IN FACT AND IN LAW

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Product Liability

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DAMAGES THAT RESULT FROM INADEQUATE PRODUCT PERFORMANCE AND TACIT WAIVER OF THE RIGHT TO ASSERT A GROUND FOR EXCLUSION:
THE QUEBEC COURT OF APPEAL CLARIFIES THE SITUATION

***Lombard du Canada ltée vs. Ezeflow inc.*, 2008 QCCA 1759**

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ON SEPTEMBER 24, 2008, THE COURT OF APPEAL REVERSED A DECISION BY THE SUPERIOR COURT THAT HAD ALLOWED AN INSURED'S CLAIM AGAINST ITS INSURER FOR DAMAGES CAUSED AS A RESULT OF THE REMOVAL OF A PRODUCT MANUFACTURED BY THE INSURED.

IN A SPLIT DECISION, THE COURT OF APPEAL RULED THAT A MULTI-PERIL CIVIL LIABILITY INSURANCE POLICY DID NOT COVER THE DAMAGES CLAIMED AS A RESULT OF THE REMOVAL OF A DEFECTIVE PRODUCT MANUFACTURED BY THE INSURED. IT ALSO RULED ON THE CONSEQUENCES OF THE FAILURE TO RAISE A GROUND FOR EXCLUSION AT THE PROPER TIME.

THE FACTS

Ezeflow is a company specialized in the manufacturing of pipe fittings intended for refineries, gas pipelines and offshore drilling platforms.

In 1998, Ezeflow entered into a contract with Genoyer to manufacture 142 pipe fittings to be incorporated into drilling platforms belonging to Sable. Kvaerner, in turn, was responsible for installing the fittings manufactured by Ezeflow.

When connecting the fittings to the platform pipes, Kvaerner noted that there were cracks in the Ezeflow fittings. Tests then showed that the fittings had sustained an imbalance when the base materials were integrated, which facilitated the spread of the cracks when exposed to heat. One hundred and fourteen (114) of the one hundred and forty-two (142) parts had already been installed when the defects surfaced.

Pressed by the delivery time for the platforms, Sable, Genoyer and Kvaerner decided to replace the fittings manufactured by Ezeflow with a competitor's fittings. Kvaerner removed the fittings and Ezeflow reimbursed the cost of the work ($410,572.80).

Ezeflow claimed the amount of $410,572.80 paid to Genoyer from its liability insurer ("Lombard"), which amount represented the cost of the repairs made to the pipes. However, Ezeflow withdrew the following from its claim:

(a) the cost of the 142 fittings previously supplied to Kvaerner; and

(b) the cost of removing the fittings.

Lombard refused to indemnify and invoked, among other things, that the cost of repairing the pipes did not result from any damage caused by a loss but rather from the removal of the defective fittings and that, consequently, these damages were not covered by the liability insurance policy.

THE INSURANCE POLICY

Ezeflow took out a multi-peril civil liability insurance policy containing, in particular, the following exclusions:

[IBC Translation]
"2. Exclusions

This insurance does not apply to:

[...]

(i) "Property damage" to "your product" arising out of it or any part of it.

(j) "Property damage" to "your work" arising out of it or any part of it and included in the "products completed operations hazard".

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

(k) "Property damage" to "impaired property" that has not been physically injured, arising out of:

a. A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or

b. A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

(l) Any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of:

1. "Your product";

2. "Your work"; or

3. "Impaired property";

if such product, work, or property is withdrawn or recalled from the market or from use by any person or organization because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it." [emphasis added]

DECISION BY THE COURT OF FIRST INSTANCE

The trial judge concluded that a loss had occurred, which she identified as the "damage to the property of a third person", that is, the damage to the pipes.

She ruled out the application of the exclusions under the liability insurance policy on the following grounds:

(a) Exclusion (I): the claim covers the costs of repairing the property of a third person (Genoyer's pipes) and not the loss of the fittings manufactured by Ezeflow;

(b) Exclusion (J): it was the welds that were defective, not the fittings;

(c) Exclusion (K): by reason of estoppel, this exclusion does not apply because the insurer did not invoke it at the proper time;

(d) Exclusion (L): it is not a case of product removal or product recall because Kvaerner was the one that decided to remove the fittings and not Ezeflow.

