Hunter Engineering Co. *v.* Syncrude Canada Ltd., [1989] 1 S.C.R. 426

Hunter Engineering Company Inc. *Appellant*

and

Hunter Engineering Company Inc., carrying on business as Hunter Machinery Canada Ltd., Integrated Metal Systems Canada Ltd. and Allis-Chalmers Canada Ltd. *Appellants*

v.

Syncrude Canada Ltd., Canada-Cities Service Ltd., Esso Resources Canada Limited, Petro-Canada Exploration Inc., Gulf Canada Resources Inc., Pan-Canadian Petroleum Limited, Her Majesty The Queen in Right of the Province of Alberta, Alberta Energy Company Ltd., Hudson's Bay Oil and Gas Limited and Petrofina Canada Ltd. *Respondents*

Indexed as: Hunter Engineering Co. *v.* Syncrude Canada Ltd.

File Nos.: 19773, 19950.

1988: February 25, 26; 1989: March 23.

Present: Dickson C.J. and Estey*, McIntyre, Wilson, Le Dain*, La Forest and L'Heureux-Dubé JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR BRITISH COLUMBIA

Contracts -- Breach -- Design Faults -- Responsibility for design faults -- Design created from buyer's specifications as to proposed use -- Whether or not company supplying specifications or company creating design liable.

Sale of goods -- Implied warranty as to fitness -- Machinery defective -- Defects appearing after expiry of contractual warranty -- Whether or not breach of implied statutory warranty -- Sale of Goods Act, R.S.O. 1970, c. 421, ss. 15(1), (4), 53.

Contracts -- Fundamental breach -- Exclusionary clause -- Contractual warranty time limited -- Portion of machinery supplied defective -- Defect discovery after expiry of warranty -- Defective machinery reparable -- Whether or not fundamental breach.

Trusts and trustees -- Constructive trust -- Trust set up as interpleader pending outcome of passing-off action -- Trust to pay for machinery with balance going to successful party in passing-off action -- Possible beneficiaries of trust not parties to trust agreement -- One possible beneficiary ineligible as a result of passing-off action -- Other beneficiary not willing to assume

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* Estey and Le Dain JJ. took no part in the judgment.

warranties as required by trust -- Whether or not company setting up trust or company intended as beneficiary of trust entitled to balance of trust moneys.

The disputes between these parties arise out of three contracts for the supply of gearboxes for the Alberta tarsands project. In the first contract, made on January 29, 1975, Syncrude Canada Ltd. (Syncrude), through its agent Canadian Bechtel, ordered 32 "mining gearboxes" from the Hunter Engineering Company Inc. (Hunter U.S.) These gearboxes, which drove conveyor belts moving sand to Syncrude's extraction plant, were fabricated by a subcontractor, Aco.

The second contract, made between Syncrude and a division of Allis-Chalmers Canada Ltd. (Allis-Chalmers), was for the supply of a $4.1M extraction conveyor system and included 4 "extraction gearboxes" to drive the machinery which separates the oil from the sand. These gearboxes were built according to the same design as the mining gearboxes supplied by Hunter U.S. and were fabricated by the subcontractor Aco. The extraction gearboxes entered service on November 24, 1977.

Both the Hunter U.S. and the Allis-Chalmers contracts included a warranty limiting their liability to 24 months from the date of shipment or to 12 months from the date of start-up, whichever occurred first. In addition, the Allis-Chalmers warranty included a clause stating that the "Provisions of this paragraph represent the only warranty . . . and no other warranty or

conditions, statutory or otherwise shall be implied". Both the Hunter U.S. and Allis-Chalmers contracts provided that the laws of Ontario were to apply.

The third contract was made between Syncrude and Aco on March 1, 1978. It arose out of some unusual circumstances. Between August and December 1977, Syncrude issued purchase orders to Hunter Machinery Canada Ltd. (Hunter Canada) for an additional 11 mining gearboxes built to the same design as the 32 purchased from Hunter U.S. Hunter Canada was a Canadian-incorporated company established by employees of Hunter U.S. without the latter's knowledge. It held itself out to Syncrude as the Canadian arm of Hunter U.S. and not until January 1978 did Hunter U.S. discover the deception. It initiated a "passing-off" action against Hunter Canada, notified Syncrude, and offered to assume the Hunter Canada contract. Syncrude, however, opted not to prejudge the result of the litigation by agreeing to let Hunter U.S. step into the contractual shoes of Hunter Canada and, instead of accepting this offer, it contracted directly with the subcontractor Aco for supply of the 11 gearboxes at the price Aco would have received from Hunter Canada. These 11 gearboxes were delivered and progressively put into service between May and December 1978.

In March 1978, Syncrude unilaterally established a trust fund into which it paid the money due under the Hunter Canada contracts. Hunter Canada waived all rights under these contracts but Hunter U.S. refused to become a party to Syncrude's trust agreement. The agreement provided, *inter alia*, that the trustee would pay to Aco its price for the gearboxes when they were completed. The balance would be paid to Hunter Canada or Hunter U.S., depending on the outcome of the

passing-off action, provided the warranty and service obligations granted by Hunter Canada were assumed. Hunter U.S. was successful in its action but refused to assume the more generous warranty provisions of the Hunter Canada contract as required by the terms of the trust agreement.

Hunter U.S. was found to be responsible at trial and on appeal, as designer of the gearboxes, for the failures and was liable because of a breach of the statutory warranty of reasonable fitness found in the Ontario *Sale of Goods Act*. Liability was not based on the contractual warranty because it had expired. Allis-Chalmers was not found liable, at trial, for breach of warranty or fundamental breach of contract; there was accordingly no need to rule on its third party claim against Hunter U.S. The Court of Appeal allowed Syncrude's appeal from that judgment. It also allowed the appeal of Hunter U.S. from the finding at trial that it was not entitled to the trust funds and that the trust income be held for Syncrude.

Hunter U.S. appealed against the finding that it was liable for design default and that s. 15(1) of the *Sale of Goods Act* applied. Allis-Chalmers appealed against the finding with respect to fundamental breach. Syncrude cross-appealed with respect to the ownership of the trust fund.

At issue here are: (i) the liability of Hunter U.S. for the design faults which caused the gearboxes to fail; (ii) the liability of Hunter U.S. under the statutory warranty in the *Sale of Goods Act*; (iii) the liability of Allis-Chalmers under the doctrine of fundamental breach; (iv) the ownership of the trust fund.

I

Held: The appeal of Hunter U.S. should be dismissed.

Per Wilson and L'Heureux-Dubé JJ.: Hunter U.S. was responsible for the design faults that caused the gearboxes to fail. Syncrude's specifications were a recitation of what the gearboxes were to be able to achieve and general guidelines as to how this was to be done. Hunter U.S. took on the task of deciding specific design details. It was the design decisions that proved to be wrong.

Hunter U.S. was liable for the repair of the gearboxes, even though their failure was discovered after the contractual warranty period had expired, because of a breach of the implied warranty of fitness contained in s. 15(1) of the Ontario *Sale of Goods Act*. The Hunter U.S. contract neither explicitly excluded the implied warranty nor was inconsistent with it so as to render it inapplicable. The circumstances surrounding this contract met the conditions necessary to bring the implied statutory warranty into play.

Per McIntyre J.: The appeal of "Hunter U.S." against the finding of liability for a design fault should be dismissed for the reasons of Wilson J.

Per Dickson C.J. and La Forest J.: The contract between Syncrude and Hunter U.S. placed responsibility for the design of the gearboxes solely upon Hunter U.S. and Hunter U.S. failed to discharge that responsibility. Hunter U.S. did more than merely design the gears according to specifications provided by Syncrude's agent. The specifications provided by Syncrude were about what the gearboxes were required to do, not how they were to be built. They were not faulty. Syncrude was out of time with respect to the contractual warranties in the Hunter U.S. and Allis-Chalmers contracts and could not rely on them.

The presence of an express warranty in the contract does not render the statutory warranties inconsistent. Clear and direct language must be used to contract out of statutory protections, particularly where the parties are two large, commercially sophisticated companies. Hunter U.S. could not avoid liability under s. 15(1) of the *Sale of Goods Act*. All three prerequisites for its application were met. The design and manufacture of the gearboxes was in the course of Hunter U.S.'s business activities. Hunter U.S. knew the purpose of the gearboxes and Syncrude, through its agent, relied upon the skill and judgment of Hunter U.S. The gearboxes were not reasonably fit for the purpose for which they were required.

II

Held: The appeal of Allis-Chalmers from that part of the judgment of the Court of Appeal imposing liability should be allowed and its third party claim against Hunter U.S. should be dismissed.

Per Wilson and L'Heureux-Dubé JJ.: The revision to the Allis-Chalmers agreement explicitly and unambiguously ousted the statutory warranty.

A fundamental breach occurs where the event resulting from the failure of one party to perform a primary obligation has the effect of depriving the other party of substantially the whole benefit that the parties intended should obtain from the contract. Fundamental breach represents an exception to the rule that the contract continues to subsist and that damages be paid for the unperformed obligation for it gives the innocent party an election to put an end to all unperformed primary obligations of both parties. This exceptional remedy is available only where the very thing bargained for has not been provided.

The breach of the Allis-Chalmers contract was not a fundamental breach because it did not undermine the contractual setting. Allis-Chalmers breached only one aspect of its contract. The inferior performance of the gears did not deprive Syncrude of substantially the whole benefit of the contract and the cost of repair was only a small part of the total cost. The gears, while not reasonably fit, worked for a period of time and were repairable. Serious but repairable defects in machinery have often been found not to amount to fundamental breach.

Even if the breach by Allis-Chalmers were to be characterized as fundamental, however, the liability of Allis-Chalmers would be excluded by the terms of the contractual warranty.

The "rule of law" approach to fundamental breach should be discarded and the construction approach to exclusionary clauses already adopted by this Court should be reaffirmed. The relevant question for the courts is whether the parties, on a true and natural construction, succeeded in excluding liability at the time the contract was made. After considering the provision's true construction, the court must consider whether or not to give it effect in the context of subsequent events, such as fundamental breach. The courts are quite unable to assess in isolation whether or not a contractual provision is reasonable and any notion that the courts should refuse to enforce a provision for want of its being reasonable should not be imported into the law. Exclusion clauses can be rendered unforceable even if no fundamental breach is found. Legislative protection exists and other judicial avenues such as unconscionability might apply in appropriate circumstances.

Even if the breach of the Allis-Chalmers contract were a fundamental breach, there would be nothing unfair or unreasonable, or unconscionable if this is a stricter test, in giving effect to the exclusion clause. The contract was made between two companies in the commercial market place, both of roughly equal bargaining power and both familiar and experienced with this type

of contract. Allis-Chalmers' reliance on the exclusion clause was not tainted by any sharp or unfair dealing.

Per McIntyre J.: The appeal of Allis-Chalmers should be allowed. Any breach of the contract by Allis-Chalmers was not fundamental and, even if the breach were properly characterized as fundamental, the liability of Allis-Chalmers would be excluded by the terms of the contractual warranty. It was therefore unnecessary to deal further with the concept of fundamental breach in this case.

Per Dickson C.J. and La Forest J.: The provision in the Allis-Chalmers contract was sufficient to exclude the operation of the implied warranty in s. 15(1) of the *Sale of Goods Act*.

Allis-Chalmers, given the inapplicability of implied statutory warranties and the expiry of its express warranty, could only be found liable under the doctrine of fundamental breach. This doctrine has served to relieve parties from the effects of contractual terms, excluding liability for deficient performance, where the effects of these terms have seemed particularly harsh. It has, however, spawned a host of difficulties. The doctrine of fundamental breach should be replaced with a rule that holds the parties to the terms of their agreement, provided the agreement is not unconscionable. The courts do not blindly enforce harsh or unconscionable bargains.

The parties should be held to the terms of their bargain. The warranty clause freed Allis-Chalmers from any liability for the defective gearboxes. In the present case there was no inequality of bargaining power and unconscionability was therefore not in issue.

III

Held (Wilson and L'Heureux-Dubé JJ. dissenting): The cross-appeal of Syncrude should be allowed.

Per Dickson C.J. and La Forest J.: There was no basis in law or in equity for awarding the trust fund to Hunter U.S. Hunter U.S. was not entitled to those moneys under the terms of the trust agreement. It did nothing for Syncrude to assist in producing the gears contemplated by the Hunter Canada Contract. The drawings used by Aco in manufacturing those gears were given by Syncrude and were properly in Syncrude's possession. There was no breach of copyright or theft. Hunter U.S. did not satisfy the criteria necessary to establish a constructive trust. There was no unjust enrichment.

As between Hunter U.S. and Hunter Canada, Hunter U.S. would have been allowed to claim any profits made by Hunter Canada under the traditional doctrine of constructive trust. Hunter Canada stood in a fiduciary relationship to Hunter U.S. and equity will not permit the fiduciary

to profit at the expense of the principal. The test for unjust enrichment enunciated in *Pettkus v. Becker*, too, would be satisfied.

The relations between Hunter Canada and Syncrude were regulated by contract. Where a party has entered a contract misled by fraudulent misrepresentations, the contract is voidable at the instance of the innocent party. Syncrude was entitled accordingly to rescind its contract with Hunter Canada and retain the money it would have paid under that contract. The fact that Hunter Canada was not entitled to the money precluded any claim by Hunter U.S. because that claim only arose as a result of Hunter Canada's actions.

Hunter U.S. was not a party to the trust agreement and consistently refused to honour the warranty and service obligations stipulated in the trust agreement. Syncrude was under no obligation to accept the offer made by Hunter U.S. To found a restitutionary remedy in favour of Hunter U.S. would be tantamount to compelling Syncrude to contract with Hunter U.S. Further, if the claim of Hunter U.S. were to prevail, Hunter U.S. would be enriched and Syncrude would suffer a corresponding deprivation for no juristic reason.

Syncrude created the trust fund, no doubt from an abundance of caution, and should not be put in a worse position than if it had merely rescinded its contract with Hunter Canada. The establishment of the fund was not an admission that the moneys belonged to either Hunter Canada or Hunter U.S. Its purpose was to ensure that someone would promptly assume the warranties.

Per McIntyre J.: Syncrude should have ownership of the trust fund for the reasons given by Dickson C.J.

Per Wilson and L'Heureux-Dubé JJ. (dissenting): The trust fund did not need to be disposed of according to the terms of the trust agreement. The trust terms were not agreed upon by either Hunter U.S. or Hunter Canada. Since Syncrude was no longer prepared to acknowledge, as it was in 1978, that the profit margin was payable to one of these two parties, entitlement to the trust fund should be decided on the equitable principles governing unjust enrichment.

Syncrude's entitlement was limited to working gearboxes at the price agreed upon and any additional money arising out of the circumstances, once repair costs were paid out of the fund, would constitute an enrichment.

Hunter U.S. would be correspondingly deprived of the interest income it would have earned on the contract for the supply of the additional 11 mining gearboxes under the Hunter Canada contract. No contractual link for the causal connection between contribution and enrichment needed to be proved. There was sufficient causal connection in the fact that Hunter U.S. first offered to assume the whole Hunter Canada contract and later, after it won its case, was prepared to offer Syncrude the warranty terms under which the original 32 gearboxes were supplied.

Syncrude had been willing to pay the profit margin to Hunter U.S. in 1978 and could not argue now that it had no need of Hunter U.S.

Cases Cited

By Dickson C.J.

Applied: *Pettkus v. Becker*, [1980] 2 S.C.R. 834; **considered**: *Suisse Atlantique Société d'Armement Maritime S.A. v. N.V. Rotterdamsche Kolen Centrale*, [1967] 1 A.C. 361; *Beaufort Realties (1964) Inc. v. Chomedey Aluminum Co.*, [1980] 2 S.C.R. 718; *Photo Production Ltd. v. Securicor Transport Ltd.*, [1980] A.C. 827; **referred to**: *Chabot v. Ford Motor Co. of Canada Ltd.* (1982), 138 D.L.R. (3d) 417; *Sperry Rand Canada Ltd. v. Thomas Equipment Ltd.* (1982), 135 D.L.R. (3d) 197; *Gafco Enterprises Ltd. v. Schofield*, [1983] 4 W.W.R. 135; *Beldessi v. Island Equipment Ltd.* (1973), 41 D.L.R. (3d) 147; *George Mitchell (Chesterhall) Ltd. v. Finney Lock Seeds Ltd.*, [1983] 2 All E.R. 737; *Cain v. Bird Chevrolet-Oldsmobile Ltd.* (1976), 12 O.R. (2d) 532 (H.C.), aff'd (1977), 88 D.L.R. (3d) 607 (Ont. C.A.); *Karsales (Harrow) Ltd. v. Wallis*, [1956] 1 W.L.R. 936; *B. G. Linton Construction Ltd. v. Canadian National Railway Co.*, [1975] 2 S.C.R. 678; *Harbutt's "Plasticine" Ltd. v. Wayne Tank & Pump Co.*, [1970] 1 Q.B. 447.

By Wilson J.

Approved: *Photo Production Ltd. v. Securicor Transport Ltd.*, [1980] A.C. 827; **distinguished**: *Beldessi v. Island Equipment Ltd.* (1973), 41 D.L.R. (3d) 147; **referred to**: *Hunter*

Engineering Co. v. Hunter Machinery Canada, Meredith J., Vancouver Registry C780211, December 28, 1978, unreported; *Wallis, Son & Wells v. Pratt & Haynes*, [1911] A.C. 394; *R. W. Heron Paving Ltd. v. Dilworth Equipment Ltd.*, [1963] 1 O.R. 201; *Cork v. Greavette Boats Ltd.*, [1940] O.R. 352; *Chabot v. Ford Motor Co. of Canada Ltd.* (1982), 138 D.L.R. (3d) 417; *Suisse Atlantique Société d'Armement Maritime S.A. v. N.V. Rotterdamsche Kolen Centrale*, [1967] 1 A.C. 361; *R. G. McLean Ltd. v. Canadian Vickers Ltd.* (1970), 15 D.L.R. (3d) 15; *Canso Chemicals Ltd. v. Canadian Westinghouse Co. (No. 2)* (1974), 54 D.L.R. (3d) 517; *Schofield v. Gafco Enterprises Ltd.* (1983), 43 A.R. 262; *Peters v. Parkway Mercury Sales Ltd.* (1975), 10 N.B.R. (2d) 703; *Keefe v. Fort* (1978), 89 D.L.R. (3d) 275; *Karsales (Harrow) Ltd. v. Wallis*, [1956] 1 W.L.R. 936; *Harbutt's "Plasticine" Ltd. v. Wayne Tank and Pump Co.*, [1970] 1 Q.B. 447; *Traders Finance Corp. v. Halverson* (1968), 2 D.L.R. (3d) 666; *Beaufort Realties (1964) Inc. v. Chomedey Aluminum Co.*, [1980] 2 S.C.R. 718; *Hayward v. Mellick* (1984), 2 O.A.C. 391; *Waters v. Donnelly* (1884), 9 O.R. 391; *Morrison v. Coast Finance Ltd.* (1965), 55 D.L.R. (2d) 710; *Harry v. Kreutziger* (1978), 95 D.L.R. (3d) 231; *Taylor v. Armstrong* (1979), 99 D.L.R. (3d) 547; *Davidson v. Three Spruces Realty Ltd.* (1977), 79 D.L.R. (3d) 481; *Gillespie Brothers & Co. v. Roy Bowles Transport Ltd.*, [1973] Q.B. 400; *Ailsa Craig Fishing Co. v. Malvern Fishing Co.*, [1983] 1 All E.R. 101; *Pettkus v. Becker*, [1980] 2 S.C.R. 834; *Sorochan v. Sorochan*, [1986] 2 S.C.R. 38; *Deglman v. Guaranty Trust Co.*, [1954] S.C.R. 725.

