as a result of the employer breaching its duty of fairness to the main contractor. The Court stated that the employer owed no duty to the subcontractors. There was insufficient proximity, and also a potential for indeterminate liability to a host of subcontractors and others in the supply chain. The Court was particularly attentive to the need to avoid turning tort law into "an after-the-fact insurer".

## (ii) The insurance position

Canadian liability policies will respond to claims for pure economic loss, provided the policy wording is sufficiently broad.

As many key liability insurers in Canada are based in foreign jurisdictions, such as the United States or the United Kingdom, it is not uncommon to see Canadian versions of policy wordings from those jurisdictions, albeit governed by Canadian law.

# China

**(i) The legal position**

China is a civil law jurisdiction.

Under Article 113 of the People's Republic of China Contract Law, pure economic loss is recoverable provided that the loss is caused by a breach of contract and such loss was foreseeable or should have been foreseeable. Claims for pure economic loss can include loss of future profits.

Economic loss, namely loss arising from or caused by injury or damage, is generally recoverable. However, pure economic loss is generally not recoverable.

There are some exceptions to the general rule, see Box 20 for two examples.

**(ii) The insurance position**

Liability for pure economic loss is normally excluded from standard liability policies, although professional liability policies will in the usual way cover claims for pure economic loss. The following types of liability are usually excluded:

- fraudulent, criminal or other intentional conduct of the insured;
- prior matters;
- assumed liability;
- related parties;
- illegal practice; and
- intellectual property infringement.

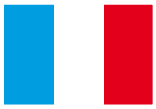
Product liability insurance policies usually require injury or damage in order to trigger coverage and exclude purely contractual liabilities.

In June 2011 one insurer in China introduced a new policy known as Manufacturers Errors & Omissions covering pure economic loss. It is intended to be complementary to product liability insurance. The policy is claims made and covers pure economic loss resulting from intentional and unintentional negligent acts, including failure of the product to perform and failure to provide instructions or warnings. The policy also provides cover for third party losses caused by a claim made against a customer of the insured, in limited circumstances. There are exclusions in relation to, amongst other things, delay in delivery, fraud and recall.

**Box 20**

**Securities Law Article 173** states that where a document contains a false record, misleading statement or major omission which causes loss, the relevant securities company along with the relevant issuer and listed company will be liable.

Accountants are also held liable under **Article 42 of the Certified Public Accountants Law** where loss is caused to another party.



# France

**(i) The legal position**

France is a civil law jurisdiction.

A claim for pure economic loss can be pursued where the loss is a direct and immediate consequence of a tortious act. A claim can be pursued in tort or contract. However, concurrent claims in tort and contract cannot be pursued. If a contract exists between the parties, the claim must be pursued in contract. This would mean, for example, that if a contract excludes claims for financial loss, there can be no claim for that loss in tort.

Articles 1382 and 1383 of the French Civil Code stipulate that any innocent party who suffers damage caused by another has a valid claim against the wrongdoer under French law, provided that the wrongdoer is at fault. The only requirement is that a causal link must be established between the fault and the loss. Therefore a party is entitled to bring a claim for pure economic loss where there is no injury or damage. This is known as "Dommages Immateriels Non Consecutifs" ("DINC"), meaning non-material, non-consequential losses.

Examples of cases in which pure economic loss has been held to be recoverable include:

- a Marseilles bus company recovered in respect of lost income when the town centre was blocked by a traffic accident for which the defendant was responsible;
- a factory-owner recovered in respect of loss of production when the defendant negligently damaged a gas pipeline serving his factory exclusively; and
- a football club recovered in respect of the economic loss it suffered as a result of an injury to one of its leading players.

**(ii) The insurance position**

Typically, the standard French insurance cover that is provided is in respect of "all economic

prejudice resulting from the reduction of enjoyment in whole or in part of goods, of a right, from the interruption of a service by a person or an item or from the loss of profit". This will be triggered where the losses flow from injury and/or damage.

