

Products Update



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Product liability cover: efficacy exclusions

John Reilly v National Insurance & Guarantee Corporation Ltd

On 19 December 2008, the Court of Appeal handed down judgment in the case of *Reilly v NIG*¹. The case provides a valuable reminder of the importance to insurers and insureds in arranging suitable product liability coverage.



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Fire suppression systems typically use water sprinklers or CO₂ gas to quell fires. Reilly was a sole trader who supplied and installed CO₂ systems to a client for use in its printing factory. A fire started and one system failed to operate, resulting in damage. The client sued Reilly, and it appears his insurers, NIG, declined cover.

Reilly and his client settled the claim on terms that the client would sue NIG for cover in Reilly's name. The settlement amount was £2m (presumably the policy limit). It appears NIG had raised numerous coverage defences, but one of them was tried as a preliminary issue. If NIG succeeded on this, the whole claim would be resolved in its favour.

The policy concerned was Reilly's "Tradesmen Insurance Policy". This type of policy

typically covers sole traders' public liability and product liability, as well as tools and equipment. Reilly claimed under the product liability section, but NIG sought to rely on an efficacy exclusion. The preliminary issue that has now been to the Court of Appeal is whether this exclusion operates.

Efficacy exclusions are intended to exclude liabilities arising from the failure of a product to perform its function. Many types of products cannot be said to have a performance function, or to carry a significant risk of damage flowing from performance failure, for example food, toys, clothes, cosmetics and electrical goods.

However, for some products, injury or damage is virtually inevitable when there is a performance failure. Performance is particularly a risk where products are intended to

"cure" (for example medicines, cleaners, and weedkiller), or where they are intended to help prevent injury or damage (for example, fire alarms, fire extinguishers, intruder alarms, rust inhibitors and safety nets). Efficacy cover is usually excluded but available for a higher premium, reflecting the relatively large losses that can arise from such a performance failure.

As Reilly's business involved fire suppression systems, performance was an important risk. However, the efficacy exclusion in his policy applied to:

"claims arising out of ...the failure of any fire or intruder alarm switch gear control panel or machinery to perform its intended function."

Reilly and NIG agreed that the failure was caused by insufficient pressure in the main CO₂ cylinder

(either because it had not been filled, or because of a leak), or because a piston failed, so that the valves did not open and release CO₂.

In deciding whether the exclusion applied, it was possible to consider the wording in two stages, as follows.

1. Are the words "*fire or intruder alarm*" adjectival, so the exclusion applies only to the switch gears, control panels and machinery of such alarms? Or does the exclusion contain a list of distinct items, so that it applies not only to fire alarms and intruder alarms, but also to switch gear, control panels and machinery that are nothing to do with fire or intruder alarms (but instead, for example, fire suppression systems like Reilly's).

At first instance, the Commercial Court decided the exclusion contained a list of distinct items, including products other than alarms.

The Court of Appeal agreed. It noted that, had it been the intention to exclude only alarms, there would have been no need to continue to itemise any parts at all. If it had been intended to exclude just certain components of alarms, it would make little sense not to list other parts such as wiring and sensors. Furthermore, although fire or intruder alarms usually include a control panel, it is not natural to expect them to have switchgear and machinery.

Although Reilly argued this interpretation would make the exclusion too wide, the Court noted the policy would still provide public liability cover, as well as product liability cover where, for example, the product had caught fire itself and thereby caused injury or damage to other property.

2. If the exclusion is a list of distinct items, did the claim arise out of a failure of "machinery" (according to its legal meaning)? In answering this, is it necessary to investigate which particular

part of the system failed, or must the question be applied to the system as a whole?

The Commercial Court decided it is not possible to enquire which particular part of the system had failed (and whether that part was "machinery"), because each part is integral to the system as a whole. The Court should not consider parts in isolation. In this case, the system was "machinery", so there was a failure of "machinery".

The Court of Appeal disagreed in part. Although it agreed that parts should not be considered *solely* in isolation, it held that Reilly's fire suppression system was not to be considered as "machinery". Instead, it was equipment incorporating some "machinery" as well as some other parts. In this way, the Court went some way to considering the components in isolation after all. The cylinders themselves were not "machinery", but their valves and actuators were.