Statutes and Regulations Cited

Business Practices Act, R.S.O. 1980, c. 55, s. 2(*b*)(vi).

Business Practices Act, S.P.E.I. 1977, c. 31, s. 3(b)(vi).

Consumer Product Warranty and Liability Act, S.N.B. 1978, c. C-18.1, ss. 24, 25, 26.

Consumer Products Warranties Act, R.S.S. 1978, c. C-30, ss. 8, 11.

Consumer Protection Act, R.S.M. 1970, c. C200, s. 58(1).

Consumer Protection Act, R.S.N.S. 1967, c. 53, s. 20C.

Consumer Protection Act, R.S.O. 1980, c. 87, s. 34(1).

Sale of Goods Act, R.S.B.C. 1979, c. 370, s. 20.

Sale of Goods Act, R.S.O. 1970, c. 421, ss. 15(1), (4), 53.

Trade Practice Act, R.S.B.C. 1979, c. 406, s. 4(e).

Trade Practices Act, S.N. 1978, c. 10, s. 6(d).

Trade Practices Inquiry Act, R.S.M. 1987, c. T110, s. 2.

Unfair Contract Terms Act 1977 (U.K.), c. 50.

Unfair Trade Practices Act, R.S.A. 1980, c. U-3, s. 4(b), (d).

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APPEAL from a judgment of the British Columbia Court of Appeal (1985), 68 B.C.L.R. 367, in respect of a judgment of Gibbs J. (1984), 27 B.L.R. 59. Appeal of Hunter U.S. dismissed.

APPEAL from a judgment of the British Columbia Court of Appeal (1985), 68 B.C.L.R. 367, in respect of a judgment of Gibbs J. (1984), 27 B.L.R. 59. Appeal from that part of the judgment of the Court of Appeal which imposed liability on Allis-Chalmers Canada Limited allowed and the third party claim against Hunter U.S. dismissed.

CROSS-APPEAL from a judgment of the British Columbia Court of Appeal (1985), 68 B.C.L.R. 367, in respect of a judgment of Gibbs J. (1984), 27 B.L.R. 59. Cross-appeal of Syncrude allowed, Wilson and L'Heureux-Dubé JJ. dissenting.

Jack Giles, Q.C., and *Robert McDonell*, for the appellants Hunter Engineering Inc. et al.

D. M. M. Goldie, Q.C., and *P. G. Plant*, for the appellant Allis-Chalmers Canada Ltd.

D. B. Kirkham, Q.C., and *Garth S. McAlister*, for the respondents Syncrude Canada Ltd. et al.

The judgment of Dickson C.J. and La Forest J. was delivered by

THE CHIEF JUSTICE -- Three main issues are raised in this appeal: (i) was Hunter Engineering Company Inc. ("Hunter U.S.") responsible for design faults which resulted in cracks in the bull gears of gearboxes used to drive conveyor belts at the oil sands operation of Syncrude Canada Ltd. ("Syncrude"); if so, is Hunter U.S. liable to Syncrude for breach of the implied warranty of fitness contained in s. 15(1) of the Ontario *Sale of Goods Act*, R.S.O. 1970, c. 421; (ii) is the "doctrine" of fundamental breach a part of Canadian contract law and what is its effect, if any, on the liability of Allis-Chalmers Canada Limited ("Allis-Chalmers") to Syncrude; (iii) can the law of constructive trust be extended to reach, for the benefit of Hunter U.S., monies held under a trust agreement, to which Hunter U.S. was not a party, entered into by Syncrude in the unusual circumstances which will be described.

I

Facts

Syncrude operates a multi-billion dollar synthetic oil plant at Fort McMurray, Alberta, where oil extracted from tar sands is processed. Large bucket wheels scoop sand from its natural state and load it onto conveyor belts, which in turn carry the sand a substantial distance to an extraction plant. Motive force from 1250 horsepower motors is transmitted to the conveyor belts through a series of gearboxes. The trial judge, Gibbs J., described a "gearbox" as a unit which comprises a collection of gears, shafts and bearings contained within a steel box or casing. Power generated by a motor is transmitted through a drive shaft into the gearbox, then through a series of intermediate gears to a very large (the larger type being six and one half feet in diameter and the smaller five and one half feet in diameter) "bull gear" which revolves, turning a large shaft set in the centre of the bull gear and extending outside the gearbox casing, to which shaft is attached a pulley which moves the conveyor belt.

In January 1975, Canadian Bechtel Ltd. ("Bechtel"), as agent for Syncrude, contracted with Hunter U.S. for the supply of thirty-two mining gearboxes for use at Syncrude's oil sands project. In July of the same year, Syncrude contracted with Allis-Chalmers for the purchase of fourteen conveyor systems, including four extraction gearboxes. Both the Hunter and the Allis-Chalmers gearboxes were designed by Hunter U.S. in accordance with Bechtel specifications and fabricated by a subcontractor for Hunter U.S.

The gearboxes acquired from Hunter U.S. were put into service in July 1978. In September 1979, more than a year later, a gearbox failure occurred. The Allis-Chalmers extraction boxes went into operation in November 1977. In September 1979, nearly two years later, one of the extraction boxes failed and cracks were discovered in two of the other three.

The trial judge [see (1984), 27 B.L.R. 59] described the cause of the failure in these terms at pp. 62-63:

> The outer rim of the bull gear is attached to the central shaft by steel plates, one on each side of the rim, called "web plates". Inside the outer rim a thicker portion of the rim provides a shoulder on each side. The intention was that the web plates be fitted snugly to the shoulder and welded in place. Halfway between the rim and the shaft eight 8 1/2 inch diameter holes were cut at regular intervals in line through each plate. Steel pipe was welded into each set of holes to provide rigid connections between the plates. At the outer edge of the web plates, where they met the inside of the rim, eight 3 inch radius "half moon" pieces were cut out at regular intervals. The result was that there was not a continuous weld attaching the web plates to the inside of the rim. The connection was broken in eight evenly spaced places by the 3 inch radius half moon cutouts.
>
> The bull gears failed because the weld between the web plates and the outer rim failed. The diagnosis was that the weld failed because of flexing of the web plates and that the web plates flexed because there was insufficient strength to withstand the torque applied by the pinion gear to the bull gear. The evidence supporting the flexing diagnosis was uneven wear and pitting of the teeth on the bull and pinion gears. The continuous flexing of the web plates weakened and cracked the weld between the web plate and the rim. In time, if remedial action had not been taken the web plates would have broken away entirely.

Syncrude was forced to undertake its own repairs to the gearboxes when Hunter U.S. and Allis-Chalmers refused warranty coverage. Syncrude and the other plaintiffs claimed damages from Hunter U.S. and from Allis-Chalmers for the cost of repairing and rebuilding the gearboxes,

contending that the gearboxes were inherently defective, unsafe and unfit for the purposes for which they were intended and were not of merchantable quality. The defendants conceded that the gear boxes failed because they were too weak for the service, but they denied liability. By third party notice, Allis-Chalmers claimed contribution or indemnity from Hunter U.S. on the ground that if Allis-Chalmers were found liable, the liability would be due to faulty design or negligence by Hunter U.S.

Both the Hunter U.S. and the Allis-Chalmers contracts included a warranty limiting their liability to 24 months from the date of shipment or to 12 months from the date of start-up, whichever occurred first. In addition, the Allis-Chalmers warranty included a clause stating that the "Provisions of this paragraph represent the only warranty . . . and no other warranty or conditions, statutory or otherwise shall be implied". Both the Hunter U.S. and Allis-Chalmers contracts provided that the laws of Ontario were to apply.

The trial judge noted that Hunter U.S. had designed the gearboxes and had drawn the plans and specifications for the internal working parts. He held that unless the Bechtel specifications provided to Hunter U.S. were inadequate, Hunter U.S. must take responsibility for the failures.

Hunter U.S. contended that there was no evidence led by Syncrude to show that the specifications were not met, to which the judge responded at p. 64:

> However, although the Canadian Bechtel specifications give detailed operating criteria for the gearboxes they do not extend to design details. Indeed, they expressly provide that: "Correct and adequate design is the seller's (sole) responsibility."

In my opinion Hunter U.S. did not discharge the responsibility cast upon it when it accepted the Canadian Bechtel specifications. The torque applied by the pinion gear to the bull gear is directly related to the conveyor belt load which is translated into bull gear inertia which must be overcome by pinion gear force. The strength required in the moving parts within the gearbox to move the loaded conveyor belt is a design function and that design function was entirely the responsibility of Hunter U.S. The evidence was that the design load on the conveyor belt was never exceeded. The irresistible conclusion is that it was a design fault that prevented the gearboxes from performing the service. I so find.

The judgment of the Court of Appeal for British Columbia (reported (1985), 68 B.C.L.R. 367), affirmed the trial judge's finding that the cracks in the bull gears in the gearboxes were due to a breach of the design obligations of Hunter U.S. under its contract. The court awarded the sum of $1,000,000 against Hunter U.S., being the agreed cost, plus interest, of the repair of cracks in gears of the 32 mining gearboxes designed and supplied directly by Hunter U.S. to Syncrude.

The courts at trial and on appeal held that Hunter U.S. was not liable for the repair of the mining gearboxes under an express warranty because that warranty had expired. However, both

courts also held that the cracks were in breach of the statutory warranty of reasonable fitness found in the *Sale of Goods Act* of Ontario.

Gibbs J. accepted Syncrude's argument that the *Sale of Goods Act* applied to the contract, barring express provisions to the contrary, and therefore held the implied warranty of fitness for purposes stipulated in s. 15(1) of that Act governed. Applying the three tests proposed by Professor Fridman in *Sale of Goods in Canada* (2nd ed. 1979) at pp. 203-4; (i) that the contract be in the course of the seller's business; (ii) that the seller have knowledge of the purpose of the goods; (iii) and that the buyer rely on the seller's skill or judgment, the trial judge found Hunter U.S. liable to Syncrude for breach of s. 15(1).

In this Court, Hunter U.S. submitted that its design responsibility was limited to providing the strength required by Bechtel's specifications, and that it was Bechtel's responsibility, as author of the specifications, to design to the strength required to move the loaded conveyor belt for the length of time Syncrude wanted the boxes to work without repair.

Paragraphs 21 and 22 of the Hunter U.S. Factum read:

> 21. It must be emphasized that there is no evidence that Hunter's design did not provide a strength required by the specifications, and there is no evidence excluding an insufficiency in the strength required by the specifications as an alternative probable cause of the cracks when they eventually appeared.

22. In the result, the issue is one of proper interpretation of the contract: is Hunter's design obligation limited to designing in accordance with the strength required by the specifications? Or does it extend to and include the responsibility for designing to the strength required to move the loaded conveyor belt (without replacing a single gear) for more than twenty months of continuous service? If the former, the appeal succeeds entirely.

Counsel for Hunter U.S. quoted the design requirements set out in the specifications:

1.11 Requirements

The specifications, requirement drawings and date sheets included herewith represent minimum requirements.

This Specification covers all engineering services required to complete the design in accordance with the specifications. Correct and adequate design is the Seller's sole responsibility. [Underlining by counsel.]

and referred to clause 10.2.4 of the Specifications, headed "Service Factors":

Gear reducers shall conform to AGMA standards for 1.5 mechanical service factor and 1 : 1 thermal service factor based on rated motor horsepower with motor service factor of 1.0. The mechanical rating shall permit loads of 275% of motor rated horsepower for starting and for momentary peak loads up to six occurrences per hour, and shall permit single starts at loads of 300 percent of motor rated horsepower (200 percent of reducer rating).

Syncrude took a somewhat different view of the matter, contending that the specifications were in fact drafted by Hunter U.S. and incorporated into the contract on the recommendation of Hunter U.S. Counsel submitted that it was necessary to review the history under which the

contract specifications came into being. I will summarize that submission in the paragraphs immediately following.

The first oil sands plant built in the area of Fort McMurray, Alberta, was built by Great Canadian Oil Sands ("GCOS") in the early 1970s. In about 1972, Hunter U.S. designed and supplied the gearboxes and the conveyor system of GCOS. The gearboxes supplied to GCOS were virtually identical in design to the gearboxes subsequently supplied to Syncrude. In 1974, Syncrude was in the planning stages for the construction of its plant. Hunter approached Syncrude and held itself out as being an expert in the design of gearboxes for the specific operation which Syncrude intended. Hunter U.S. supplied complete specifications for its gearboxes to Syncrude and represented that the specifications would be suitable for the particular purpose Syncrude intended.

The specifications gave various details regarding performance requirements of the gearboxes. However, they did not give any details of the dimensions of the components within the gearboxes. The service factors to which counsel for Hunter U.S. referred were taken directly from the original proposal of Hunter U.S. The mechanical service factor of 1.5 x horsepower, the thermal service factor of 1 : 1 and the mechanical rating of 275% of motor rated horsepower for up to six starts per hour are all found in proposed specifications. There was nothing in the specifications which related to the part of the low speed gear which eventually failed.

Syncrude accepted the representations of Hunter U.S. as to its ability to produce suitable gearboxes for Syncrude's purpose and issued a Purchase Order to Hunter U.S. into which the specifications suggested by Hunter U.S., including the precise service factors were incorporated.

Counsel for Syncrude also made the following additional points:

(i) the contract expressly provided, "Correct and adequate design is the Seller's sole responsibility";

(ii) Mr. Rao Duvvuri, the design engineer employed by Hunter U.S., who designed the gearboxes for both GCOS and Syncrude and prepared detailed design drawings of all the components of the gearboxes for the purposes of manufacture never discussed any of the matters relating to the design of the bull gear with Syncrude or Bechtel at any time;

(iii) the gearboxes should last 20 years; bull gears would normally be expected to last "10 years or beyond", yet Hunter U.S. conceded at paragraph 27 of its Statement of Facts that, "There is no dispute that the strength of the moving parts within the gear boxes was inadequate to carry the conveyor belt for longer than two years without at least one failure.";

(iv) Hunter U.S. called no expert witness, nor any evidence at all, except for certain extracts from the examination for discovery.

The following passage from the reasons of the trial judge at pp. 70-71, is apposite:

> . . . on February 20, 1974 Hunter U.S., in the course of soliciting orders, sent Canadian Bechtel a technical description of their gearboxes, described as "shaft mounted conveyor drives". In the covering letter they said:
>
> > "Furthering our telephone conversation of last week, I am attaching two (2) copies of Specifications for the 1250 HP, 60 RPM output gear reducers.
> >
> > Three Specifications are drawn up for installations in locations such as the Fort McMurray, Alberta Oil Sands Operation, and have been found quite suitable in other installations in that area.
> >
> > We have included the Ringfedar ring shaft mounting as you indicated, also.
> >
> > Please keep us informed on this project, and when you are in a position to accept prices for these units, we will be happy to respond with a minimum of delay."

And in a summary sheet:

> > "This specification is for a geared drive assembly designed to power a belt conveyor.
> >
> > This drive group has been designed for installation and operation in the remote areas and hostile environment normal to the mining industry. The units are designed for a high degree of reliability based on design arts developed in similar installations. Special design consideration has been made for field servicings in the event it is necessary."

And on the introduction page of the descriptive document, described as "technical specifications":

> > "This specification has been prepared to qualify HUNTER ENGINEERING COMPANY INC., as a competent and experienced manufacturer of specialized gear driving equipment.

> Hunter drives are designed for specific applications, incorporating those features required to minimize operational and environmental hazards having an adverse effect on the performance of the unit. Our market effort is directed towards those unique applications which challenge our designer's [*sic*] ingenuity. Hunter has the engineering, manufacturing and financial resources to supply the complete drive package designed to reliably power any defined processing function."

I am strongly of the opinion that upon its true construction the contract dated January 29, 1975, between Syncrude and Hunter U.S., places responsibility for the design of the gearboxes solely upon Hunter U.S., and that Hunter U.S. failed to discharge that responsibility. I would affirm the conclusions of the British Columbia courts on this point. I would reject the argument that Hunter U.S. had merely designed the gears according to specifications provided by Syncrude's agent and, therefore, if the specifications were inadequate, Syncrude was to blame. The words used in the contract clearly indicate a creative role for Hunter U.S. The specifications provided by Syncrude in the contract were specifications about what gearboxes were required to do, not how they were to be built. Specific design details were Hunter U.S.'s responsibility. There is no evidence that the specifications themselves were faulty; the evidence shows that the design was inadequate and design was solely Hunter U.S.'s responsibility.

Hunter U.S. knew the gearboxes were required to move a conveyor belt. Its tender to Syncrude of February 20, 1974, read in part:

This specification is for a geared drive assembly designed to power a belt conveyor.

As Anderson J.A. observed in the Court of Appeal at p. 376:

> Hunter was well aware from the outset that the specifications were not to be construed in a vacuum but with regard to the system as a whole.

II

The Contractual Warranty

In light of the design obligations of Hunter U.S., Syncrude attempts to rely on the contractual warranty provisions in both the Hunter U.S. and Allis-Chalmers contracts. Although the general clause is the same in both contracts, the warranty was modified differently in each document. Because the difference between these modifications is important for the statutory warranty argument, I include the entire text of the main provisions and the modifications. The general provision common to both contracts provided:

> 8. WARRANTIES -- GUARANTEES: Seller warrants that the goods shall be free from defects in design, material, workmanship, and title, and shall conform in all respects to the terms of this purchase order, and shall be of the best quality, if no quality is specified. If it appears within one year from the date of placing the equipment in service for the purpose for which it was purchased, that the equipment, or any part thereof, does not conform to these warranties and Buyer so notifies Seller within a reasonable time after its discovery, Seller shall thereupon promptly correct such nonconformity as its sole expense . . . . Except as otherwise provided in this purchase order, Seller's liability hereunder shall extend to all damages

proximately caused by the breach of any of the foregoing warranties or guarantees, but such liability shall in no event include loss of profit or loss of use.