Since the 1970s, many insurers will also provide cover in respect of DINC. This is usually given as an extension to policy cover and will indemnify an insured against either:

a loss which is the consequence of property damage or bodily injury which is not covered by the policy; or

loss which is not directly consequent on property damage or bodily injury.

Cover in respect of DINC was initially only available in product liability policies, although it is now also available in public liability policies.

Contractual liability is usually excluded. However, liability arising from certain types of contract (for example with administrative bodies or monopolies) may be covered, depending on the policy wording. The DINC extension of cover is normally sub-limited to an amount of €300,000 in the aggregate. The extension will also usually cover recall costs that are incurred by a third party where the insured is at fault.

## Germany

**(i) The legal position**

Germany is a civil law jurisdiction.

Section 823 of the German Civil Code (the BGB) allows economic loss to be recovered which is the immediate consequence of intentional or negligent injury or physical damage. However, pure economic loss (as the term is defined in this guide) is not recoverable.

Whilst effectively therefore the situation under English law and German law is similar in the way pure economic loss is treated, there are some significant differences, for example in the area of negligent misstatements where tort law does not allow recovery but contractual and quasi contractual remedies have been developed.

Under section 280 of the German Civil Code, parties to a contract may demand damages in lieu of performance where a party fails to perform its obligations under a contract entirely. Specifically, a claimant is entitled to damages for all direct and indirect negative consequences of the other party's behaviour.

**(ii) The insurance position**

German liability policies do not ordinarily provide cover for claims in respect of pure economic loss.

In the early 1970s insurers worked with representatives from large German manufacturers to develop a model policy for product liability cover. This was known as GDV model cover, and provided cover for, amongst other things, pure economic loss. This cover was provided principally to protect the insured manufacturer against claims in contract from industrial and commercial customers, the focus being where the products of the insured are mixed, processed or assembled by a third party industrial manufacturer - including where such mixing causes physical damage to the final product, a situation that is considered as 'pure economic' loss in Germany.

The cover is much more specific and extensive than an equivalent, typical, UK cover which would not, for example, provide cover for replacement costs.

# United States of America

**(i) The legal position**

The United States is a common law jurisdiction. The laws of each state often differ, so this short account is inevitably a generalisation. There are many similarities to the law in the UK.

Pure economic losses are recoverable in contract, provided its terms permit such recovery.

The extent to which pure economic loss is recoverable in tort is not clear cut, and varies between states and between types of claim. While there is general recognition of the existence of an 'economic loss doctrine' preventing the recovery of pure economic loss in tort, its scope and application is the subject of much academic debate. However, there appears to be a high degree of common ground about the following propositions:

1. Pure economic losses caused by a defective product are not recoverable in tort. There has to be personal injury or damage to other property.

2. If there is a contract between the plaintiff and the defendant, then a claim between them for pure economic losses is not normally actionable as a tort (though there are exceptions). In other words, where there is a contract, it is the contract which will normally govern liability for purely economic harm.

3. Pure economic loss will often be recoverable in tort from the provider of a service (since there will normally be a contract between the plaintiff and the service provider, this is an exception to proposition 2 above).

4. In other categories of case, the position is less clear, and is variable between states.

Examples of situations where pure economic loss has tended to be recoverable in tort include:

- negligent misrepresentation
- defamation
- professional malpractice
- breach of fiduciary duty
- nuisance
- where there is a 'special relationship' between the plaintiff and the defendant.

Underlying the various approaches appears to be an acceptance that there has to be a limit to what is recoverable in tort, echoing the famous words of Cardozo, C.J. in *Ultramares Corporation v. Touche,*[1] a claim in negligence against auditors which failed on the ground that the auditors owed the plaintiff no duty of care, there being no sufficiently proximate relationship. Cardozo, C.J said that the floodgates would otherwise be opened "to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."

Consistent with this is a frequently quoted judgment of Oliver Wendell Holmes, sitting in the Supreme Court, in *Robins Dry Dock & Repair Co v Flint*.