Applying this reasoning, as there was doubt as to the precise cause in this case, it was not possible to reach a firm conclusion on coverage. The Court said if the master cylinder were the cause, the exclusion would not apply and Reilly would have cover. The other possible cause was the failure of a piston on the cylinder valve to operate. This moving part did constitute "machinery", so if it were to blame, the exclusion would apply and there would be no cover.

Comment

The Court has reaffirmed that a product liability policy for a performance product can effectively exclude the efficacy risk, while still covering other product risks.

It is not obvious exactly what the exclusion in this case was intended to exclude. It is quite common in product liability policies to exclude "*the failure of any Product or part thereof*". An exclusion worded in this way would undoubtedly have applied to Reilly's fire suppression system and would also have avoided the debate about "machinery", and parts of

"machinery". It is quite possible Reilly would have paid a higher premium for any efficacy cover.

It appears NIG and its brokers accepted cover in error. The Tradesmen Policy was intended not to cover specialists like Reilly, but general electricians and the like. It may be that neither Reilly nor NIG considered the question of efficacy cover for fire suppression systems.

Looking at the wider picture, in at least one instance this exclusion is described and marketed as an "*Electrical Contractors Alarm Efficacy Exclusion*". Furthermore, as efficacy exclusions are intended to apply primarily to products with a performance risk, it is perhaps unlikely that they are intended to apply to "machinery", as well as alarms. So, it is quite possible that at least some insurers are using this exclusion intending that it apply only to alarms, not to fire suppression systems, and that this inelegant wording has worked in insurers' favour.

If the CO₂ cylinder had been the cause of the loss, this would be because it had been incorrectly filled or pressurised (human error, rather than machine failure), or because gas had leaked out due to incorrect sealing (again, due to human error in sealing). It may be that the Court felt it would be undesirable to describe such an error as being a failure of machinery to perform.

In the circumstances, although it is not clear what were the relative probabilities of the two alternative possible causes, perhaps the outcome was the fairest that could be achieved. Reilly and NIG would likely have to compromise, given the uncertainty of the underlying cause and its impact on the coverage position.

This case is a reminder that, if suitable policy terms and endorsements are not used and worded clearly, there is fertile ground for dispute.

¹ [2008] EWCA Civ 1460

Damages: lost profits



The recent case of *Sony Computer Entertainment UK Limited v Cinram Logistics UK Limited*¹ reviews the law on recovering loss of profits in addition to manufacturing costs.

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When a claimant's products cannot be sold, for example because they are damaged or have reasonably been recalled, the claimant can normally recover its manufacturing costs from the responsible party. However, lost profit is usually recoverable only where the claimant did not sell replacement products. Where parties trade regularly on a large scale, this can become a complicated issue of fact. This dispute considered which party bears the evidential burden, and what has to be proved.

The case concerned memory cards for the Sony Playstation2 console. Sony's distributor (Cinram) lost 17,000 cards that had been ordered by the "Game" stores group, which had substantial business with Sony. Sony claimed the manufacturing cost, as well as lost profit, of the 17,000 cards. Cinram denied liability for the lost profit element (approximately 70% of the total claim), on the basis Sony had

effectively sold replacement memory cards to Game and thereby avoided loss of profit.

At first instance, the Court said Sony bore the burden of proving its full loss, including that it had not sold replacement cards to Game. It held that the burden had been discharged, and Sony could recover the full amount claimed, including lost profit. Cinram appealed.

The Court of Appeal disagreed with the finding on the evidential burden, and held that it was for Cinram to prove (on the balance of probabilities) that Sony had made replacement sales to Game. However, the result was the same – there was insufficient evidence of any orders for cards that could be said to be replacements, and the Court of Appeal upheld the award.

Comment

The Courts considered in detail the chronology of trade between Game and Sony. The trade was

almost constant and it appeared that, once the loss was discovered and reported, the parties simply "moved on". By the time the next orders were placed, there was no evidence that Game had addressed itself to re-ordering the lost cards, or that Sony had considered re-shipping them. Where parties trade in this way, and there is little or no evidence showing a particular order relates to any other, it may be difficult to defend a claim for the full price of the products, including lost profit.

¹ [2008] EWCA Civ 955

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