The clause was modified in the Hunter U.S. contract to read:

WARRANTY:

Twenty-four (24) months from date of shipment to twelve (12) months from date of start-up whichever occurs first.

The Allis-Chalmers contract was modified to read:

WARRANTY:

24 months from date of shipment or 12 months from date of start-up, whichever occurs first.

NOTES:

Buyer's General Conditions supersede the Seller's Terms and Conditions of Sale and shall apply to this Purchase Order except as amended herein:

A. Paragraph 8 -- "Warranties -- Guarantees"

The final sentence of paragraph 8 is hereby deleted. In its place shall be, "The Provisions of this paragraph represent the only warranty of the Seller and no other warranty or conditions, statutory or otherwise shall be implied." The warranty period shall be twelve (12) months from the date of operation or 24 months from the date of shipment, whichever occurs first . . . .

Two crucial factors emerge from these provisions. First, the relevant time period during which the warranties apply is 12 months from the date of putting the equipment into operation or

24 months from the date of shipment, whichever occurs first. Second, the Hunter U.S. provision does not exempt Hunter U.S. from warranties that arise from statutes.

The trial judge found the date of start-up to have been July 4, 1978. This was more than one year before the weakness in the gearboxes was first detected in September 1979. On this basis the trial judge rightly held that Syncrude was out of time and could not rely on the contractual warranty provisions.

Syncrude advances two arguments to suggest that it is entitled to rely on the contractual warranty. Both arguments are unconvincing and can be dismissed with little discussion. First, Syncrude alleges that the warranty clauses were not limited in time. It bases this claim on reading s. 8 as containing four distinct provisions. The first provision, contained in the first sentence, makes no mention of time and is therefore not limited in duration. This seems an incredible interpretation of a warranty provision. As a matter of contractual interpretation it makes sense to read the provision as a whole and not as four disjunctive parts.

The second argument is Syncrude's allegation that the defect "appeared" in the sense that the word is used in the warranty clause within the relevant time period. This claim rests on the allegations that the design defect "appeared" in the original drawings submitted by Hunter U.S. and that Hunter U.S. had knowledge of the defect before the gearboxes were operational. In response to this argument the trial judge stated that Syncrude was proposing an extraordinary

meaning of "appears", i.e., knowledge or deemed knowledge of Hunter U.S. The judge held that the word "appears" should be given its ordinary meaning, which is to become visible to Syncrude. This interpretation must be correct; any other interpretation would be stretching the meaning of the word beyond recognition.

III

The Implied Statutory Warranty

Since neither Hunter U.S. nor Allis-Chalmers could be held liable for breach of contractual warranty, the remaining option is to found liability on the basis of statutory warranty. The parties, an Alberta based and an American based company had provided in the contract that the laws of Ontario were to apply. Syncrude contends that both Hunter U.S. and Allis-Chalmers breached s. 15(1) of the Ontario *Sale of Goods Act*, which reads:

> **15.** Subject to this Act and any statute in that behalf, there is no implied warranty or condition as to the quality or fitness of any particular purpose of goods supplied under a contract of sale, except as follows:
>
> 1. Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which the goods are required so as to show that the buyer relies on the seller's skill or judgment, and the goods are of a description that it is in the course of the seller's business to supply (whether he is the manufacturer or not), there is an implied condition that the goods will be reasonably fit for such purpose, but in the case of a contract for the sale of a specified article under its

> patent or other trade name there is no implied condition as to its fitness for any particular purpose. [Emphasis added.]

Section 53 of the *Sale of Goods Act* expressly provides for contracting out of the provisions of the Act. This may be accomplished by express agreement. Clearly the provision in the Allis-Chalmers contract reproduced above is sufficient to exclude the operation of the implied warranty.

The trial judge had no difficulty in concluding that, as against Hunter U.S., all three prerequisites for the application of s. 15(1) had been met. Hunter U.S. presents three arguments challenging this result. First, it submits that Syncrude did not rely on Hunter's expertise as it was Syncrude which supplied the specifications. In light of the earlier finding concerning the nature of Hunter's design obligation, this argument cannot prevail. As the trial judge pointed out, Hunter U.S. could only succeed if there were evidence that Syncrude or Bechtel possessed and exercised skill and judgment in the design and manufacture of gearboxes. No such evidence was introduced.

Second, Hunter U.S. argues that because the gearboxes worked for more than one year, they were reasonably fit for their purpose. This seems difficult to accept when, as Syncrude contends, a gearbox is expected to operate without problem for more than ten years. I fail to understand how anything as seriously flawed as the gearboxes in the case at bar could be said to be reasonably fit.

Finally, Hunter U.S. argues that Syncrude cannot rely on the statutory warranty because it is inconsistent with the warranty embodied in the contract. According to s. 15(4) of the *Sale of Goods Act*, an implied condition can be negated by an express warranty if the two are inconsistent. As mentioned earlier, s. 53 also allows parties to contract out of the provisions of the Act. Hunter U.S.'s argument is that the very presence of the express warranty renders the statutory warranty inapplicable. Again, this cannot be the correct position. The mere presence of an express warranty in the contract does not mean that the statutory warranties are inconsistent. If one wishes to contract out of statutory protections, this must be done by clear and direct language, particularly where the parties are two large, commercially sophisticated companies. This seems to be well-established in the case law, as Eberle J. makes clear in *Chabot v. Ford Motor Co. of Canada Ltd.* (1982), 138 D.L.R. (3d) 417 (Ont. H.C.)

I would adopt the following passage from the reasons of Gibbs J. at trial at p. 73:

> Hunter U.S. cannot avoid liability under s. 15.1 of the Ontario Sale of Goods Act. The design and manufacture of the gearboxes was in the course of Hunter U.S. business activities. Hunter U.S. knew the purpose of the gearboxes. Syncrude, through its agent, relied upon the skill and judgment of Hunter U.S. The gearboxes were not reasonably fit for the purpose for which they were required. Hunter U.S. is in breach of the implied condition in s. 15.1.

IV

Fundamental Breach

It will now be convenient to consider the liability to Syncrude of Allis-Chalmers and in turn of Hunter U.S. on the third party claim of Allis-Chalmers. The facts can be briefly stated. The purchase agreement contained in para. 8 a warranty modified, as stated earlier, to exclude statutory warranties or conditions. Paragraph 14 of the agreement read:

C. Paragraph 14 - Limitation of Liability

> Notwithstanding any other provision in this contract or any applicable statutory provisions neither the Seller nor the Buyer shall be liable to the other for special or consequential damages or damages for loss of use arising directly or indirectly from any breach of this contract, fundamental or otherwise or from any tortious acts or omissions of their respective employees or agents and in no event shall the liability of the Seller exceed the unit price of the defective product or of the product subject to late delivery.

The price of the fourteen conveyor systems and accessories purchased from Allis-Chalmers was $4,166,464. The agreed cost of the repairs was $400,000; including pre-judgment interest, $535,000. In the face of the contractual provisions, Allis-Chalmers can only be found liable under the doctrine of fundamental breach.

The Court of Appeal differed with the trial judge on the question of fundamental breach. At trial Gibbs J., at pp. 74-76, quoted with approval from the judgment of Stratton J.A., as he then was, in *Sperry Rand Canada Ltd. v. Thomas Equipment Ltd.* (1982), 135 D.L.R. (3d) 197

(N.B.C.A.), at pp. 205-6, and the judgment of Harradence J.A. in *Gafco Enterprises Ltd. v. Schofield*, [1983] 4 W.W.R. 135 (Alta. C.A.), at pp. 139-41.

Applying the principle of these cases to the purchase order and the nature of the defect in the bull gears, Gibbs J. concluded that the case for fundamental breach had not been made out. He said at pp. 77-78:

> As to the nature of the defect, in my opinion it was not so fundamental that it went to the root of the contract. The contract between the parties was still a contract for gearboxes. Gearboxes were supplied. They were capable of performing their function and did perform it for in excess of a year which, given the agreed time limitations, was the "cost free to Syncrude" period contemplated by the parties. It was conceded that the gearboxes were not fit for the service. However, the unfitness, or defect, was repairable and was repaired at a cost significantly less than the original purchase price. No doubt the bull gear is an important component of the gearbox but no more important than the engine in an automobile and in the *Gafco Ent.* case the failure of the engine was not a sufficiently fundamental breach to lead the Court to set aside the contract of sale. On my appreciation of the evidence Syncrude got what it bargained for .... It has not convinced me that there was fundamental breach.

On appeal, Anderson J.A. reviewed a number of authorities including the judgment of Seaton J.A. in *Beldessi v. Island Equipment Ltd.* (1973), 41 D.L.R. (3d) 147 (B.C.C.A.), and held that Allis-Chalmers was in fundamental breach because Syncrude was deprived of substantially the whole benefit of the contract.

In reaching that conclusion he said at p. 393:

> It follows that the cost of repair was not significantly less than the original purchase price but, on the contrary, the cost of repair constituted 86 per cent of the purchase price. Moreover, the expected life of a gearbox is 20 years. The expected life of a bull gear is at least 10 years. The bull gear failed within less than two years after Syncrude's operations commenced.

He rejected as without merit the argument of counsel for Allis-Chalmers that Syncrude's contract with Allis-Chalmers was not just a "contract for gearboxes" but was rather a contract for the purchase of a package of fourteen conveyor systems for a price of over $4,000,000, and viewed in relation to the total purchase price actually paid by Syncrude, the cost of repair of one component, whether it is considered to be the bull gear or the gearbox, was indeed "significantly less than the original purchase price."

Hunter U.S., ultimately liable on account of the third-party claim against it, submits that the British Columbia Court of Appeal was wrong on this branch of the case because the effect of its decision is to re-establish the doctrine of fundamental breach as a rule of law invalidating a clause limiting liability.

Counsel submits that in England, since *Suisse Atlantique Société d'Armement Maritime S.A. v. N.V. Rotterdamsche Kolen Centrale*, [1967] 1 A.C. 361, the doctrine of fundamental breach has been rejected as a rule of law invalidating exemption clauses. At page 405, Lord Reid said: "In my view no such rule of law ought to be adopted". In commenting upon that decision, Professor P. S. Atiyah in his text, *The Sale of Goods* (6th ed. 1980), at p. 157, says, "This was not in all

respects an easy decision to understand . . . ." With that statement I am in full agreement. Professor Atiyah continues:

> . . . but the principal point to emerge from the *Suisse Atlantique* case was the firm and unanimous holding that the "doctrine" of fundamental breach is not a rule of law but merely a rule of construction. Parties are free to make whatever provision they desire in their contracts, but it is a rule of construction that an exemption clause does not protect a party from liability for fundamental breach. It follows that if the contract by express provision does protect a party from such a result and the court thinks that the provision was intended to operate in the circumstances which have occurred, the provision must be given full effect.

It was contended by Hunter U.S. that, at bar, the Court of Appeal approached the matter by asking whether the warranty in the contract excluded liability for fundamental breach. Upon finding it did not, the Court of Appeal then found as a fact, contrary to the finding of fact made by the trial judge, that the breach was fundamental, and awarded the buyer the full amount of its claim.

It was submitted that by doing this, the Court of Appeal erroneously adopted the approach (as it did in *Beldessi v. Island Equipment Ltd.*, *supra*, upon which it relied so heavily in this case) that to be effective a limitation of liability clause must expressly exclude liability for fundamental breach. It was submitted this approach involves returning to the notion of treating fundamental breach as something which, as a rule of law, will displace the terms of the contract; to paraphrase Lord Bridge's decision in *George Mitchell (Chesterhall) Ltd. v. Finney Lock Seeds Ltd.*, [1983]

2 All E.R. 737 (H.L.) at p. 741: it reintroduces by the back door a doctrine which the *Suisse Atlantique* case, and cases following, had evicted by the front.

Allis-Chalmers adopted in its entirety the argument of Hunter U.S. with respect to the fundamental breach issue. The argument in the factum of Allis-Chalmers was directed to the further question whether the Court of Appeal erred in failing to construe properly the warranty clause in ascertaining whether it applied to the instant breach.

Allis-Chalmers argued that the words of clause 8 are clear and fairly susceptible of only one meaning, and the Court of Appeal erred in failing to give effect to them; instead of giving effect to the language of the contract, the Court of Appeal imported its own implied warranty and erroneously embarked on a consideration of whether clause 8 was effective to eliminate the "essential undertaking of Allis-Chalmers to provide gearboxes capable of meeting the requirements of the extraction process". In proceeding in this fashion, the Court of Appeal in effect resurrected a term analogous to the implied statutory warranty of fitness for the purpose required, which the parties had expressly excluded. By importing this additional term into the contract the court re-wrote the bargain which the parties had made for themselves.

Syncrude argues in response that the seller's fundamental obligation does not derive from, and is not dependent upon, the existence of express or implied warranties or conditions. It is inherent in the contract of sale.

Syncrude relied upon the pronouncement of the doctrine of fundamental obligation of the seller enunciated by Weatherston J. in *Cain v. Bird Chevrolet-Oldsmobile Ltd.* (1976), 12 O.R. (2d) 532 (H.C.), (aff'd (1977), 88 D.L.R. (3d) 607 (Ont. C.A.)) The court stated at pp. 534-35:

> The first and most important thing in any case is to determine what are the terms of the contract, so as to decide what performance was required by the defaulting party.
>
> . . .
>
> Where a machine has been delivered which has such a defect, or "such a congeries of defects" as to destroy the workable character of the machine, there is said to be a fundamental breach of contract by the seller. This is so because the purported performance of the contract is quite different than that which the contract contemplated . . . . There has been no failure of consideration, no failure to deliver the thing contracted for, but it is implicit in the transaction, as a fundamental term, that the thing contracted for is what it seems to be.

The House of Lords' cases decided that liability for breach of a fundamental term may be excluded by a suitably worded exclusion clause. However, counsel contended that there is a rule of construction that exemption clauses must be very clearly worded if they are to be sufficient to exclude liability for fundamental breach. It was said that this approach to the construction of a contract was confirmed in this Court in *Beaufort Realties (1964) Inc. v. Chomedey Aluminum Co.*, [1980] 2 S.C.R. 718.

On the application of the principles to the present case, Syncrude asked the question whether Allis-Chalmers and Syncrude intended that Allis-Chalmers could supply gearboxes which were

so fundamentally defective as to require complete replacement, or in this case, complete reconstruction, after fifteen months' service, at Syncrude's sole cost. Syncrude would give a negative response to this question.

I have had the advantage of reading the reasons for judgment prepared by my colleague, Justice Wilson, in this appeal and I agree with her disposition of the liability of Allis-Chalmers. In my view, the warranty clauses in the Allis-Chalmers contract effectively excluded liability for defective gearboxes after the warranty period expired. With respect, I disagree, however, with Wilson J.'s approach to the doctrine of fundamental breach. I am inclined to adopt the course charted by the House of Lords in *Photo Production Ltd. v. Securicor Transport Ltd.*, [1980] A.C. 827, and to treat fundamental breach as a matter of contract construction. I do not favour, as suggested by Wilson J., requiring the court to assess the reasonableness of enforcing the contract terms after the court has already determined the meaning of the contract based on ordinary principles of contract interpretation. In my view, the courts should not disturb the bargain the parties have struck, and I am inclined to replace the doctrine of fundamental breach with a rule that holds the parties to the terms of their agreement, provided the agreement is not unconscionable.

The doctrine of fundamental breach in the context of clauses excluding a party from contractual liability has been confusing at the best of times. Simply put, the doctrine has served to relieve parties from the effects of contractual terms, excluding liability for deficient performance where

the effects of these terms have seemed particularly harsh. Lord Wilberforce acknowledged this in *Photo Production*, *supra*, at p. 843:

> 1. The doctrine of "fundamental breach" in spite of its imperfections and doubtful parentage has served a useful purpose. There was a large number of problems, productive of injustice, in which it was worse than unsatisfactory to leave exception clauses to operate.

In cases where extreme unfairness would result from the operation of an exclusion clause, a fundamental breach of contract was said to have occurred. The consequence of fundamental breach was that the party in breach was not entitled to rely on the contractual exclusion of liability but was required to pay damages for contract breach. In the doctrine's most common formulation, by Lord Denning in *Karsales (Harrow) Ltd. v. Wallis*, [1956] 1 W.L.R. 936 (C.A.), fundamental breach was said to be a rule of law that operated regardless of the intentions of the contracting parties. Thus, even if the parties excluded liability by clear and express language, they could still be liable for fundamental breach of contract. This rule of law was rapidly embraced by both English and Canadian courts.

A decade later in the *Suisse Atlantique* case, the House of Lords rejected the rule of law concept in favour of an approach based on the true construction of the contract. The Law Lords expressed the view that a court considering the concept of fundamental breach must determine whether the contract, properly interpreted, excluded liability for the fundamental breach. If the parties clearly intended an exclusion clause to apply in the event of fundamental breach, the party

in breach would be exempted from liability. In *B. G. Linton Construction Ltd. v. Canadian National Railway Co.*, [1975] 2 S.C.R. 678, this Court approved of the *Suisse Atlantique* formulation. The renunciation of the rule of law approach by the House of Lords and by this Court, however, had little effect on the practice of lower courts in England or in Canada. Lord Denning quickly resuscitated the rule of law doctrine in *Harbutt's "Plasticine" Ltd. v. Wayne Tank & Pump Co.*, [1970] 1 Q.B. 447 (C.A.)

Finally, in 1980, the House of Lords definitively rejected the rule of law approach to fundamental breach in *Photo Production*, *supra*. In that case, the plaintiff, Photo Production, had contracted with Securicor, a company in the business of supplying security services, to provide four nightly patrols of its factory. At issue was whether Securicor was liable for a fire deliberately set by one of its employees in the course of his duties at the Photo Production factory. The contract between the two parties contained the following limitation clause (at p. 840):

> "1. Under no circumstances shall the company (Securicor) be responsible for any injurious act or default by any employee of the company unless such act or default could have been foreseen and avoided by the exercise of due diligence on the part of the company as his employer; nor, in any event, shall the company be held responsible for (a) any loss suffered by the customer through burglary, theft, fire or any other cause, except insofar as such loss is solely attributable to the negligence of the company's employees acting within the course of their employment . . . ."

The limitation clause clearly excluded liability for fire with the exception of fires started by negligent acts. Securicor argued it could not be liable under the contract for the fire that

occurred. Photo Production contended that Securicor was liable for the damage done to the factory under the doctrine of fundamental breach.