**Case 33 Robins Dry Dock & Repair Co v. Flint (US Supreme Court) (275 US 303) 1927**

A vessel, chartered to the claimant, was docked with the defendant. A provision of the charter allowed the claimant to dock the vessel with the defendant every six months. The claimant's payments to the owner for the charter were suspended at each docking until the vessel was ready to sail.

The defendant negligently damaged the vessel. This caused delays and the claimant brought a claim against the defendant for the loss of the use of the vessel. Crucially, there was no contract between the claimant and the defendant. Nor did the Claimant have a proprietary interest in the vessel.

The Supreme Court held that the claimant had no cause of action against the defendant. Justice Wendell Holmes held:

*"a tort to the person or property of one man does not make the tortfeasor liable to another merely because the injured person was under a contract with that other unknown to the doer of the wrong... The law does not spread its protection so far."*

1 174 N.E. 441 (1932)

**(ii) The insurance position**

The primary focus of the standard Commercial General Liability (CGL) policy is (like its UK counterpart) injury and damage and accordingly the intention is broadly not to provide cover for liability in tort for pure economic loss. CGL policies will however often provide some pure economic loss cover, for example for advertising liability.

Insurance policies do not generally cover breaches of contractual obligations. There are circumstances, however, in which such coverage may exist. For example if a claim is made for breach of contract and the breaching party also could be subject to liability in tort for the same conduct, coverage would be triggered despite the existence of a contractual breach.

CGL policies are often enhanced by "broad form endorsements" which provide coverage for liability arising under contracts entered into during the ordinary course of business.

Any such extended 'contractual liability' cover of course relates only to the covered occurrences of injury and damage etc.

A significant difference between the standard CGL wording and a typical UK wording is the cover provided in the US for 'loss of use' unrelated to physical damage. This would constitute pure economic loss (as the term is used in this guide), although cover is substantially restricted through the limitation of damage to 'impaired property'.

Professional Liability policies, Employment Practices Lability policies and Directors & Officers Liability policies are examples of insurance contracts offering coverage for pure economic losses.

# Summary

1. Most common law jurisdictions and many civil law ones are reluctant to allow recovery for pure economic loss in tort but such losses are freely recoverable if they arise from breach of contract.

2. Any comparison between countries can be made more complicated by the fact that what constitutes 'pure economic loss' or 'physical damage' can vary. The situation can change as case law, or codified law, changes in overseas countries, and the underwriter's understanding of the law may not therefore, always be correct.

3. Legal justification can be complex in the various countries but the key tests filtering those claims that are allowable and those that are not, seem to be the 'proximity' and the 'fairness and justice of the case' tests. As an overlay, more prevalent perhaps in common law jurisdictions, the words of Cardozo, C.J. warning against opening the floodgates to 'liability in an indeterminate amount for an indeterminate time to an indeterminate class' still exert their influence.

Financial Loss Guide Part 4

# Summary and outlook

This is a comprehensive guide which seeks to explain the law in relation to Financial Loss, to explain how insurance policies interact with Financial Loss, and to provide a brief overview of how Financial Loss is addressed in certain other countries.

The guide has been written for the benefit of insurers, brokers, risk managers and insureds. It arose out of discussions at the IUA's Liability Underwriters Group (LUG) which was concerned that despite the fact that this was a complex subject and Financial Loss covers were becoming an increasingly common feature of UK wordings, there was little by way of detailed guidance for the market in the UK.

An appendix, Frequently Asked Questions, provides some shortened answers to some of the basic questions on Financial Loss, but the reader will gain the most from reading the report in detail.

Lord Justice Toulson rightly says in the Preface that there is a confusing range of expressions in common usage (which includes insurers and indeed the legal profession) which do not have a uniform legal definition: financial loss, pecuniary loss, economic loss, pure economic loss and so on.

We have attempted to simplify the subject by creating a consistent definition and this is summarised in Box 1 of Part 1. We define Financial Loss to mean a pure economic loss being a pecuniary (monetary) loss that is not consequent upon injury to a third party or consequent on damage to third party property. We use this definition throughout this report and indeed we use the expression "pure economic loss" in preference to the words 'financial loss'. In doing so we are creating a definition and making it easier for all concerned to comprehend.