DECISION BY THE COURT OF APPEAL

A. DAMAGES RESULTING FROM THE DEFECT IN A PRODUCT MANUFACTURED BY THE INSURED

In a split decision, the Court of Appeal overturned the judgment of first instance. Although the judges all arrived to the same conclusion, their reasons differ.

▸ THE MAJORITY

Chief Justice Robert and Justice Rochette were of the opinion that the damage occurred when cracks appeared in the fittings and not in the welds connecting them to the pipes. This assessment of the facts differed from the trial judge's.

According to the judges in the majority, the damages did not result from a loss because the appearance of the cracks was not caused by an accident, bad luck or some unforeseen misfortune. The Ezeflow fittings were defective and the damages associated with their removal are covered by Exclusion 2 (L) of the Lombard policy.

The cracks appeared when the heat needed to weld the fittings was applied. Thus, it was the welds made when the fittings were manufactured that were defective, and not the welds connecting the fittings to the pipes.

The claim thus concerns damages resulting from a defect discovered in the product manufactured by the insured, Ezeflow, and not from an accident.

The majority applied Exclusion 2(L) of the policy based on the following facts:

- the fittings were "withdrawn from use" because of their real or suspected defects;

- the fittings could not be used for the purpose for which they were intended;
- although the fittings were not withdrawn or recalled from the market and Ezeflow did not request their removal, the costs were caused by the removal and repair of goods deemed defective within the meaning of the policy.

The judges in the majority are of the opinion that damages that result from inadequate product performance are not the consequence of a loss. The costs incurred in re-beveling the pipes to permit the installation of new fittings constituted damage of an economic nature resulting from a defect in a product, which is not covered by the insurance.

In this case, Exclusion 2(L) applied even though the removal of the fittings was not requested by the insured, Ezeflow, but by a third person, namely Kvaerner.

▸ THE MINORITY

Although he comes to the same result, Justice Beauregard justified his position based on other reasons. In his opinion, the damages caused to the pipes constituted *a priori* a covered loss because these damages resulted from an accidental act by the insured. However, he is of the view that Exclusion 2(K) applied and that the material damage caused to the customer's property as a result of a defect in the insured's product was not covered.

B. FAILURE TO RAISE A GROUND FOR EXCLUSION

▸ THE MAJORITY

In not ruling on Exclusion 2(K), the judges in the majority also upheld an important rule, i.e. that it is necessary to raise an exclusion clause at the proper time, and they underscored the consequences of the failure to do so.

Indeed, the insurer's failure to invoke a ground of defence in its letter informing the insured of its decision to disallow the claim, as well as the fact of not having mentioned it in its defence, constituted a tacit waiver and precluded the insurer from subsequently setting up this ground against the insured.

According to the judges in the majority, the common law concept of estoppel must be differentiated from the concept of tacit waiver. The former has no place in civil law whereas the latter is applicable. However, the outcome is the same: the failure to raise this exclusion clause has far-reaching implications for the insurer.

▸ THE MINORITY

Justice Beauregard's position differs on this point. He is of the opinion that no presumption may be inferred from the insurer's failure to invoke a ground of defence. In his view, the failure to raise Exclusion 2(K) of the policy could not ultimately have the effect of transforming a liability insurance policy into a policy covering an insured against defects in its products.

CONCLUSION

This decision clarifies that the sole fact that an insured's product is defective cannot be considered a loss. Liability insurance does not cover monetary claims resulting from defective products where there is an exclusion clause to this effect. Only losses and damages resulting from accidents are covered.

The second aspect clarifies that where the insurer fails to raise the appropriate exclusion in its letter of denial and in its defence, it risks having to pay the price for its inadvertence.

Therefore, from the moment a claim is made, the file must be thoroughly studied to ensure that all the grounds of defence are invoked.

Furthermore, we recommend that legal advisors be promptly consulted if you believe that an exclusion must be raised. It will therefore be easier to invoke the appropriate grounds at the proper time.

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