Lord Wilberforce rejected Photo Production's argument. He began by reviewing the fractured history of the doctrine of fundamental breach and then forcefully repudiated the rule of law concept. Lord Wilberforce reiterated the thoughts articulated in *Suisse Atlantique*, stating at pp. 842-43, he had no doubt as to,

> . . . the main proposition that the question whether, and to what extent, an exclusion clause is to be applied to a fundamental breach, or a breach of a fundamental term, or indeed to any breach of contract, is a matter of construction of the contract.

The policy behind this approach is stated by Lord Wilberforce, at p. 843, as follows:

> At the stage of negotiation as to the consequences of a breach, there is everything to be said for allowing the parties to estimate their respective claims according to the contractual provisions they have themselves made, rather than for facing them with a legal complex so uncertain as the doctrine of fundamental breach must be . . . .
>
> At the judicial stage there is still more to be said for leaving cases to be decided straightforwardly on what the parties have bargained for rather than on analysis, which becomes progressively more refined, of decisions in other cases leading to inevitable appeals.

Lord Wilberforce proceeded to examine the contract between Securicor and Photo Production to determine exactly what the parties had provided, at p. 846:

As a preliminary, the nature of the contract has to be understood. Securicor undertook to provide a service of periodical visits for a very modest charge . . . . It would have no knowledge of the value of the plaintiffs' factory: that, and the efficacy of their fire precautions, would be known to the respondents. In these circumstances nobody could consider it unreasonable, that as between these two equal parties the risk assumed by Securicor should be a modest one, and that the respondents should carry the substantial risk of damage or destruction.

The duty of Securicor was, as stated, to provide a service. There must be implied an obligation to use due care in selecting their patrolmen, to take care of the keys and, I would think, to operate the service with due and proper regard to the safety and security of the premises. The breach of duty committed by Securicor lay in a failure to discharge this latter obligation. Alternatively it could be put upon a vicarious responsibility for the wrongful act . . . . This being the breach, does condition 1 apply? It is drafted in strong terms, "Under no circumstances" . . . "any injurious act or default by any employee." <u>These words have to be approached with the aid of the cardinal rules of construction that they must be read contra proferentem and that in order to escape from the consequences of one's own wrongdoing, or that of one's servant, clear words are necessary. I think that these words are clear</u>. The respondents in facts [*sic*] relied upon them for an argument that since they exempted from negligence they must be taken as not exempting from the consequence of deliberate acts. But this is a perversion of the rule that if a clause can cover something other than negligence, it will not be applied to negligence. <u>Whether, in addition to negligence, it covers other, e.g., deliberate, acts, remains a matter of construction requiring, of course, clear words. I am of the opinion that it does, and being free to construe and apply the clause, I must hold that liability is excluded</u>. [Emphasis added.]

Lord Diplock alluded to the importance of negotiated risk allocation at p. 851:

> My Lords, the reports are full of cases in which what would appear to be very strained constructions have been placed on exclusion clauses, mainly in what to-day would be called consumer contracts and contracts of adhesion . . . . In commercial contracts negotiated between business-men capable of looking after their own interests and of deciding how risks inherent in the performance of various kinds of contract can be most economically borne (generally by insurance), it is, in my view, wrong to place a strained construction upon words in an exclusion clause which are clear and fairly susceptible of one meaning only even after due allowance has been made for the presumption in favour of the implied primary and secondary obligations.

In *Beaufort Realties*, *supra*, Ritchie J., delivering the judgment of this Court, stated, at p. 723:

> Stated bluntly, the difference of opinion as to the true intent and meaning of their Lordships' judgment in the *Suisse Atlantique* case centered around the question of whether a rule of law exists to the effect that a fundamental breach going to the root of a contract eliminates once and for all the effect of all clauses exempting or excluding the party in breach from rights which it would otherwise have been entitled to exercise, or whether the true construction of the contract is the governing consideration in determining whether or not an exclusionary clause remains unaffected and enforceable notwithstanding the fundamental breach. The former view was espoused by Lord Denning and is illustrated by his judgment which he delivered on behalf of the Court of Appeal in the *Photo Production* case (*supra*) . . . .

and at p. 725:

> It has been concurrently found by the learned trial judge and the Court of Appeal that article 6 of this contract constituted an exclusionary or exception clause and Madame Justice Wilson adopted the same considerations as those which governed the House of Lords in the *Photo* case in holding that the question of whether such a clause was applicable where there was a fundamental breach was to be determined according to the true construction of the contract. I concur in this approach to the case.

As Wilson J. notes in her reasons, Canadian courts have tended to pay lip service to contract construction but to apply the doctrine of fundamental breach as if it were a rule of law. While the motivation underlying the continuing use of fundamental breach as a rule of law may be laudatory, as a tool for relieving parties from the effects of unfair bargains, the doctrine of fundamental breach has spawned a host of difficulties; the most obvious is how to determine whether a particular breach is fundamental. From this very first step the doctrine of fundamental breach invites the parties to engage in games of characterization, each party emphasizing different aspects of the contract to show either that the breach that occurred went to the very root of the contract or that it did not. The difficulty of characterizing a breach as fundamental for the purposes of exclusion clauses is vividly illustrated by the differing views of the trial judge and the Court of Appeal in the present case.

The many shortcomings of the doctrine as a means of circumventing the effects of unfair contracts are succinctly explained by Professor Waddams (*The Law of Contracts* (2nd ed. 1984), at pp. 352-53):

> The doctrine of fundamental breach has, however, many serious deficiencies as a technique of controlling unfair agreements. The doctrine requires the court to identify the offending provision as an "exemption clause", then to consider the agreement apart from the exemption clause, to ask itself whether there would have been a breach of that part of the agreement and then to consider whether that breach was "fundamental". These inquiries are artificial and irrelevant to the real questions at issue. An exemption clause is not always unfair and there are many unfair provisions that are not exemption clauses. It is quite unsatisfactory to look at the agreement apart from the exemption clause, because the exemption clause is

> itself part of the agreement, and if fair and reasonable a perfectly legitimate part. Nor is there any reason to associate unfairness with breach or with fundamental breach . . . .
>
> . . .
>
> More serious is the danger that suppression of the true criterion leads, as elsewhere, to the striking down of agreements that are perfectly fair and reasonable.

Professor Waddams makes two crucially important points. One is that not all exclusion clauses are unreasonable. This fact is ignored by the rule of law approach to fundamental breach. In the commercial context, clauses limiting or excluding liability are negotiated as part of the general contract. As they do with all other contractual terms, the parties bargain for the consequences of deficient performance. In the usual situation, exclusion clauses will be reflected in the contract price. Professor Waddams' second point is that exclusion clauses are not the only contractual provisions which may lead to unfairness. There appears to be no sound reason for applying special rules in the case of clauses excluding liability than for other clauses producing harsh results.

In light of the unnecessary complexities the doctrine of fundamental breach has created, the resulting uncertainty in the law, and the unrefined nature of the doctrine as a tool for averting unfairness, I am much inclined to lay the doctrine of fundamental breach to rest, and where necessary and appropriate, to deal explicitly with unconscionability. In my view, there is much to be gained by addressing directly the protection of the weak from over-reaching by the strong, rather than relying on the artificial legal doctrine of "fundamental breach". There is little value

in cloaking the inquiry behind a construct that takes on its own idiosyncratic traits, sometimes at odds with concerns of fairness. This is precisely what has happened with the doctrine of fundamental breach. It is preferable to interpret the terms of the contract, in an attempt to determine exactly what the parties agreed. If on its true construction the contract excludes liability for the kind of breach that occurred, the party in breach will generally be saved from liability. Only where the contract is unconscionable, as might arise from situations of unequal bargaining power between the parties, should the courts interfere with agreements the parties have freely concluded. The courts do not blindly enforce harsh or unconscionable bargains and, as Professor Waddams has argued, the doctrine of "fundamental breach" may best be understood as but one manifestation of a general underlying principle which explains judicial intervention in a variety of contractual settings. Explicitly addressing concerns of unconscionability and inequality of bargaining power allows the courts to focus expressly on the real grounds for refusing to give force to a contractual term said to have been agreed to by the parties.

I wish to add that, in my view, directly considering the issues of contract construction and unconscionability will often lead to the same result as would have been reached using the doctrine of fundamental breach, but with the advantage of clearly addressing the real issues at stake.

In rejecting the doctrine of fundamental breach and adopting an approach that binds the parties to the bargains they make, subject to unconscionability, I do not wish to be taken as expressing an opinion on the substantial failure of contract performance, sometimes described as

fundamental breach, that will relieve a party from future obligations under the contract. The concept of fundamental breach in the context of refusal to enforce exclusion clauses and of substantial failure of performance have often been confused, even though the two are quite distinct. In *Suisse Atlantique*, Lord Wilberforce noted the importance of distinguishing the two uses of the term fundamental breach, at p. 431:

> Next for consideration is the argument based on "fundamental breach" or, which is presumably the same thing, a breach going "to the root of the contract." These expressions are used in the cases to denote two quite different things, namely, (i) a performance totally different from that which the contract contemplates, (ii) a breach of contract more serious than one which would entitle the other party merely to damages and which (at least) would entitle him to refuse performance or further performance under the contract
>
> Both of these situations have long been familiar in the English law of contract . . . . What is certain is that to use the expression without distinguishing to which of these, or to what other, situations it refers is to invite confusion.
>
> The importance of the difference between these meanings lies in this, that they relate to two separate questions which may arise in relation to any contract.

I wish to be clear that my comments are restricted to the use of fundamental breach in the context of enforcing contractual exclusion clauses.

Turning to the case at bar, I am of the view that Allis-Chalmers is not liable for the defective gearboxes. The warranty provision of the contract between Allis-Chalmers and Syncrude clearly limited the liability of Allis-Chalmers' to defects appearing within one year from the date of placing the equipment into service. The trial judge found that the defects in the gearboxes did

not become apparent until after the warranty of Allis-Chalmers had expired. It is clear, therefore, that the warranty clause excluded liability for the defects that materialized, and subject to the existence of any unconscionability between the two parties there can be no liability on the part of Allis-Chalmers. I have no doubt that unconscionability is not an issue in this case. Both Allis-Chalmers and Syncrude are large and commercially sophisticated companies. Both parties knew or should have known what they were doing and what they had bargained for when they entered into the contract. There is no suggestion that Syncrude was pressured in any way to agree to terms to which it did not wish to assent. I am therefore of the view that the parties should be held to the terms of their bargain and that the warranty clause freed Allis-Chalmers from any liability for the defective gearboxes.

V

The Trust Agreement

In 1977, almost three years after it originally contracted with Hunter U.S. for gearboxes, Syncrude determined it required an additional 11 gearboxes. It was approached by individuals with whom it had previously dealt at Hunter U.S. who said they now represented the Canadian subsidiary of Hunter U.S., Hunter Machinery (Canada) Limited ("Hunter Canada"). In fact, Hunter Canada was incorporated independently by employees of Hunter U.S. and the President of Aco Sales and Engineering ("Aco"), a subcontractor used by Hunter U.S. It had no connection

with Hunter U.S. All representations that Hunter Canada was in any way affiliated with Hunter U.S. amounted to fraudulent misrepresentations.

Unaware of the fraud being perpetrated by Hunter Canada, Syncrude contracted with Hunter Canada for the purchase of the 11 gearboxes in the fall of 1977. The gearboxes were to be of the same design as the original 32 mining gearboxes. The only noteworthy feature of the contract was the warranty provision which was significantly broader than that normally negotiated by Hunter U.S. Unlike the Hunter U.S. warranty which was limited in time, the Hunter Canada warranty was unlimited in time.

Hunter Canada subcontracted with Aco for the manufacture of the gearboxes. After Aco had commenced work on the gearboxes but before Syncrude had made any payments to Hunter Canada under the contract, Hunter U.S. discovered Hunter Canada's deception. Hunter U.S. immediately alerted Syncrude and, on January 13, 1978, commenced a "passing-off" action against Hunter Canada and the individuals who owned Hunter Canada. Syncrude, in the meantime, had an urgent need for the additional gearboxes. The gearboxes were essential for its operation and Syncrude was very concerned that receipt of the gearboxes would be held up until judgment in the passing-off action. In January 1978, Syncrude secured a waiver from Hunter Canada of any right, title or interest arising from the contract, subject to the creation of a trust agreement acceptable to Hunter Canada.

On March 1, 1978, in an attempt to ensure prompt delivery of the gearboxes, Syncrude entered into two agreements. In the first agreement, Aco agreed to manufacture gearboxes for Syncrude at the price it would have received from Hunter Canada. Aco, it should be said, had already begun production of gearboxes under the Hunter Canada subcontract. The second agreement between Syncrude and one Donald E. Mann and Aco, appended as a schedule to the first, established a trust fund. All monies that would have been payable by Syncrude to Hunter Canada were to be paid into the trust fund and administered by Mann as trustee. Aco was to be paid the contract price out of the fund. The balance was to be dealt with as follows:

> 7. Following the payments made pursuant to clauses 5 and 9, the trustee shall hold the remainder of the trust funds and trust income for payment pending determination by agreement between Hunter Canada and Hunter Engineering, or by a decision of a Court of competent jurisdiction in Canada as to the identity of the holder of a valid and lawful interest in the remainder of trust funds as between Hunter Engineering and Hunter Canada, or upon determination of certain issues in Canada, currently the subject of legal proceedings between Hunter Engineering and Hunter Canada by settlement agreement or by a decision of a Court of competent jurisdiction in Canada.
>
> 8. The trustee shall pay from the remainder of the trust fund at such time as the holder of a valid interest in the trust fund is determined pursuant to Clause 7, above, an amount or portion of the remainder of the trust fund which represents the value of such valid interest to the holder so identified, being an amount no more than the value of the interest Hunter Canada would have had under the purchase orders identified in Schedule "A" of the said Agreement less any payments made pursuant to Clauses 5 and 9 hereof; provided, however, the trustee shall refrain from making any such payment of the said remainder of the trust fund and trust income until the holder of the valid and lawful interest in the trust fund has undertaken, by agreement with Syncrude, to assume warranty and service obligations with respect to the Work under the said Agreement, as provided expressly or impliedly by the provisions of the purchase orders identified in Schedule "A" thereto, and until the trustee is notified by Syncrude of such agreement.

9. Reasonable legal expenses incurred by the trustee in the performance of his duties herein and remuneration to the trustee in accordance with the provisions of The Trustee Act shall be paid from the remainder of the trust funds following payments made pursuant to Clause 5.

10. In the event that Syncrude and the holder of the valid and lawful interest in the trust fund are unable to agree with respect to the warranty and service of Work in Schedule "A" of the said Agreement, the trustee shall pay the remainder of the trust fund, as determined by Clause 7 and Clause 8 of this Agreement, to Syncrude.

11. Upon satisfaction of the payments provided in Clauses 5, 7, 8 and 9 hereto, the trustee shall pay the balance of the remainder of the trust fund, if any, and trust income to Syncrude.

It will be noted that an amount representing the profit Hunter Canada would have made, less the administration costs of the trust fund, was to be payable from the trust fund to the successful party in the litigation between Hunter U.S. and Hunter Canada, provided that party agreed to assume the Hunter Canada warranty and service obligations. By the express terms of the trust agreement, Syncrude was entitled to the interest (the trust income) on the principal of the trust. Both Hunter U.S. and Hunter Canada had knowledge of the two agreements mentioned. Neither was a party to the Aco agreement or to the trust agreement.

The full scope of the discussions between Hunter U.S. and Syncrude during this period is unclear. The trial judge found that Hunter U.S. was prepared to assume warranty and service obligations if Syncrude repudiated its obligations under the Hunter Canada contract and contracted directly with it. Syncrude disputes this finding and claims that the discussions were limited to the creation of the trust fund. In my view, whether or not Hunter U.S. offered to assume the Hunter Canada contract is immaterial to the outcome of this appeal because it is clear

that by the time the two agreements were entered into, Hunter U.S. was no longer willing to assume the Hunter Canada warranty provisions. Hunter U.S. continued to maintain the position, in the present proceedings, that it was not bound by the terms of the trust agreement and not obliged to honour any warranty or service obligations as a condition of payment to it of the trust monies. Paragraph 25C(i) of the Further Amended Statement of Defence and Counterclaim of Hunter U.S. reads:

> Further and in any event this Defendant says the Plaintiff is a constructive trustee of the monies in the Trust Fund for this Defendant and this Defendant is not bound by the terms of the Trust Agreement and is not obliged to honour any warranty or service obligations as a condition of payment to it of the trust monies in view of all the circumstances of this case being those recited herein together with the fact the Plaintiff accepted certain warranty and service obligations from Aco and Hunter Canada in respect of the gearboxes and enforced or attempted to enforce the same against Aco and Hunter Canada.

The trust fund now contains the profit Hunter Canada would have made, plus interest on the amount of this principal. Hunter U.S. claims it is entitled to all monies in the trust fund under the doctrine of constructive trust. This amount is significantly greater than the amount Hunter U.S. could have claimed under the express terms of the trust fund had Hunter U.S. complied with its terms.

Judgment was given in favour of Hunter U.S. in the passing-off action in December, 1978. Meredith J. held that as between Hunter U.S. and Hunter Canada, Hunter U.S. was entitled to the trust fund. Syncrude was not, however, a party to that action. Also, it is important to note that

the judgment provided that Hunter U.S.'s entitlement was conditional upon Hunter U.S. assuming warranty and service obligations, which it declined to assume.

The balance in the trust fund, when the trial began, was approximately $420,000. The gearboxes which were the subject of the Hunter Canada purchase orders underwent repair and rebuilding at a cost to Syncrude of $200,000, inclusive of prejudgment interest. That cost would have been covered by the warranty in the Hunter Canada purchase orders.

At trial, Gibbs J. rejected the claim of Hunter U.S. under the head of constructive trust. He said at pp. 81-82:

> In my opinion, the entitlement to the trust moneys is to be determined solely in accordance with the terms of the trust agreement. Hunter U.S. claimed entitlement under the doctrines of constructive trust and unjust enrichment, sometimes called restitutionary proprietory claims, but it cannot succeed on those grounds. The indicia are not present. Prior to the creation of the trust, there was not that nexus between the parties that is found in the reported cases on restitutionary proprietory claims. There was no fiduciary relationship between Syncrude and Hunter U.S.; there had not been a payment of money or delivery of property by Hunter U.S. to Syncrude under circumstances where it would be against conscience for Syncrude to retain it; Hunter U.S. was not a party with Syncrude to any agreement which gave Hunter U.S. a claim on Syncrude's funds. Hunter U.S. had, and established, a claim against Hunter Canada. If Syncrude had paid the purchase price to Hunter Canada, on the authorities, Hunter U.S. could have recovered the profit element from Hunter Canada because of the fiduciary duty owed to Hunter U.S. by those of its employees who were the owners of Hunter Canada. In my opinion however, in the absence of the trust agreement, Hunter U.S. would have no claim against Syncrude. It had not contracted with Syncrude, nor had it provided any of those things for which profit stands as compensation, such as risk capital, skilled and knowledgeable staff, supervision, overhead, and like matters. None of its plant or personnel had been used. I am satisfied that if Hunter U.S. has an entitlement, it must be found within the four corners of the trust agreement.