The reader would benefit from focusing on understanding the law and addressing, afterwards, how insurance policy wordings then fit in with the concept of what is a pure economic loss.

The law of tort itself is an evolutionary process. Laws are made for the benefit of society. As society evolves, so too does the law. To understand where we are today it is important to have a good grasp of how the law has developed and Part 1 attempts to provide this for the reader.

In the tort of negligence, who should your liability be to? The answer, as Lord Atkin said in *Donoghue v Stevenson (1932)*, is your neighbour. "Who then in law is my neighbour? The answer seems to be persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation…" (Case 1). It was a ground-breaking development of the law.

What then should your liability be to your neighbour? The basic answer is, you have a liability for injury to their person and a liability for damage to their property. Beyond that, in the tort of negligence, for virtually nothing else. That changed in 1963 in *Hedley Byrne v Heller* (Case 12) when the House of Lords confirmed that you could have a liability in negligence for a misstatement; and more importantly, thus a liability, in the tort of negligence, for a pure economic loss suffered by another.

This is elaborated in Part 1, in the "tort strand 2" line of cases, led off by *Hedley Byrne*. It is an important strand which gives rise to, as the insurance industry would perceive it, professional indemnity insurance. It is, though, concerned with pure economic loss by another name. This, of course, is one of the important points to draw from this guide – the law evolves through the process of the courts and the judiciary, and Parliament. It is concerned with justice, not with insurance terminologies such as PL or PI.

The law of tort does not solely consist of the tort of negligence. There are other torts such as trespass, nuisance, breach of rights of access and way, conversion, to name but a few. These are discussed in detail later on in Part 1. Some of these, in fact most, are liabilities for pure economic loss. Readers may find the "wheel" diagram at the end of Part 1 particularly useful. Finally Part 1 addresses liability in contract and some relevant statutory liabilities.

Part 2 of the report looks at how insurance policy wordings respond. Attention is given to product liability cases which have a bearing on how the operative clause is written. It is a point that should not be overlooked – the difference between "in respect of" and "arising out of" for example.

Equally important in Part 2 is the analysis of the exclusion of contractual liability in a Financial Loss extension – with, in effect, a spectrum spelt out in Box 19. Some types of exclusionary wording leave an amount of residual cover for contractual liability which can provide valuable real cover.

If the operative clause of a Financial Loss extension is a relatively straightforward affair – covering "all risks" of liability for a pure economic loss - then the question of what is, or could be, excluded will be of special interest to the underwriter and the broker.

Finally Part 3 looks at the legal situation for pure economic loss in other countries, from the codified law of France, Germany and China, to the common law of Australia, USA and Canada. In a world of contrasts – France at one extreme, and the USA at the other, there is a common understanding of the issues or the problems of pure economic loss – that there is a potential liability "in an indeterminate amount for an indeterminate time to an indeterminate class" (Chief Judge Cardozo – see Box 8). The uniformity ends there. France embraces pure economic loss, the USA repels it.

The law though is an evolutionary animal. What is established law in the UK today could change tomorrow, and the same applies for overseas jurisdictions, and not just the six that are featured. The only recourse for the underwriter is to have a thorough knowledge of these overseas jurisdictions, if entertaining the concept of writing foreign pure economic loss exposures.

As regards the UK, the outlook appears settled. Pure economic loss enjoyed a brief moment in the limelight in the 1980's with *Junior Books* (Case 11). However, following *Murphy v Brentwood (1991)* (Case 7) the "tort strand 1" doors of negligence liability for pure economic loss closed. Cases such as *Linklaters v McAlpine* (see Case 8) test the boundaries, but without effect. Conversely though, "tort strand 2" has evolved continually since the 1980's (see Box 7), with the recent incremental development of *McKie v Swindon College (2011)* (Case 15).