It will be observed from the foregoing passage that the trial judge was of the opinion that entitlement to the trust monies had to be determined solely in accordance with the terms of the trust agreement. In his view, none of the indicia of restitutionary proprietary claims was present. He awarded Syncrude the trust income and awarded the principal of the trust to Hunter U.S. on the condition that it assume the warranty obligations of Hunter Canada before October 1, 1984. That date, by order of Gibbs J., dated September 17, 1984, was later extended to the date which is two months after final judgment in appeal has been handed down.

The Court of Appeal reversed the decision of the trial judge. The court held that the issue fell to be determined by reference to the judgment of this Court in *Pettkus v. Becker*, [1980] 2 S.C.R. 834. Anderson J.A. was of the opinion that the criteria necessary to establish a successful claim for unjust enrichment, namely, (1) an enrichment of the defendant, (2) a corresponding deprivation of the plaintiff, and (3) the absence of a juristic reason for the enrichment, were satisfied.

The Court of Appeal held that if Syncrude were to keep the trust income, Syncrude would be enriched. This enrichment would come at the expense of Hunter U.S., which would have earned the profit on the construction of the 11 gearboxes but for the fraud of Hunter Canada. Syncrude's actions in establishing the trust fund were interpreted by the appeal court as evidence of an acknowledgement by Syncrude that Hunter U.S. was entitled to the fund. The court was of the

view that there was a sufficient causal nexus between the enrichment and the deprivation in the fact that Hunter Canada had performed all its contractual obligations with the exception of its service and warranty obligations. By offering to assume the warranty obligations of the Hunter Canada contract, Hunter U.S. satisfied the necessary causal connection. Finally, the Court of Appeal could find no juristic reason to justify Syncrude's enrichment. In the result, the court allowed the appeal of Hunter U.S. and held that Hunter U.S. was entitled to the whole of the trust fund and the income therefrom, except that Syncrude was entitled to deduct the sum of $200,000, being the agreed repair costs for which Hunter U.S. was responsible. It was held also that Syncrude be entitled to the income on the sum of $200,000 from the date of trial.

With respect, I am unable to agree with the view of the Court of Appeal and the view of my colleague, Wilson J., that the monies in the trust fund established by Syncrude should be awarded to Hunter U.S. I can conceive of no basis in law or in equity for awarding the trust fund to Hunter U.S. Hunter U.S. is not entitled to those monies under the terms of the trust agreement. Hunter U.S. has not satisfied any of the three criteria mentioned in *Pettkus v. Becker*, *supra*. In my view, there was no unjust enrichment and therefore no possibility of a constructive trust arising in this case. I would therefore allow the cross-appeal and declare that Syncrude is entitled to the principal of the trust fund and the interest accrued thereon.

If a restitutionary remedy is not available, Hunter U.S. is left trying to make a claim under a document the express terms of which deny recovery by Hunter U.S. Hunter U.S. provided

nothing whatsoever to Syncrude in connection with the 11 gearboxes. Nor did Hunter Canada. All the work was done by Aco. The drawings were supplied by Syncrude. Counsel for Hunter U.S. lays emphasis on the fact that Hunter U.S. provided the design drawings to Aco under a pledge of confidentiality. That may be true but it overlooks the provision in the original contract between Syncrude and Hunter U.S. which required Hunter U.S. to provide Syncrude with such drawings, free of any such pledge. No restriction was placed on the use of these drawings by Syncrude. The design drawings were already in Syncrude's possession in 1977 and were provided to Aco by Syncrude. Hunter U.S. does not allege any breach of copyright on the part of anyone. Anderson J.A. refers to drawings "stolen from Hunter". No drawings were stolen by Syncrude.

The constructive trust has existed for over two hundred years as an equitable remedy for certain forms of unjust enrichment. In its earliest form, the constructive trust was used to provide a remedy to claimants alleging that others had made profits at their expense. Where the claimant could show the existence of a fiduciary relationship between the claimant and the person taking advantage of the claimant, the courts were receptive (see Waters, *The Law of Trusts in Canada* (2nd ed. 1984), at pp. 378-82). Equity would not countenance the abuse of the trust and confidence inherent in a fiduciary relationship and imposed trust obligations on those who profited from abusing their position of loyalty. The doctrine was gradually extended to apply to situations where other persons who were not in a fiduciary relationship with the claimant acted in concert with the fiduciary or knew of the fiduciary obligations. Until the decision of this

Court in *Pettkus v. Becker*, the constructive trust was viewed largely in terms of the law of trusts, hence the need for the existence of a fiduciary relationship. In *Pettkus v. Becker*, the Court moved to an approach more in line with restitutionary principles by explicitly recognizing constructive trust as one of the remedies for unjust enrichment. In finding unjust enrichment the Court, as I have said, invoked three criteria: namely (1) an enrichment, (2) a corresponding deprivation, and (3) absence of any juristic reason for the enrichment. The Court then found that in the circumstances of the case a constructive trust was the appropriate remedy to redress the unjust enrichment.

In determining whether a restitutionary remedy may be available in this case, an understanding of the legal positions of the three parties, Hunter U.S., Hunter Canada and Syncrude is of paramount importance. In my view, an analysis of the facts and of legal positions of all three parties reveals why a restitutionary remedy is not available to Hunter U.S.

I note that this appeal presents a unusually complex fact situation. Three parties are involved, rather than the two one usually finds when a constructive trust is advanced. Of the three parties, there is only one wrongdoer. Two of the parties, Syncrude and Hunter U.S., are completely innocent actors. As between the two innocent parties, only one will be entitled to the money in dispute. In my view, the complexities can best be minimized by examining separately the legal relationship between the wrongdoer and each of the innocent parties. Once the legal positions

of Hunter U.S. and Syncrude are determined *vis-à-vis* Hunter Canada, the relationship between Hunter U.S. and Syncrude can be meaningfully examined.

There is no doubt that as between Hunter U.S., a company defrauded by disloyal employees, and Hunter Canada, Hunter U.S. would have been able to claim any profits made by Hunter Canada under the traditional doctrine of constructive trust. Hunter Canada was founded by trusted employees of Hunter U.S., persons who clearly stood in a fiduciary relationship to Hunter U.S. Equity will not permit a fiduciary to profit at the expense of its principal. The *Pettkus v. Becker* test for unjust enrichment would also be satisfied. Hunter Canada would be enriched to the amount of the profit it would have received under its contract with Syncrude. The enrichment would be at the expense of Hunter U.S. There would be no juristic reason to justify the enrichment. As between Hunter U.S. and Hunter Canada, Hunter U.S. clearly has the better claim to money accruing to Hunter Canada.

An entirely different situation exists between Hunter Canada and Syncrude. The relations between Hunter Canada and Syncrude are regulated by contract. Syncrude can only be said to owe money to Hunter Canada on the basis of the agreement for gearboxes negotiated in 1977. Syncrude was induced to enter into that contract on the strength of Hunter Canada's fraudulent misrepresentations. It is a basic principle of contract law that where a party had entered into a contract, having been misled by a fraudulent misrepresentation, the contract is voidable at the instance of the innocent party (see Waddams, *The Law of Contracts* (2nd ed. 1984), at p. 308).

Once Syncrude discovered Hunter Canada's deception, it was entitled to elect to continue with the contract or to treat the contract at an end. Syncrude could not be compelled to continue with a contract it had been led to assume on fraudulent premises. As between Syncrude and Hunter Canada, Syncrude has a stronger claim to the money payable under the contract by virtue of its ability to elect to end the contract and retain the money it would have expended.

What then, is the situation between Hunter U.S. and Syncrude? In my view, Syncrude is entitled to retain the money it would have paid under the Hunter Canada contract. The only connection between Hunter U.S. and Syncrude is Hunter Canada. Hunter U.S.'s claim to the entire trust fund arises only as a result of Hunter Canada's actions. As against Syncrude, Hunter U.S. has no higher claim than does Hunter Canada. While the actions of Hunter Canada are, on the one hand, essential to found Hunter U.S.'s claim of unjust enrichment, the need to rely on the conduct of Hunter Canada is fatal to this claim.

Hunter Canada's entitlement *vis-à-vis* Syncrude arose purely as a result of contractual obligation. Under ordinary principles of contract law, Syncrude could not be compelled to remain a party to the Hunter Canada contract. Even before the fraud of Hunter Canada was brought to light, it was open to Syncrude to breach the contract with Hunter Canada and to face an action for damages. In light of Hunter Canada's fraudulent misrepresentation to Syncrude, Syncrude was entitled to rescind the contract on the basis of fraud. Syncrude's actions in January through March 1978 essentially amounted to exercising its option to rescind. Rather than

involve itself in the competing claims of Hunter Canada and Hunter U.S., Syncrude chose to extricate itself from the Hunter Canada contract as it was properly entitled to do. Syncrude's primary concern was the timely production of gearboxes. Syncrude sought to terminate its contract with Hunter Canada and requested Hunter Canada's approval of this course of action. Hunter Canada agreed to renounce its rights under the contract subject to the creation of a trust fund. Long before the legal resolution of the dispute between Hunter U.S. and Hunter Canada, the contract between Hunter Canada and Syncrude had come to an end as had any entitlement of Hunter Canada under the contract.

The result of Syncrude's decision to terminate the Hunter Canada contract and Hunter Canada's acceptance of the termination is that Hunter Canada is no longer entitled to any payment under the contract. In my view, this precludes any claim by Hunter U.S. as I have indicated. The claim of Hunter U.S. is predicated upon Hunter Canada's contractual entitlement. If Hunter Canada has no entitlement, Hunter U.S. has no entitlement. Hunter U.S. can be in no better position *vis-à-vis* Syncrude than that Hunter Canada occupies *vis-à-vis* Syncrude. Finding unjust enrichment in favour of Hunter U.S. on monies held by Syncrude would be to found an entitlement deriving from a contractual entitlement of Hunter Canada that is no longer in existence.

Clause 8 of the trust agreement expressly provided that the trustee should refrain from making any payment out of the said trust fund and trust income "until the holder of the valid and lawful

interest in the trust fund had undertaken, by agreement with Syncrude, to assume warranty and service obligations with respect to the work under the said Agreement, as provided expressly or impliedly by the provisions of the purchase orders identified in Schedule "A" thereto, and until the trustee is notified by Syncrude of such agreement."

Hunter U.S. at no time gave any such undertaking. Hunter U.S. refused to become a party to the trust agreement. In its pleading in the present proceedings it claimed all the monies in the trust fund but denied any obligation to honour any warranty or service obligations as a condition of payment. In the Court of Appeal judgment the following passage appears at p. 385:

> I agree with counsel for Syncrude that Hunter would not be entitled to any profit if Hunter had refused to assume the obligations of Hunter Canada under the 1977 agreement. A court of equity would not assist Hunter in such a case. Moreover, there would not be a true "corresponding deprivation" or "causal connection".
>
> In the circumstances, it is not, however, open to Syncrude to contend that Hunter did not assume the service and warranty obligations contained in the 1977 agreement. Hunter offered to ratify or adopt the 1977 agreement made between Hunter Canada and Syncrude. Hunter offered to contract directly with Syncrude and to assume the service and warranty obligations contained in the 1977 agreement. Syncrude, prior to the discovery of the fraud, believed that Hunter Canada was the subsidiary of Hunter and, therefore, the offer made by Hunter to deal with Syncrude directly was exactly the contract Syncrude wanted in the first place. Syncrude, however, for reasons of its own and solely for its own benefit, refused to enter into any agreement with Hunter. Instead, it contracted with Aco, using Hunter's designs, and unilaterally attempted to impose onerous and additional obligations on Hunter.

Counsel for Syncrude strongly contests the finding that Hunter U.S. offered to assume the obligations of Hunter Canada. The evidence on this point is far from satisfactory. Hunter U.S.

advanced no evidence on the point at trial other than a brief passage from an examination for discovery, which reads:

> Q. And there is this allegation:
>
> > "At the time the plaintiff entered into the 1978 agreement, this defendant offered to assume all warranty and service obligations provided the plaintiff"
> >
> > that's Syncrude,
> >
> > "entered into contracts directly with this defendant",
> >
> > that's Hunter Engineering, and that is true as well, isn't it?
>
> A. Yes.

This is the best evidence Hunter U.S. can produce. There is no letter or other document evidencing such offer. No one testified, on behalf of Hunter U.S., in affirmation of the offer. Be that as it may, Hunter U.S. declined to be a party to the trust agreement or to the 1978 agreement and has since consistently denied any warranty obligations. Equally, if such an offer were made, I cannot understand why, in light of the circumstances prevailing at the time, Syncrude was under any obligation to accept such an offer.

At the time Syncrude rescinded the Hunter Canada contract, Syncrude was free to procure the gearboxes any way it pleased. If a company unrelated to either Hunter Canada or Hunter U.S. offered to supply the gearboxes on more advantageous terms, Hunter U.S. could not have

prevented Syncrude from contracting with that other company. Viewing Hunter U.S.'s offer as a sufficient connection between Syncrude and Hunter U.S. to found a restitutionary remedy in Hunter U.S.'s favour is tantamount to compelling it to contract with Hunter U.S.

It is no answer to say that at some time in the negotiations Hunter U.S. agreed to assume the service and warranty obligations contained in the 1977 Agreement. Opinions and attitudes frequently change in negotiations and it is clear that Hunter U.S. changed. It refused to sign the 1977 agreement or the trust agreement when the time came. Even after the trial judge awarded Hunter U.S. the trust fund under the terms of the trust agreement on the condition that Hunter U.S. accept the warranty provision within a certain period of time, Hunter U.S. did not assume the Hunter Canada warranty. The monies paid into the trust fund can only be viewed as having been originally owed to Hunter Canada to pay for services that Syncrude had purchased from it. If Hunter U.S. is to receive those monies, then it should also be found that it would have been liable in so far as any of those services were not provided. Yet it is difficult to see what Hunter U.S. might be liable for. An important "service" which Syncrude purchased from Hunter Canada was the extended warranty which Hunter Canada offered. Hunter U.S. did not take up their warranty and, therefore, could not have been held liable under it. Thus, it would be unfair to award it monies intended to compensate the party which had agreed to assume the risks inherent in the warranty. In my view, it is no longer open to Hunter U.S. to claim under the express trust agreement.

In imposing a constructive trust in the circumstances of this case, the Court of Appeal carried the decision in the *Pettkus* case beyond the breaking point. Apart perhaps from an element of sympathy which one might have because of the attempt by its dishonest employees to cheat Hunter U.S., I can find nothing which would entitle Hunter U.S. to the funds set aside by Syncrude pursuant to an agreement with Hunter Canada in an attempt to extricate itself from an extremely difficult and potentially costly situation created by Hunter's employees or former employees. In my view, if Hunter U.S.'s claim prevailed, (i) Hunter U.S. would be enriched, (ii) with a corresponding deprivation of Syncrude, (iii) and for no juristic reason that I am able to detect.

The impact of a finding of constructive trust, as *per* the Court of Appeal, as compared with a finding of entitlement under the terms of the express trust is not minimal. Clause 9 of the trust agreement provides that reasonable legal expenses incurred by the trustee in the performance of his duties and remuneration to the trustee are to be paid from the trust funds. If all of the trust funds are payable to Hunter U.S. under a constructive trust, to whom does the trustee look for payment of his remuneration and the legal expenses he has incurred?

I disagree with the interpretation the Court of Appeal and Wilson J. have placed on Syncrude's decision to establish the trust fund. I do not see the creation of the trust as an admission on the part of Syncrude that either Hunter U.S, or Hunter Canada was entitled to the profit under the Hunter Canada contract. Upon suspecting fraud, Syncrude was entitled to rescind the Hunter

Canada contract. Until Syncrude was completely convinced that Hunter Canada was fraudulent, rescission entailed a certain amount of risk. Had the litigation between Hunter U.S. and Hunter Canada been resolved in Hunter Canada's favour, Syncrude would have been vulnerable to an action for breach of contract by Hunter Canada. It could protect itself against a lawsuit by requesting Hunter Canada's approval of its decision to consider the contract at an end. In my view, it was not strictly necessary for Syncrude to secure Hunter Canada's acceptance of its termination of the contract. Nor was it necessary for Syncrude to establish a trust fund. Syncrude's decision to create a trust fund, motivated no doubt by an abundance of caution, should not make it worse off than it would have been had it simply rescinded the contract. There was no onus on Syncrude to secure the approval of Hunter U.S. who was not even a party to the contract, to the terms of the trust fund.

The Court of Appeal said at p. 384:

> The trust balance represents the profit Hunter would have earned by designing the 11 gearboxes but for the fraud of Hunter Canada. The judgment of Meredith J. establishes that these funds are rightfully the property of Hunter. So much is acknowledged by Syncrude in the trust agreement. It follows that the trust income is also the property of Hunter.

I do not understand how it can be said that the trust balance represented the profit Hunter U.S. would have earned by designing the 11 gearboxes. Hunter U.S. earned its profit on the gearbox design when Syncrude paid Hunter U.S. for 32 mining gearboxes and for the design under the

1975 contract. The judgment of Meredith J. said nothing with respect to Syncrude's entitlement to the funds held in trust as Syncrude was not a party to that action.

Wilson J. makes the point that Syncrude was ready to pay the principal contractor's portion to Hunter U.S. and that Syncrude cannot now argue that it had no need of Hunter U.S. Reliance is placed on clause 7 of the trust agreement. At the time of the agreement Syncrude appears to have been prepared to pay the principal contractor's portion to Hunter U.S., but upon terms to which Hunter U.S. did not agree. Syncrude had no need of Hunter U.S. The facts bear that out. Syncrude's act of establishing a trust fund was not an admission that the trust monies belonged to either Hunter U.S. or Hunter Canada, but, at most, an indication that it was willing to pay the contract price if it received its negotiated warranties. Even if Hunter U.S. did make an offer to assume the warranties prior to the litigation between Hunter U.S. and Hunter Canada, Syncrude was not then, as I have indicated, in a position to have accepted.

I am therefore of the view that Hunter U.S.'s claim to the monies in the trust fund under constructive trust fails. I am also of the view that Hunter U.S. is not entitled to claim under the express terms of the trust agreement. To qualify under the trust agreement, Hunter U.S. would have had to agree to the terms of the trust agreement. It did not do so. The most important of these terms was the agreement to assume the Hunter Canada warranty provisions.