Some would argue that the decision in *Tomlinson v Congleton Borough Council (2003)* (a personal injury case), the Compensation Act 2006, the Jackson Reforms and the Legal Aid, Sentencing and Punishment of Offenders Act 2012 are signs that the judiciary and Parliament are moving towards a less claimant-friendly environment, and that the reluctance of the law to expand liability in tort for pure economic loss is consistent with this. At the same time there is perhaps an increasing society-wide expectation of legal redress in the event of a dispute or an economic hardship caused by the fault of another party.

Be all this as it may, there remain two final points. The underwriter needs to understand the law relating to pure economic loss and whether he or she is prepared to offer cover for it and to what extent. The brokers for their part require the same knowledge of the law relating to pure economic loss, but also an understanding of what their clients' exposures are, and what cover they seek to place for them.

Financial Loss Guide Appendix

# Frequently asked questions

# Frequently asked questions

## 1. What is the legal meaning of 'financial loss'?

Generally, the phrase 'financial loss' has no technical legal meaning. This contrasts with phrases used by judges in their judgments such as "economic loss", "consequential loss" and "pure economic loss", which are recognised as having technical meanings.

'Financial loss' is, however, an expression which is used very frequently by insurers, and what it means depends on how it is defined in the wording of the insurer in question. There are variations in the way it is defined, but the general approach tends to require the loss to be a pecuniary one which does not arise out of physical injury or damage to property (see Box 1 in Part 1). In this guide it is treated as equivalent to "pure economic loss".

## 2. Do UK policies typically cover liability for 'financial loss'?

No. It is not regarded as part of standard policy cover. Where it is given, it is generally by way of optional extension.

## 3. Are UK insurers prepared to offer such cover?

Generally yes, but the level of cover offered may vary considerably. It may range from almost no cover at all (for example a "tort only" extension) to very wide cover indeed (for example it may include significant contractual liability cover and not be restricted to products). It will depend as well on the range of other pure economic loss liabilities that are either excluded or not.

## 4. What is the difference between cover for 'financial loss' and cover for professional indemnity (PI) risks?

Professional indemnity policies cover both tortious and contractual liabilities, arising from breaches of duty in the course of carrying out professional services. Depending on the profession concerned, such breaches will often give rise to purely economic losses rather than ones based on injury or damage. Where the claim is based on the tort of negligence, it will normally be a "Strand 2" claim, following the *Hedley Byrne* line of cases (please refer to Part 1).

A 'financial loss' extension should not overlap with any other policy the insured has. Therefore, if the insured already has PI cover, the PI risk should be excluded. If the insured does not already have PI cover, then the Financial Loss extension will cover breach of professional duty claims if PI is not specifically excluded, given the "all risks" nature of the typical 'financial loss' extension insuring clause.

However, if it is *intended* to give a measure of PI cover in the 'financial loss' extension, then as much of the PI risk arises from contractual liability, the ambit of any contractual liability exclusion in the extension needs to be carefully considered.

Both PI and 'financial loss' covers are normally written on a claims made basis.

## 5. Why are 'financial loss' extensions to general liability policies common in the UK market but almost unknown as extensions to standard US casualty forms?

The basic starting position of tort law in the UK and the US is the same: that the law does not allow recovery of economic loss unless there has been physical injury or damage to the property of the claimant.

However, in the UK, 'financial loss' extensions in general liability policies came into existence when, on the basis of certain legal decisions (the *Anns v Merton* and *Junior Books* line of cases) it looked as though courts were becoming more sympathetic to recovery in such cases. The way cover is given in general liability policies left a gap in cover, which "tort only" 'financial loss' extensions filled.

Since then *Junior Books* has been sidelined by the courts. There have, however, been a few limited incremental changes to the law in relation to the tort of negligence, in "special relationship" cases (also referred to as "Strand 2" in this guide), which are summarised in Part 1.

In the UK therefore the *Junior Books* case was a catalyst but even when that case was effectively set aside, the few other limited developments in economic loss law (coupled with a very soft market) meant that such extensions continued to be offered even though they had limited value. Thus 'financial loss' extensions now often feature as a "standard" extension on larger risks, even though the original underlying cause for the extension has gone.