Clause 10 of the trust agreement made provision for the precise situation which developed. It provides:

> 10. In the event that Syncrude and the holder of the valid and lawful interest in the trust fund are unable to agree with respect to the warranty and service of Work in Schedule "A" of the said Agreement, the trustee shall pay the remainder of the trust fund, as determined by Clause 7 and Clause 8 of this Agreement, to Syncrude. [Emphasis added.]

The trial judge, at p. 82, gave Hunter U.S. until October 1984, later extended, to assume the warranty and service obligations:

> That valid and lawful interest [the interest of Hunter U.S. in the trust fund] does not crystallize into an entitlement or right to be paid until the condition precedent of assumption of the Hunter Canada warranty and service obligations by agreement with Syncrude has been met. The trust income accruing prior to the date upon which the condition precedent is met belongs to Syncrude under cl. 11 of the trust agreement.

In my view, with respect, the judge erred in allowing Hunter U.S. to become entitled to the trust monies by assuming the warranty obligation after judgment without incurring liability for warranty claims prior to its assumption of the warranties. The purpose of the trust fund was to ensure someone would promptly assume the warranties. Once Hunter U.S. elected not to do this, giving it another chance potentially requires the trustee to hold the fund in perpetuity. The trial judge erred by arbitrarily imposing a later date than that which would have entitled Hunter U.S. to the trust fund.

I am of the view that the judgment of the Court of Appeal of British Columbia be set aside. The cross-appeal of Syncrude should be allowed with costs here and below. The appeal of Hunter U.S. should fail and must be dismissed with costs. The appeal from that part of the judgment of the Court of Appeal which imposed liability on Allis-Chalmers Canada Limited should be allowed with costs here and below, payable by Syncrude.

The following are the reasons delivered by

MCINTYRE J. -- I agree with Wilson J. that the appeal of "Hunter U.S." against the finding of liability for a design fault should be dismissed and I agree, as well, that the appeal of "Allis-Chalmers" should succeed. I agree with Wilson J. that any breach of the contract by Allis-Chalmers was not fundamental and in any event, even if the breach was properly characterized as fundamental, the liability of Allis-Chalmers would be excluded by the terms of the contractual warranty. In my view, it is therefore unnecessary to deal further with the concept of fundamental breach in this case.

As to the issue concerning the trust fund, I agree with the Chief Justice that the cross-appeal, claiming ownership of the trust fund, by "Syncrude", should be allowed with costs here and below, and I agree with his reasons for reaching this conclusion. In the result, then, I would dispose of the appeal as would the Chief Justice.

The reasons of Wilson and L'Heureux-Dubé JJ. were delivered by

WILSON J. (dissenting in cross-appeal) -- This appeal and cross-appeal raise a variety of issues relating to the interpretation of engineering contracts. They also require the Court to consider the effect of exclusionary clauses in the context of implied statutory warranties and in the context of fundamental breach. The viability of the doctrine of fundamental breach is itself in issue as is also the applicability of the law of constructive trust to the facts of this case.

1. The Facts

The disputes between these parties arise out of three contracts for the supply of gearboxes for the Alberta tarsands industry. In the first contract, made on January 29, 1975, Syncrude Canada Ltd. (Syncrude), through its agent Canadian Bechtel, ordered 32 "mining gearboxes" from the Hunter Engineering Company Inc. (Hunter U.S.) These gearboxes were intended to drive conveyor belts which move sand to Syncrude's extraction plant at Fort McMurray where the oil is separated out. The responsibility of each of the contracting parties for the various design features of the gearboxes is one of the matters in dispute before the Court and I will deal below with these aspects of the contract. The 32 mining gearboxes were manufactured by a subcontractor (Aco Sales and Engineering), delivered to Syncrude between January 1977 and February 1978, and entered service on July 4, 1978.

The second contract was made on July 29, 1975, between Syncrude and Stephens-Adamson Ltd., a division of Allis-Chalmers Canada Ltd. (Allis-Chalmers). It was for the supply of a $4.1M extraction conveyor system which included 4 "extraction gearboxes" to drive the machinery which separates the oil from the sand. Although supplied under the contract with Allis-Chalmers they were built according to the same design as the mining gearboxes supplied by Hunter U.S. and like them were fabricated by the subcontractor Aco. The extraction gearboxes entered service on November 24, 1977.

The third contract was made between Syncrude and Aco on March 1, 1978. It arose out of some unusual circumstances. Between August and December 1977, Syncrude issued purchase orders to Hunter Machinery Canada Ltd. (Hunter Canada) for an additional 11 mining gearboxes built to the same design as the 32 purchased from Hunter U.S. Hunter Canada was a Canadian-incorporated company established by employees of Hunter U.S. without the latter's knowledge. It held itself out to Syncrude as the Canadian arm of Hunter U.S. and not until January 1978 did Hunter U.S. discover the deception. It initiated a "passing-off" action against Hunter Canada in the British Columbia courts, notified Syncrude, and offered to assume the Hunter Canada contract. Syncrude, however, opted not to prejudge the result of the litigation by agreeing to let Hunter U.S. step into the contractual shoes of Hunter Canada and, instead of accepting this offer, it contracted directly with the subcontractor Aco for supply of the 11 gearboxes which were the subject of the Hunter Canada contract at an identical price to that which Aco would have received

from Hunter Canada. These 11 gearboxes were delivered and progressively put into service between May and December 1978.

Then, in March 1978, Syncrude unilaterally established a trust fund into which it paid the money due under the Hunter Canada contracts. Hunter Canada waived all rights under these contracts but Hunter U.S. refused to become a party to Syncrude's trust agreement. That agreement provided, *inter alia*, that the trustee would pay to Aco its price for the gearboxes when they were completed. The rest of the money in the fund was to be dealt with as follows:

> 7. The trustee shall hold the remainder of the trust funds and trust income for payment pending determination by agreement between Hunter Canada and Hunter Engineering, or by a decision of a Court of competent jurisdiction in Canada as to the identity of the holder of a valid and lawful interest in the remainder of trust funds as between Hunter Engineering and Hunter Canada, or upon determination of certain issues in Canada, currently the subject of legal proceedings between Hunter Engineering and Hunter Canada by settlement agreement or by a decision of a Court of competent jurisdiction in Canada.

Clause 8 of the fund made any such payment contingent upon an assumption by Hunter U.S. or Hunter Canada of the warranty and service obligations contained in Syncrude's 1977 agreements with the latter. Clause 9 provided for the payment of the trustee's expenses out of the fund. Clause 10 stated that if the winner of the Hunter U.S./Hunter Canada litigation did not assume the service and warranty obligations mentioned in clause 8, the money would go to Syncrude. Clause 11 specified that any money remaining after payment to Aco and satisfaction of the requirements of clauses 7-9, including any trust income, would be paid to Syncrude.

In December 1978, Meredith J. of the British Columbia Supreme Court gave judgment to Hunter U.S. (*Hunter Engineering Co. v. Hunter Machinery Canada*, Vancouver Registry C780211, December 28, 1978, unreported). The judgment included a declaration that as between Hunter U.S. and Hunter Canada the former was entitled to the money referred to in clause 7 of the trust agreement. The trust fund remained in place, however, because the parties could not agree on warranty and service terms. Hunter U.S. wanted the same terms as in its other contract with Syncrude. The latter insisted on the more extensive guarantees contained in its contract with Hunter Canada and specifically mentioned in the trust agreement. I pause here to note that this dispute arose before the defects in the gearboxes discussed below were discovered.

In September 1979 defects were discovered in the extraction gearboxes. These gearboxes were made up of gears, shafts and bearings housed within a steel casing. Each box contained a number of smaller gears and one large one, the bull gear, some 6 1/2 feet in diameter. The bull gear attaches to the drive shaft by two steel plates, one on each side of the rim. It was found that the welds joining these side plates and the rim had cracked under the strain because the welding was not continuous all the way around the rim. The extraction gearboxes were progressively taken out of service and repaired, primarily by putting in a continuous weld. This apparently solved the problem.

On examination in October 1979 the same problem was discovered with the smaller (5 1/2 feet in diameter) bull gears in the mining gearboxes. All 47 gearboxes were progressively taken out of service and repaired. Total repair expenses, not including interest, amounted to $750,000 for the mining gearboxes and $400,000 for the extraction gearboxes. Neither Hunter U.S. nor Allis-Chalmers considered themselves responsible for these repair expenses on the grounds that their contractual warranties had expired. Syncrude commenced proceedings in the British Columbia courts.

2. The Judgments Below

(a) *British Columbia Supreme Court*

In a judgment delivered in July 1984 and reported at (1984), 27 B.L.R. 59, the trial judge, Gibbs J., dealt first with the question of design responsibility. This was a threshold issue since Hunter U.S. had argued before him that Canadian Bechtel, Syncrude's agent, provided the design on the basis of which Hunter U.S. built the gearboxes. The trial judge found, however, that while Bechtel had provided specifications which gave "detailed operating criteria", these specifications did "not extend to design details". Design was Hunter U.S.'s responsibility and the trial judge's review of the evidence convinced him that the failure of the gearboxes was due to design default.

Having established the *prima facie* responsibility of both Hunter U.S. and Allis-Chalmers, Gibbs J. considered the effect of the warranty clauses in the sales agreements. Both contained the following clause:

> 8. WARRANTIES -- GUARANTEES: Seller warrants that the goods shall be free from defects in design, material, workmanship, and title, and shall conform in all respects to the terms of this purchase order, and shall be of the best quality, if no quality is specified. If it appears within one year from the date of placing the equipment into service for the purpose for which it was purchased, that the equipment, or any part thereof, does not conform to these warranties and Buyer so notifies Seller within a reasonable time after its discovery, Seller shall thereupon promptly correct such nonconformity at its sole expense. The conditions of any subsequent tests shall be mutually agreed upon and Seller shall be notified of and may be represented at all tests that may be made. Except as otherwise provided in this purchase order, Seller's liability hereunder shall extend to all damages proximately caused by the breach of any of the foregoing warranties or guarantees, but such liability shall in no event include loss of profit or loss of use.

Both warranties were modified by the purchase orders so that they expired either 24 months after delivery or 12 months after the gearboxes entered service, whichever occurred first. Gibbs J. found that the time limit in the warranties excused both companies from liability under them.

This did not, however, dispose of the issue of liability because the general conditions of each agreement also provided that:

> 13. APPLICABLE LAW -- DEFINITIONS: The definition of terms used, interpretation of this agreement and the rights of all parties hereunder shall be construed under and governed by the Laws of the Province of Ontario.

The Ontario *Sale of Goods Act*, R.S.O. 1970, c. 421, s. 15, provides a statutory warranty of fitness:

> **15.** Subject to this Act and any statute in that behalf, there is no implied warranty or condition as to the quality of fitness for any particular purpose of goods supplied under a contract of sale, except as follows:
>
> 1. Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which the goods are required so as to show that the buyer relies on the seller's skill or judgment, and the goods are of a description that it is in the course of the seller's business to supply (whether he is the manufacturer or not), there is an implied condition that the goods will be reasonably fit for such purpose, but in the case of a contract for the sale of a specified article under its patent or other trade name there is no implied condition as to its fitness for any particular purpose.
>
> . . .
>
> 4. An express warranty or condition does not negative a warranty or condition implied by this Act unless inconsistent therewith.

Gibbs J. found that this statutory warranty was not excluded by the contractual warranty. It was therefore applicable to the Hunter U.S. contracts. In deciding whether Hunter U.S. had breached the statutory warranty he applied the following test from Fridman, *Sale of Goods in Canada* (2nd ed. 1979), at pp. 203-4:

> The implied condition set out in section 15(1) applies, except where the proviso to that subsection operates, "where the goods are of a description which it is in the course of the seller's business to supply (whether he be the manufacturer or not)" and "where the buyer, expressly or by implication, makes known to the seller the particular purpose for which the

goods are required, so as to show that the buyer relies on the seller's skill or judgment." Three factors are therefore relevant: (i) the course of the seller's business: (ii) knowledge on the part of the seller of the purpose of the goods: (iii) reliance on the seller's skill or judgment. Only if a contract of sale satisfies these requirements will it be possible to imply into it the condition of fitness of the goods that is contained in this subsection.

Gibbs J. found that all three aspects of the test were met. The gearboxes "were goods which it was in the course of the business of Hunter U.S. to supply" and Hunter U.S. "knew the purpose for which the gearboxes were required". The third aspect of the test:

> . . . is satisfied by the express provision in the Canadian Bechtel specifications, incorporated by reference into the Hunter U.S. purchase order that: "Correct and adequate design is the Seller's sole responsibility". I understand those words to convey, in plain and simple language, that Syncrude, through Canadian Bechtel, was relying upon the skill and judgment of Hunter U.S. in matters of gearbox design. It is evident from the . . . [evidence] that they held themselves out as being possessed of the requisite skill and judgment. [p. 72.]

This finding applied only to the contracts between Syncrude and Hunter U.S. The Allis-Chalmers purchase order, in addition to modifying the sales agreement in the same way as that of Hunter U.S., also contained this more extensive change:

> The final sentence of Paragraph 8 is hereby deleted. In its place shall be, "The Provisions of this paragraph represent the only warranty of the Seller and no other warranty or conditions, statutory or otherwise shall be implied."

Gibbs J. considered this sufficient to exclude the statutory warranty in the Allis-Chalmers contract.

The trial judge then turned his attention to Syncrude's claim that Allis-Chalmers had nevertheless committed a fundamental breach of contract so as to negate the exclusion clause. He rejected the argument for two reasons. First, he held at p. 77 that Syncrude had fully and freely accepted the exclusion clause:

> With respect to the clause excluding statutory or other warranties or conditions, it is significant to me that liability was not completely excluded. Liability still existed under warranty cl. 8 of the general conditions, limited only in time to the twelve or twenty-four month period. Warranty cl. 8 was put forward by Syncrude. Presumably it provided the protection Syncrude wanted . . . . Syncrude freely accepted the time limitations; there is no evidence that they were under any disadvantage or disability in the negotiating of them. There is no reason why they should not be held to their bargain, including that part which effectively excludes the implied condition of s. 15(1) of the Ontario Sale of Goods Act.

Second, he did not consider that the problems with the gearboxes amounted to a fundamental breach (pp. 77-78):

> As to the nature of the defect, in my opinion it was not so fundamental that it went to the root of the contract. The contract between the parties was still a contract for gearboxes. Gearboxes were supplied. They were capable of performing their function and did perform it for in excess of a year which, given the agreed time limitations, was the "cost free to Syncrude" period contemplated by the parties. It was conceded that the gearboxes were not fit for the service. However, the unfitness, or defect, was repairable and was repaired at a cost significantly less than the original purchase price . . . . On my appreciation of the evidence Syncrude got what it bargained for from Stephens-Adamson. It has not convinced me that there was fundamental breach.

The final issue dealt with at trial concerned the trust fund unilaterally set up by Syncrude pending the outcome of the Hunter U.S./Hunter Canada litigation. When Hunter U.S. initiated its passing-off action it offered to assume the entire Hunter Canada contract with Syncrude, including this warranty:

> SELLER expressly warrants that the goods covered by this order are of merchantable quality, and satisfactory and safe for the use of the PURCHASER. Acceptance of the order shall constitute an agreement upon SELLER'S part to indemnify and hold the PURCHASER harmless from liability, loss, damage and expense, incurred or sustained by PURCHASER by reason of the failure of the goods to conform to such warranties.

As noted above, Syncrude opted instead to set up the trust fund, including the provision that acceptance of the Hunter Canada warranty was a precondition to receiving payment from it. After Hunter U.S. was successful in its action against Hunter Canada it was no longer prepared to assume the full warranty, preferring to substitute the same guarantees as were contained in its other contract with Syncrude, and claimed ownership of the fund on that basis.

By the time this matter came to trial the trust fund held $420,000. The cost of repairs to the 11 mining gearboxes, for which Hunter U.S. had been found liable, was $200,000 inclusive of pre-judgment interest. Gibbs J. held that Syncrude should receive the income from the original fund and that Hunter U.S. was entitled to the principal of $242,229 but only if it met the conditions, particularly the warranty obligation, of the Hunter Canada contract. Hunter U.S. was given approximately two months to do so, failing which Syncrude would be entitled to keep all the

money. Gibbs J. rejected an argument by Hunter U.S. that it was entitled to the entire fund "under the doctrines of constructive trust or unjust enrichment". He said at p. 81:

> In my opinion, the entitlement to the trust moneys is to be determined solely in accordance with the terms of the trust agreement . . . . There was no fiduciary relationship between Syncrude and Hunter U.S.; there had not been a payment of money or delivery of property by Hunter U.S. to Syncrude under circumstances where it would be against conscience for Syncrude to retain it; Hunter U.S. was not a party with Syncrude to any agreement which gave Hunter U.S. a claim on Syncrude's funds. Hunter U.S. had, and established, a claim against Hunter Canada. If Syncrude had paid the purchase price to Hunter Canada, on the authorities, Hunter U.S. could have recovered the profit element from Hunter Canada because of the fiduciary duty owed to Hunter U.S. by those of its employees who were the owners of Hunter Canada. In my opinion however, in the absence of the trust agreement, Hunter U.S. would have no claim against Syncrude. It had not contracted with Syncrude, nor had it provided any of those things for which profit stands as compensation, such as risk capital, skilled and knowledgeable staff, supervision, overhead, and like matters. None of its plant or personnel had been used.

The final judgment in favour of Syncrude was for $750,000 plus pre-judgment interest plus whatever sum it eventually kept from the trust fund.

(b) *British Columbia Court of Appeal*

Syncrude appealed the finding of no fundamental breach by Allis-Chalmers and Hunter U.S. cross-appealed the other findings by Gibbs J. The Court of Appeal (Carrothers, Aikins and Anderson JJ.A.), in a judgment reported at (1985), 68 B.C.L.R. 367, rejected Hunter U.S.'s appeal on its liability under the statutory warranty primarily by adopting the reasoning of the trial judge.

Anderson J.A., for the court, in dealing with Hunter U.S.'s argument that it was not responsible for the design faults, added this comment at p. 377:

> . . . the reasons for judgment of the learned trial judge were based on a comprehensive consideration of the evidence. He heard all the witnesses and examined all of the documentary evidence and it is difficult, if not impossible, for this court to substitute its judgment for that of the trial judge by fragmentary reference to the evidence and the contract documents, as counsel for Hunter would have us do. Palpable and overriding error cannot be demonstrated in that way.

The Court of Appeal did, however, allow Hunter U.S.'s appeal on the ownership of the income from the trust fund. Anderson J.A. said at p. 382:

> In my opinion, this issue falls to be determined by reference to the judgment of the Supreme Court of Canada in *Pettkus v. Becker* . . . . In that case, Dickson J. (as he then was), speaking for the majority, set forth the criteria necessary to establish a successful claim for unjust enrichment as being:
>
> (1) An enrichment of the defendant;
>
> (2) A corresponding deprivation of the plaintiff;
>
> (3) The absence of a juristic reason for the enrichment.

He then held that, were Syncrude to retain the trust income, it would be unjustly enriched and Hunter U.S. correspondingly deprived of income from profit rightfully theirs but for the fraud of Hunter Canada. No juristic reasons justified the enrichment of Syncrude. Provided Hunter U.S. adopted the warranty obligations in the Hunter Canada contract it was entitled to the fund after trustee's expenses minus the sum required to repair the 11 gearboxes, i.e., $200,000.

The Court of Appeal also allowed Syncrude's appeal against Allis-Chalmers on the question of fundamental breach. Anderson J.A. found that the warranty exclusion clause, although broad, was not broad enough "`to destroy the foundation of the contract and its business efficacy by eliminating the . . . essential undertaking' of Allis-Chalmers to provide gearboxes capable of meeting the requirements of the extraction process" (p. 392). He then went on to note:

> There is, however, another compelling reason for holding that the warranty clause was not intended to exclude claims for "fundamental breach". The contract between Syncrude and Allis-Chalmers included a "Limitation of Liability" clause, reading as follows:
>
> > Paragraph 14 -- Limitation of Liability
> >
> > Notwithstanding any other provision in this contract or any applicable statutory provisions neither the Seller nor the Buyer shall be liable to the other for special or consequential damages or damages for loss of use arising directly or indirectly from any breach of this contract, *fundamental* or otherwise or from any tortious act or omissions of their respective employees (sic) or agents and in no event shall the liability of the Seller exceed the unit price of the defective product or of the product subject to late delivery. (The italics are mine.)
>
> It will be seen that this clause clearly stipulates that Allis-Chalmers shall not be liable "for special or consequential damages or damages for loss of use arising directly or indirectly from any breach of this contract, *fundamental* or otherwise". It follows that if claims for "fundamental breach" were excluded by the terms of the warranty clause, it would not have been necessary to make specific provision for the exclusion of liability in cases where the "fundamental" breach resulted in a "loss of use" claim. In other words, when the parties intended to exclude liability for "fundamental breach", they said so in clear and express terms.

Having found that liability for fundamental breach was not excluded, Anderson J.A. held Allis-Chalmers liable on that ground. The cost of repairs was 86% of the purchase price and the bull gear failed after less than two years' service when it should have lasted for ten. Accordingly, "Allis-Chalmers was in `fundamental breach' because Syncrude was deprived of substantially the whole benefit of the contract".

The Court of Appeal's judgment thus gave Syncrude the $750,000 it had won at trial plus $400,000 for repairs to the extraction gearboxes. Interest on both these sums brought the total to $1.535M.

4. The Issues Before This Court

Both Hunter U.S. and Allis-Chalmers appealed to this Court and there is also a cross-appeal by Syncrude concerning the Court of Appeal's award of the trust fund to Hunter U.S. Four separate grounds of appeal were argued. I will deal with them in the following order:

(i) the liability of Hunter U.S. for the design faults which caused the gearboxes to fail;

(ii) the liability of Hunter U.S. under the statutory warranty in the *Sale of Goods Act*;

(iii) the liability of Allis-Chalmers under the doctrine of fundamental breach;

(iv) the ownership of the trust fund.

(i) *Responsibility for Design Faults*

In argument before this Court, Mr. Giles, counsel for Hunter U.S., devoted much of his time to this aspect of the appeal. He sought to persuade us that Hunter U.S. had merely designed the gears according to the specifications laid down by Canadian Bechtel, Syncrude's agent. Accordingly, if the specifications were inadequate for the task to be performed, the fault was that of Syncrude and not Hunter U.S. Hunter U.S. could only be to blame if its design failed to meet those specifications. Since Syncrude led no evidence to show that Hunter U.S.'s design failed to comply with Bechtel's specifications, the verdict of the trial judge was unreasonable.

As noted in my review of the judgments below, this argument was considered and rejected both by the trial judge and the British Columbia Court of Appeal. I do not believe that Mr. Giles' position finds any support in the terms of the contract between the parties. I would accordingly adopt the findings of the courts below on this issue. I will, however, add some observations of my own. In the purchase order of January 29, 1975, Hunter U.S.'s task is stated to be to "furnish all labour and material for the design, fabrication and delivery of the following equipment in accordance with specification 9776-3T-14 in your possession". The use of the word "design" in addition to "fabrication" indicates a creative role for Hunter U.S. going well beyond the mere construction of a gearbox from specifications prepared for Syncrude by Canadian Bechtel. The

willingness of Hunter U.S. to take on such a role is further evidenced by its tender to Syncrude of February 20, 1974, which contains *inter alia* the following statements:

> This specification is for a geared drive assembly designed to power a belt conveyor.
>
> > This drive group has been designed for installation and operation in the remote areas and hostile environment normal to the mining industry. The units are designed for a high degree of reliability based on design arts developed in similar installations . . . .
> >
> > This specification has been prepared to qualify HUNTER ENGINEERING COMPANY, INC., as a competent and experienced manufacturer of specialized gear drive equipment.
> >
> > Hunter drives are designed for specific applications, incorporating those features required to minimize operational and environmental hazards having an adverse effect on the performance of the unit. Our market effort is directed towards those unique applications which challenge our designers' ingenuity. Hunter has the engineering, manufacturing and financial resources to supply the complete drive package designed to reliably power any defined processing function. [Emphasis added.]

Perhaps more significantly, the specifications referred to in the purchase order are, in layman's language, specifications about what the gearboxes were required to do, not specifications of how they were to be built. Section 1.11 of those specifications states that "correct and adequate design is the seller's sole responsibility". Sections 4 and 5 provide information about site elevation, climatic conditions, and expected hours of operation of the gears. Section 7 warns the seller of the need for materials able to withstand the extreme climate of the tarsands region. Other sections, particularly s. 10, lay out further details of what the gearboxes were required to do and make reference to how to achieve this. Some of these references are very general, for example, s. 10.1.1:

> 10.1.1 All components shall be of heavy duty design as required for the specified operating conditions.

Some of the references are more specific. For example, in 10.2.6, dealing with "Housings", it states:

> Housings shall be made from steel, stress relieved after welding in accordance with 8.2.2 . . . .
>
> Generous inspection openings with bolted and gasketed doors complete with lifting handles shall be provided in the housing cover, to allow for inspection of high speed, intermediate and low speed gearing without removal of major housing sections. In addition, the upper half of the housing shall be removable to allow for removal and replacement of gearing . . . .
>
> Housings shall be provided with oil level indicators at each point in the housing where oil level is critical to successful reducer performance.

I include these extracts merely to illustrate the kinds of general requirements -- operating conditions, operating load and hours, desired features -- that are put forward in the specifications. Nowhere is there any instruction to Hunter U.S. about what thickness of steel should be used for the gear housings or about how the assembly was to be put together. There may be aspects of this contract where the dividing line between the responsibilities of the parties is unclear but I do not think that this is one of them. I do not believe there is any need to delve further into the details of the contract and Syncrude's specifications. The extracts that I have summarized and quoted demonstrate the different roles played by the parties. Syncrude's

specifications are a recitation of what the gearboxes should be able to achieve and general guidelines as to how this should be done. Hunter U.S. took on the task of deciding specific design details. The thickness of the steel plates and the way in which the gear housing was to be welded together were both within Hunter U.S.'s purview. It was these design decisions that proved to be wrong. Hunter U.S.'s appeal on this issue must accordingly fail.

(ii) *The Statutory Warranty*

Although Hunter U.S. was liable for the design fault that caused the gearboxes to fail, the failure was discovered after the contractual warranty period had expired. For Syncrude to succeed, therefore, it must find an alternative route to establishing Hunter U.S.'s liability. Two issues are of concern here. The first is whether either or both of the exclusionary clauses in the Hunter U.S. and Allis-Chalmers contracts are sufficient to preclude the application of the statutory warranty. If not, then a second issue arises as to whether the gearboxes were "reasonably fit" for their purpose.

I would answer these questions in the same way as Gibbs J. and the British Columbia Court of Appeal. Section 15(4) of the *Sale of Goods Act* provides that an express warranty "does not negative a warranty or condition implied by this Act unless inconsistent therewith". Hunter U.S. argues that it may invoke s. 15(4) because the specific limitation period in its express warranty serves to exclude any other warranty which would extend beyond that period. This argument

runs counter to two long-established and related principles in the law of contract: 1) that an exclusion clause should be strictly construed against the party seeking to invoke it and 2) that clear and unambiguous language is required to oust an implied statutory warranty: see *Wallis, Son & Wells v. Pratt & Haynes*, [1911] A.C. 394 (H.L.); *R. W. Heron Paving Ltd. v. Dilworth Equipment Ltd.*, [1963] 1 O.R. 201 (H.C.); *Cork v. Greavette Boats Ltd.*, [1940] O.R. 352 (C.A.); Fridman, *Sale of Goods in Canada* (3rd ed. 1986), at p. 282. I would adopt the following statement of the law by Eberle J. of the Ontario Supreme Court in *Chabot v. Ford Motor Co. of Canada Ltd.* (1982), 138 D.L.R. (3d) 417, at p. 430:

> . . . although a vendor may exclude conditions implied by the *Sale of Goods Act*, he must use explicit language, in the absence of which the court will not be prepared to find that the conditions have been excluded.

In the present case there is clearly no explicit exclusion of the implied warranty contained in the Hunter U.S. contract. I find it equally clear that the revision to the Allis-Chalmers agreement did explicitly and unambiguously oust the statutory warranty by stating: "The Provisions of this paragraph represent the only warranty of the seller and no other warranty or conditions, statutory or otherwise shall be implied" (my emphasis). The explicit reference to the statutory warranty is crucial here and in my view serves to prevent the application of s. 15(1) of the *Sale of Goods Act* to the Allis-Chalmers contract.

This finding on the Hunter U.S. warranty requires a consideration of whether the gearboxes were, in the words of s. 15(1) of the Act, "reasonably fit" for the purpose for which they were supplied. I think this issue can be disposed of very shortly. It is abundantly clear that Syncrude informed Hunter U.S. of the purpose for which the gearboxes were required, that Syncrude relied on Hunter U.S.'s expertise, and that the gears were "goods . . . which it is in the course of the seller's business to supply". It is equally clear that the gears were not reasonably fit for their purpose. The trial judge found as facts that:

(a) the gears would normally be expected to work for ten years before needing extensive overhauling;

(b) the gears needed to be replaced after only 15 months or so, despite never being put to more than 60 per cent of their intended workload;

(c) the cost of repairing the extraction gearboxes was $400,000 compared to the original price of $464,300.

Gibbs J.'s conclusion was that in such circumstances the gears could not be considered reasonably fit for their purpose. The Court of Appeal endorsed that finding and I would unequivocally affirm it also. The defects in design were crucial. The cracking was not

something that would be expected to happen in the normal lifetime of the gearboxes. I would conclude therefore that Hunter U.S. is liable for the cost of repairs to the mining gearboxes.

(iii) *Fundamental Breach*

Fundamental breach has been the subject of many judicial definitions. It has been described as "a breach going to the root of the contract" (*Suisse Atlantique Société d'Armement Maritime S.A. v. N.V. Rotterdamsche Kolen Centrale*, [1967] 1 A.C. 361 (H.L.), *per* Lord Reid at p. 399) and as one which results "in performance totally different from what the parties had in contemplation" (*R. G. McLean Ltd. v. Canadian Vickers Ltd.* (1970), 15 D.L.R. (3d) 15 (Ont. C.A.), *per* Arnup J.A. at p. 20). In *Canso Chemicals Ltd. v. Canadian Westinghouse Co. (No. 2)* (1974), 54 D.L.R. (3d) 517 (N.S.C.A.), MacKeigan C.J.N.S. gave nine different definitions from leading Canadian and United Kingdom cases. The definitional uncertainty that has pervaded this area of the law is further illustrated by Fridman, *Law of Contract in Canada* (2nd ed. 1986), at p. 531, and the cases cited therein.

The formulation that I prefer is that given by Lord Diplock in *Photo Production Ltd. v. Securicor Transport Ltd.*, [1980] A.C. 827 (H.L.), at p. 849. A fundamental breach occurs "Where the event resulting from the failure by one party to perform a primary obligation has the effect of depriving the other party of substantially the whole benefit which it was the intention of the parties that he should obtain from the contract" (emphasis added). This is a restrictive

definition and rightly so, I believe. As Lord Diplock points out, the usual remedy for breach of a "primary" contractual obligation (the thing bargained for) is a concomitant "secondary" obligation to pay damages. The other primary obligations of both parties yet unperformed remain in place. Fundamental breach represents an exception to this rule for it gives to the innocent party an additional remedy, an election to "put an end to all primary obligations of both parties remaining unperformed" (p. 849). It seems to me that this exceptional remedy should be available only in circumstances where the foundation of the contract has been undermined, where the very thing bargained for has not been provided.

I do not think the present case involves a fundamental breach. The trial judge had this to say on the question at pp. 77-78:

> As to the nature of the defect, in my opinion it was not so fundamental that it went to the root of the contract. The contract between the parties was still a contract for gearboxes. Gearboxes were supplied. They were capable of performing their function and did perform it for in excess of a year which, given the agreed time limitations, was the "cost free to Syncrude" period contemplated by the parties. It was conceded that the gearboxes were not fit for the service. However, the unfitness, or defect, was repairable and was repaired at a cost significantly less than the original purchase price. No doubt the bull gear is an important component of the gearbox but no more important than the engine in an automobile and in the *Gafco Ent.* case the failure of the engine was not a sufficiently fundamental breach to lead the Court to set aside the contract of sale. On my appreciation of the evidence Syncrude got what it bargained for from Stephens-Adamson. It has not convinced me that there was fundamental breach.

The Court of Appeal, in overturning this finding, seems to have been influenced by two factors: that the repair cost was 85 per cent of the original contract price and that the gear which should have lasted ten years failed after less than two. I will deal with each of these factors in turn.

There is an obvious conflict between the judgments below over the relationship between the size of the contract and the cost of repairs. The Court of Appeal treated the contract for the gearboxes as a discrete transaction in coming to its conclusion. The trial judge, however, was influenced by the fact that the overall contract with Allis-Chalmers was for 14 conveyor systems, only 4 of which contained extraction gearboxes. The total cost of these systems was in excess of $4M. It seems to me that the trial judge was right to take this into account. If he was, then Allis-Chalmers breached only one aspect of its contract with Syncrude, one "primary obligation". Although the gears were obviously an important component of the conveyor system, their inferior performance did not have the effect of depriving Syncrude of "substantially the whole benefit of the contract" to use Lord Diplock's phrase. The cost of repair was only a small part of the total cost.

Syncrude bargained for and received bull gears. Clearly, they were not very good gears. They were not reasonably fit for the purposes they were intended to serve. But they did work for a period of time and were repairable. There are numerous cases in which serious but repairable defects in machinery of various kinds have been found not to amount to fundamental breach. In *Schofield v. Gafco Enterprises Ltd.* (1983), 43 A.R. 262 (C.A.), a case relied on by

Gibbs J. in this case, the purchaser bought a second-hand car for $12,000 which immediately required some $4,000 worth of engine repairs. Harradence J.A. held that the defects "do not amount to a breach going to the root of the contract. They are repairable, albeit at some expense" (p. 267). Similarly, in *Peters v. Parkway Mercury Sales Ltd.* (1975), 10 N.B.R. (2d) 703 (C.A.), a transmission failure shortly after the expiration of a 30-day warranty on a used car was found not to be a fundamental breach. Hughes C.J.N.B. said at p. 711:

> In my view the car which the defendant sold the plaintiff was not essentially different in character from what the parties should have had in contemplation. Although the car was in poorer condition than either party probably knew, I do not think the defects amounted to "such a congeries of defects as to destroy the workable character of the machine" and consequently the plaintiff's claim for a declaration that there has been a fundamental breach entitling him to rescission if [*sic*] the contract fails.

In *Keefe v. Fort* (1978), 89 D.L.R. (3d) 275 (N.S.S.C.A.D.), another case involving a faulty but repairable car, Pace J.A. said, at p. 279, that "the doctrine of fundamental breach was never intended to be applied to situations where the parties have received substantially what they had bargained for".

In the present case the Court of Appeal relied on its own prior judgment in *Beldessi v. Island Equipment Ltd.* (1973), 41 D.L.R. (3d) 147 (B.C.C.A.), which it said was "very similar" to this one (p. 390). *Beldessi*, however, involved a log skidding machine which, despite numerous repairs, never worked properly. It was therefore similar to *R. G. McLean Ltd. v. Canadian Vickers Ltd.*, *supra*, in which a printing press could not be made to function adequately. It seems

to me that the present case is more akin to those cited above where the purchaser got a poor, but nonetheless repairable, version of what it contracted for. I do not think that in these circumstances it can be said that the breach undermined the entire contractual setting or that it went to the very root of the contract. It was not, in other words, fundamental. I would therefore allow the appeal by Allis-Chalmers on this issue.

However, if I am wrong in this and the breach by Allis-Chalmers is properly characterized as fundamental, the liability of Allis-Chalmers would, in my view, be excluded by the terms of the contractual warranty.

Prior to 1980, in both the United Kingdom and in Canada, there were two competing views of the consequences of fundamental breach. One held that there was a rule of law that a fundamental breach brought a contract to an end, thereby preventing the contract breaker from relying on any clause exempting liability. This view was most closely identified with Lord Denning in the English Court of Appeal: see *Karsales (Harrow) Ltd. v. Wallis*, [1956] 1 W.L.R. 936 (C.A.); *Harbutt's "Plasticine" Ltd. v. Wayne Tank and Pump Co.*, [1970] 1 Q.B. 447 (C.A.) The other view was that exemption clauses should be construed by the same rules of contract interpretation whether a fundamental breach had occurred or not. Whether or not liability was excluded was to be decided simply on the construction of the contract: see *Suisse Atlantique*, *supra*; *Traders Finance Corp. v. Halverson* (1968), 2 D.L.R. (3d) 666 (B.C.C.A.); *R. G. McLean Ltd. v. Canadian Vickers Ltd.*, *supra*.

In England the issue was unequivocally resolved by the House of Lords in favour of the construction approach in the *Photo Production* case. The defendants, Securicor, had contracted to provide security services for the plaintiff's factory. One of the security guards deliberately set a fire which destroyed the building. When sued, Securicor pleaded the following exemption clause:

> "1. Under no circumstances shall the company [Securicor] be responsible for any injurious act or default by any employee of the company unless such act or default could have been foreseen and avoided by the exercise of due diligence on the part of the company as his employer; nor, in any event, shall the company be held responsible for: (a) Any loss suffered by the customer through burglary, theft, fire or any other cause, except insofar as such loss is solely attributable to the negligence of the company's employees acting within the course of their employment . . . ."