A further development in the UK has been the willingness of insurers to consider extending these tort only 'financial loss' extensions to include breach of contract (see Section 2) which significantly extends the exposure and scope of cover.

In the US, there was no "swing of the pendulum" towards the *Junior Books* position and back again, and accordingly there was no call for 'financial loss' extensions there.

## 6. And... a parallel point, in this case why do most UK market 'financial loss' covers exclude cover for USA?

UK insurers, and UK treaty reinsurers, are cautious about the US legal environment due to the high compensation awards and the jury-based process. As a consequence they choose not to offer this extension of cover for US situations. In addition, as this is not a standard market extension in the US, there is no reason for UK insurers to offer this.

## 7. What is the difference in legal risk between a 'financial loss' extension which includes cover for contractual liability and one that does not?

It is important to remember that the cover given for contractual liability makes a huge difference to insurers' exposure. The most limited 'financial loss' extensions – those that are restricted to products and exclude both contractual liability and parallel liability in tort - actually give very limited cover if the territorial limits are restricted to the UK. Arguably, the only cover given is for the risk that the law will change. A simple change to the exclusion wording can increase the exposure enormously.

If the extension covers contractual liability, then there is a lot of cover. But, the extent of contractual liability cover can vary quite a lot (see Part 2), depending on the exact words that are used in the relevant exclusion.

Sometimes a claim against the insured may be based on contract and tort at the same time; if the policy has a 'financial loss' extension which excludes contractual liability but covers tort liability that overlaps with any contractual liability, cover would apply provided that the tort liability exists independently of the contractual liability. This is not always straightforward because the tort liability *may* be held to exist only because of the contractual relationship.

It can be seen therefore that those 'financial loss' extensions that include any level of provision for contractual liability (ranging from cover for terms implied by law, to all contract liability other than express warranties, to no contractual liability exclusion) provide a very wide measure of cover that should only be given after careful and stringent underwriting.

See Part 1 (Contractual liability and Liability in tort and contract at the same time) and Part 2.

## 8. Why does English law treat liability for physical damage and pure 'financial loss' so differently?

See Box 9 in Part 1.

## 9. What is the usual 'trigger' for cover under a 'financial loss' extension? Why is this the case?

The majority of wordings provide cover on a 'claims made basis' (see Part 2, Box 18) but some provide cover on the same 'occurrence' basis as the main policy.

The main rationale for the claims made approach is simply the perceived difficulty of defining when a 'financial loss' occurs or is sustained. The point at which injury or damage occurs is usually relatively straightforward to identify. But "financial losses" unrelated to a more precise trigger may have any number of possible trigger moments: for example when a product was first purchased or used, or when it failed...or even when a breach of contract occurred. Further, there is the problem of when the 'financial loss' of the third party customer/ claimant took place.

It is possible, for example, that a customer may suffer losses from a defective product over a long period. Products with a long shelf life could therefore have a very long 'shelf life' for possible financial loss claims (subject of course to the relevant period of limitation).

Another reason is that the claims made basis of cover is perceived by insurers as a tighter way of underwriting difficult or uncertain risk exposures.

## 10. Is there a standard form of 'financial loss' wording used in the UK market?

No, although there are many similarities between commonly used wordings, especially in the SME market; e.g. claims made basis, exclusions of (to a greater or lesser extent) claims arising under contract, rectification and recall costs, late delivery or completion and claims brought outside UK jurisdiction. The indemnity limit is usually restricted to a lower figure than that provided by the policy to which the extension is attached.

## 11. What is the difference between financial loss, economic loss and consequential loss?

This is explained in Part 1 (and Box 1). The expressions, "economic loss", "pure economic loss" and "consequential loss" are used by the courts. The expression 'financial loss' is not used very often by the courts and has basically been created by the insurance industry.

In this guide "economic loss" and "consequential loss" are regarded as the same thing. Further, 'financial loss' is treated as meaning "pure economic loss", namely a pecuniary loss of a third party that is not accompanied either by injury or by damage to property.

See further Box 1 in Part 1, and also the answer to Question 1 above.

## 12. How does the 'financial loss' cover relate to the Public/Product Liability cover given under the main part of the policy?

It is given as an extension and is intended to supplement the main cover, which effectively is cover for injury to a third party or damage to a third party's property.

In essence, 'financial loss' extensions are, to a large part, a product of history. As a result of the *Junior Books* line of cases, liability in negligence for a pure economic loss (pecuniary loss not accompanied by injury or damage to property) was widened. Since this liability was not covered under the PL/Product Liability policy, there was a perceived need to provide additional cover, and it was done by means of a 'financial loss' extension. Meanwhile, PL/Product Liability policies have provided, and continue to provide, cover for the consequences of injury or damage to property.

## 13. Does all financial loss liability constitute fortuitous insurable risk?

No. There is an underlying presumption by insurers that in a 'financial loss' extension, cover is given only for losses that are fortuitous, in the sense that the 'financial loss' of the claimant is unexpected by the insured and not the predictable outcome of the behaviour of the insured.

Under a "tort only" cover (see Question 3 above), where the likelihood of liability is in any case very remote, this is less likely to be an issue.

When, however, insurers provide cover for 'financial loss' liability that arises directly out of a contractual relationship, clearly they will want to exclude those responsibilities that are entered into knowingly by the insured as part of the contract and are deemed to be "trading" or pure business or enterprise risks (see Part 2 – 'financial loss' exclusions section 5).

Insurers generally therefore will seek to exclude those risks for which the insured should be making normal commercial provision. Such risks might include contractual penalties for failure to deliver on time or failure to complete in accordance with the strict requirements of the contract; or failure of the product to conform with a critical specification agreed in the contract.

The other aspect of this is that most insurers will also exclude any liability that arises from a deliberate act or omission of the insured where the loss is a predictable outcome of the insured's conduct or activity.

## 14. Why will you not cover losses outside the UK or, if pushed, outside UK/Europe?

Because liability underwriters in the UK primarily work with, and understand, UK law and its impact on liability exposures. Part 1 has shown that even in relation to the UK, 'financial loss' liabilities are by no means straightforward. Part 3 has shown how diverse the range of potential financial loss liabilities can be in overseas jurisdictions. Inevitably most UK underwriters will be unfamiliar with such exposures. To underwrite such exposures requires a lot of additional information and rigorous underwriting scrutiny and experience. This concern is exacerbated in the USA where court awards can be unpredictable.

## 15. With a contractual liability exclusion what cover are you actually giving?

Where the extension is restricted to products, very little – arguably only cover for the risk of a future change in the law which makes it easier to recover 'financial loss' (i.e. pecuniary loss not accompanied by injury or damage to property) in tort.

Where the extension is not restricted to products, there is potentially more cover, as "special relationship" cases (see Part 2) continue to develop the law incrementally, and result in new liability situations which might not have been excluded – the recent case of *McKie* would be an example (see Case 15).

It should be appreciated though that as most 'financial loss' extensions are written on an "all risks" basis - i.e. all liabilities for 'financial loss' are covered unless excluded – the scope of cover is totally dependent on what is excluded.

See also the answer to Question 7, above.

## 16. Do 'financial loss' extensions apply to PL only, Products only or PL and Products?

There are no rules as such and it depends on how the insurer has presented its 'financial loss' extension within the policy wording.

## 17. Why do insurers give lower limits for Financial Loss extensions? What is a typical limit?

Where uncertainty surrounds a subject it is common for insurers to take a cautious approach. Typical SME businesses will have a 'financial loss' limit of £1m and sometimes as much as £5m.

It can be that treaty reinsurers may also impose restrictions on the limits of their cedants.

## 18. What additional information do you need to underwrite this exposure?

The insurer needs to understand its 'financial loss' extension, and understand how much (or how little) cover it is giving. The insurer then needs to understand the business of the insured and think about the risk exposures that arise from that. If the 'financial loss' extension includes contractual liability, then the insurer needs to think about how this will expose its company in relation to the insured's activities.

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