Lord Wilberforce, on behalf of all the other Law Lords, stated succinctly at pp. 842-43:

> . . . the question whether, and to what extent, an exclusion clause is to be applied to a fundamental breach, or a breach of a fundamental term, or indeed to any breach of contract, is a matter of construction of the contract.

Lord Wilberforce gave three reasons in support of this conclusion. Firstly, the rule of law approach was based on faulty reasoning. He said at p. 844:

> I have, indeed, been unable to understand how the doctrine can be reconciled with the well accepted principle of law, stated by the highest modern authority, that when in the context of a breach of contract one speaks of "termination," what is meant is no more than that the innocent party or, in some cases, both parties, are excused from further performance.

> Damages, in such cases, are then claimed under the contract, so what reason in principle can there be for disregarding what the contract itself says about damages -- whether it "liquidates" them, or limits them, or excludes them?

Secondly, the courts should allow the parties to make their own bargain. The courts' role should be limited to upholding that bargain (p. 843):

> At the stage of negotiation as to the consequences of a breach, there is everything to be said for allowing the parties to estimate their respective claims according to the contractual provisions they have themselves made, rather than for facing them with a legal complex so uncertain as the doctrine of fundamental breach must be. What, for example, would have been the position of the respondents' factory if instead of being destroyed it had been damaged, slightly or moderately or severely? At what point does the doctrine (with what logical justification I have not understood) decide, ex post facto, that the breach was (factually) fundamental before going on to ask whether legally it is to be regarded as fundamental? How is the date of "termination" to be fixed? Is it the date of the incident causing the damage, or the date of the innocent party's election, or some other date? All these difficulties arise from the doctrine and are left unsolved by it.
>
> At the judicial stage there is still more to be said for leaving cases to be decided straightforwardly on what the parties have bargained for rather than upon analysis, which becomes progressively more refined, of decisions in other cases leading to inevitable appeals.

Lord Diplock in his concurring reasons stressed that parties of equal bargaining power should be allowed to make their own bargains. He said at p. 851:

> In commercial contracts negotiated between business-men capable of looking after their own interests and of deciding how risks inherent in the performance of various kinds of contract can be most economically borne (generally by insurance), it is, in my view, wrong to place a strained construction upon words in an exclusion clause which are clear and fairly susceptible of one meaning only . . . .

Thirdly, Lord Wilberforce, while recognizing that fundamental breach "has served a useful purpose" in the area of consumer and standard form contracts, found that legislation in the form of the *Unfair Contract Terms Act 1977* (U.K.), 1977, c. 50, had taken the place of judicial intervention in that area. He noted at p. 843 that the Act "applies to consumer contracts and those based on standard terms and enables exception clauses to be applied with regard to what is just and reasonable". For the future, the courts did not need to lay down rules to cover such situations and should refrain from doing so in other circumstances (p. 843):

> It is significant that Parliament refrained from legislating over the whole field of contract. After this Act, in commercial matters generally, when the parties are not of unequal bargaining power, and when risks are normally borne by insurance, not only is the case for judicial intervention undemonstrated, but there is everything to be said, and this seems to have been Parliament's intention, for leaving the parties free to apportion the risks as they think fit and for respecting their decisions.

Lord Wilberforce concluded that the exemption clause in the case, even interpreted *contra proferentem*, was sufficiently clear to exclude liability.

The construction approach to exclusionary clauses in the face of a fundamental breach affirmed in *Photo Production* was adopted by this Court as the law in Canada in *Beaufort Realties (1964) Inc. v. Chomedey Aluminum Co.*, [1980] 2 S.C.R. 718. The Court did not, however, reject the concept of fundamental breach. The respondent entered into a construction contract with Beaufort in which it agreed to waive all liens for work and materials provided in the event of a failure to make payments. Such a failure took place and Justice Ritchie had no difficulty in

concluding that the failure constituted a fundamental breach. He adopted Lord Wilberforce's construction approach to the exclusion clause and stated at p. 725 "that the question of whether such a clause was applicable where there was a fundamental breach was to be determined according to the true construction of the contract".

As Professor Waddams noted (see (1981), 15 *U.B.C. Law Rev.* 189) shortly after this Court's decision in *Beaufort Realties*:

> . . . the Supreme Court of Canada followed the House of Lords in holding that there is no rule of law preventing the operation of exclusionary clauses in cases of fundamental breach of contract. The effect of such clauses is now said to depend in each case on the true construction of the contract.

Thus, the law in Canada on this point appears to be settled. Some uncertainty, however, does remain primarily with regard to the application of the construction approach. Some decisions of our courts clearly follow the construction approach in both theory and practice. In *Hayward v. Mellick* (1984), 2 O.A.C. 161 (C.A.), for example, Weatherston J.A. noted that as "the courts of this province adopted the doctrine from the English courts, I think we should now follow their lead in rejecting it as a rule of law" (p. 168). Even when the exclusion clause in issue was "strictly construed" Weatherston J.A. recognized at p. 168 that "it would be too strained a construction of the disclaimer clause to say that it applies only to representations that are not negligent. I think that effect must be given to it . . . ." He went on to hold that the exclusion clause in that case was sufficient to cover any breach of contract.

Commentators seem to be in agreement, however, that the courts, while paying lip service to the construction approach, have continued to apply a modified "rule of law" doctrine in some cases. Professor Fridman in *Law of Contract in Canada* has suggested at p. 558 that:

> Under the guise of "construction", some courts appear to be utilizing something very much akin to the `rule of law' doctrine. What Canadian courts may be doing is to apply a concept of "fair and reasonable" construction in relation to the survival of the exclusion clause after a fundamental breach, and the application of such a clause where the breach in question involves not just a negligent performance of the contract, but the complete failure of the party obliged to fulfil the contract in any way whatsoever.

Professor Ogilvie, in a review of Canadian cases decided shortly after *Photo Production*, including *Beaufort Realties* itself, argues that the rule of law approach "has been replaced by a substantive test of reasonableness which bestows on the courts at least as much judicial discretion to intervene in contractual relationships as fundamental breach ever did": see Ogilvie, "The Reception of *Photo Production Ltd.* v. *Securicor Transport Ltd.* in Canada: *Nec Tamen Consumebatur*" (1982), 27 *McGill L.J.* 424, at p. 441.

Little is to be gained from a review of the recent cases which have inspired these comments. Suffice it to say that the law in this area seems to be in need of clarification. The uncertainty might be resolved in either of two ways. The first way would be to adopt *Photo Production* in its entirety. This would include discarding the concept of fundamental breach. The courts would give effect to exclusion clauses on their true construction regardless of the nature of the

breach. Even the party who had committed a breach such that the foundation of the contract was undermined and the very thing bargained for not provided could rely on provisions in the contract limiting or excluding his or her liability. The only relevant question for the court would be: on a true and natural construction of the provisions of the contract, did the parties, at the time the contract was made, succeed in excluding liability? This approach would have the merit of importing greater simplicity into the law and consequently greater certainty into commercial dealings, although the results of enforcing such exclusion clauses could be harsh if the parties had not adequately anticipated or considered the possibility of the contract's disintegration through fundamental breach.

The other way would be to import some "reasonableness" requirement into the law so that courts could refuse to enforce exclusion clauses in strict accordance with their terms if to do so would be unfair and unreasonable. One far-reaching "reasonableness" requirement which I would reject (and which I believe was rejected in *Beaufort Realties* both by this Court and the Ontario Court of Appeal) would be to require that the exclusion clause be *per se* a fair and reasonable contractual term in the contractual setting or bargain made by the parties. I would reject this approach because the courts, in my view, are quite unsuited to assess the fairness or reasonableness of contractual provisions as the parties negotiated them. Too many elements are involved in such an assessment, some of them quite subjective. It was partly for this reason that this Court in *Beaufort Realties* and the House of Lords in *Photo Productions* clearly stated that exclusion clauses, like all contractual provisions, should be given their natural and true

construction. Great uncertainty and needless complications in the drafting of contracts will obviously result if courts give exclusion clauses strained and artificial interpretations in order, indirectly and obliquely, to avoid the impact of what seems to them *ex post facto* to have been an unfair and unreasonable clause.

I would accordingly reject the concept that an exclusion clause in order to be enforceable must be *per se* a fair and reasonable provision at the time it was negotiated. The exclusion clause cannot be considered in isolation from the other provisions of the contract and the circumstances in which it was entered into. The purchaser may have been prepared to assume some risk if he could get the article at a modest price or if he was very anxious to get it. Conversely, if he was having to pay a high price for the article and had to be talked into the purchase, he may have been concerned to impose the broadest possible liability on his vendor. A contractual provision that seems unfair to a third party may have been the product of hard bargaining between the parties and, in my view, deserves to be enforced by the courts in accordance with its terms.

It is, however, in my view an entirely different matter for the courts to determine <u>after a particular breach has occurred</u> whether an exclusion clause should be enforced or not. This, I believe, was the issue addressed by this Court in *Beaufort Realties*. In *Beaufort Realties* this Court accepted the proposition enunciated in *Photo Production* that no rule of law invalidated or extinguished exclusion clauses in the event of fundamental breach but rather that they should be given their natural and true construction so that the parties' agreement would be given effect.

Nevertheless the Court, in approving the approach taken by the Ontario Court of Appeal in *Beaufort Realties*, recognized at the same time the need for courts to determine whether in the context of the particular breach which had occurred it was fair and reasonable to enforce the clause in favour of the party who had committed that breach even if the exclusion clause was clear and unambiguous. The relevant question for the Court in *Beaufort Realties* was: is it fair and reasonable in the context of this fundamental breach that the exclusion clause continue to operate for the benefit of the party responsible for the fundamental breach? In other words, should a party be able to commit a fundamental breach secure in the knowledge that no liability can attend it? Or should there be room for the courts to say: this party is now trying to have his cake and eat it too. He is seeking to escape almost entirely the burdens of the transaction but enlist the support of the courts to enforce its benefits.

It seems to me that the House of Lords was able to come to a decision in *Photo Production* untrammelled by the need to reconcile the competing values sought to be advanced in a system of contract law such as ours. We do not have in this country legislation comparable to the United Kingdom's *Unfair Contract Terms Act 1977*. I believe that in the absence of such legislation Canadian courts must continue to develop through the common law a balance between the obvious desirability of allowing the parties to make their own bargains and have them enforced through the courts and the obvious undesirability of having the courts used to enforce bargains in favour of parties who are totally repudiating such bargains themselves. I fully agree with the commentators that the balance which the courts reach will be made much clearer if we do not

clothe our reasoning "in the guise of interpretation". Exclusion clauses do not automatically lose their validity in the event of a fundamental breach by virtue of some hard and fast rule of law. They should be given their natural and true construction so that the meaning and effect of the exclusion clause the parties agreed to at the time the contract was entered into is fully understood and appreciated. But, in my view, the court must still decide, having ascertained the parties' intention at the time the contract was made, whether or not to give effect to it in the context of subsequent events such as a fundamental breach committed by the party seeking its enforcement through the courts. Whether the courts address this narrowly in terms of fairness as between the parties (and I believe this has been a source of confusion, the parties being, in the absence of inequality of bargaining power, the best judges of what is fair as between themselves) or on the broader policy basis of the need for the courts (apart from the interests of the parties) to balance conflicting values inherent in our contract law (the approach which I prefer), I believe the result will be the same since the question essentially is: in the circumstances that have happened should the court lend its aid to A to hold B to this clause?

In affirming the legitimate role of our courts at common law to decide whether or not to enforce an exclusion clause in the event of a fundamental breach, I am not unmindful of the fact that means are available to render exclusion clauses unenforceable even in the absence of a finding of fundamental breach. While we do not have legislation comparable to the United Kingdom's *Unfair Contract Terms Act 1977*, we do have some legislative protection in this area. Six provinces prevent sellers from excluding their obligations under Sale of Goods Acts where

consumer sales are concerned: see *Consumer Protection Act*, R.S.O. 1980, c. 87, s. 34(1); *Consumer Protection Act*, R.S.N.S. 1967, c. 53, s. 20C, as amended by S.N.S. 1975, c. 19; *The Consumer Protection Act*, R.S.M. 1970, c. C 200, s. 58(1); *Sale of Goods Act*, R.S.B.C. 1979, c. 370, s. 20; *Consumer Product Warranty and Liability Act*, S.N.B. 1978, c. C-18.1., ss. 24-26 (except in so far as an exclusion is fair and reasonable); *The Consumer Products Warranties Act*, R.S.S. 1978, c. C-30, ss. 8 and 11. In addition, some provinces have legislation dealing with unfair business practices which affects the application of some exclusion clauses: see *Business Practices Act*, R.S.O. 1980, c. 55, s. 2(*b*)(vi); *Trade Practice Act*, R.S.B.C. 1979, c. 406, s. 4(e); *Unfair Trade Practices Act*, R.S.A. 1980, c. U-3, s. 4(b), (d); *The Trade Practices Inquiry Act*, R.S.M. 1987, c. T110, s. 2; *The Trade Practices Act*, S.N. 1978, c. 10, s. 6(d); *Business Practices Act*, S.P.E.I. 1977, c. 31, s. 3(b)(vi). Such legislation, in effect, imposes limits on freedom of contract for policy reasons.

There are, moreover, other avenues in our law through which the courts (as opposed to the legislatures) can control the impact of exclusion clauses in appropriate circumstances. Fundamental breach has its origins in that aspect of the doctrine of unconscionability which deals with inequality of bargaining power: see Waddams, "Unconscionability in Contracts" (1976), 39 *Modern Law Review* 369. As Professor Ziegel notes in "Comment" (1979), 57 *Can. Bar Rev.* 105, at p. 113:

> The initial impulse that prompted the development of the doctrine of fundamental breach was very sound insofar as it was designed to prevent overreaching of a weaker party by a stronger party. The impulse became distorted when subsequent courts confused cause and effect and treated the doctrine, albeit covertly, as expressing a conclusive rule of public policy regardless of the circumstances of the particular case. What is needed therefore is a return to a regime of natural construction coupled with an explicit test of unfairness tailored to meet the facts of particular cases. [Emphasis added.]

The availability of a plea of unconscionability in circumstances where the contractual term is *per se* unreasonable and the unreasonableness stems from inequality of bargaining power was confirmed in Canada over a century ago in *Waters v. Donnelly* (1884), 9 O.R. 391 (Ch.) It has been used on many subsequent occasions: see *Morrison v. Coast Finance Ltd.* (1965), 55 D.L.R. (2d) 710 (B.C.C.A.); *Harry v. Kreutziger* (1978), 95 D.L.R. (3d) 231 (B.C.C.A.); *Taylor v. Armstrong* (1979), 99 D.L.R. (3d) 547 (Ont. H.C.)

While this is perhaps not the place for a detailed examination of the doctrine of unconscionability as it relates to exclusion clauses, I believe that the equitable principles on which the doctrine is based are broad enough to cover many of the factual situations which have perhaps deservedly attracted the application of the "fair and reasonable" approach in cases of fundamental breach. In particular, the circumstances surrounding the making of a consumer standard-form contract could permit the purchaser to argue that it would be unconscionable to enforce an exclusion clause. *Davidson v. Three Spruces Realty Ltd.* (1977), 79 D.L.R. (3d) 481 (B.C.S.C.), is a case in point. The plaintiff and others deposited valuables with the defendants. When they were stolen as a result of the latter's negligence a broad exclusion clause was pleaded. Anderson

J. found the defendant liable for fundamental breach and for misrepresentation but he also expressed the view that the exclusion clause should not be applied because of unconscionability. He said at pp. 492-93:

> Counsel for the bailee submits that the Courts should not interfere with freedom of contract. He submits that if the parties to contracts are not held to the terms of their bargain, however harsh or one-sided, the element of certainty so important in the commercial world will be eliminated. He submits that the plaintiffs agreed in writing, in clear terms, that the bailee would not be responsible for any negligence on its part . . . .
>
> I agree that as a general rule, apart from fraud, it would be a dangerous thing to hold that contracts freely entered into should not be fully enforced. It is not correct, however, to suppose that there are no limitations on freedom of contract. The point has been reached in the development of the common law where, in my opinion, the Courts may say, in certain circumstances, that the terms of a contract, although perfectly clear, will not be enforced because they are entirely unreasonable . . . .
>
> I take the view that the Courts are not bound to accept all contracts at face value and enforce those contracts without some regard to the surrounding circumstances. I do not think that standard form contracts should be construed in a vacuum. I do not think that mere formal consensus is enough. I am of the opinion that the terms of a contract may be declared to be void as being unreasonable where it can be said that in all the circumstances it is unreasonable and unconscionable to bind the parties to their formal bargain. [Emphasis added.]

He concluded at p. 494:

> (c) Even if the limitation clause was such as to protect the bailee against conduct amounting to a fundamental breach, the clause is, in all the circumstances, so offensive to all right-thinking persons that the Courts will hold that to allow the bailee to rely on the limitation clause would be unconscionable and an abuse of freedom of contract.

Anderson J. suggested the following criteria, at p. 493, to ascertain whether "freedom of contract has been abused so as to make it unconscionable for the bailee to exempt itself from liability":

(1) Was the contract a standard form contract drawn up by the bailee?

(2) Were there any negotiations as to the terms of the contract or was it a commercial form which may be described as a "sign here" contract?

(3) Was the attention of the plaintiffs drawn to the limitation clause?

(4) Was the exemption clause unusual in character?

(5) Were representations made which would lead an ordinary person to believe that the limitation clause did not apply?

(6) Was the language of the contract when read in conjunction with the limitation clause such as to render the implied covenant made by the bailee to use reasonable care to protect the plaintiffs' property meaningless?

(7) Having regard to all the facts including the representations made by the bailee and the circumstances leading up to the execution of the contract, would not the enforcement of the limitation clause be a tacit approval by the Courts of unacceptable commercial practices?

Anderson J.'s judgment in *Davidson* drew on *Gillespie Brothers & Co. v. Roy Bowles Transport Ltd.*, [1973] Q.B. 400 (C.A.), in which Lord Denning said at pp. 415-16:

> The time may come when this process of "construing" the contract can be pursued no further. The words are too clear to permit of it. Are the courts then powerless? Are they to permit the party to enforce his unreasonable clause, even when it is so unreasonable, or applied so unreasonably, as to be unconscionable? When it gets to this point, I would say, as I said many years ago: "there is the vigilance of the common law which, while allowing freedom of contract, watches to see that it is not abused": *John Lee & Son (Grantham) Ltd. v. Railway Executive* [1949] 2 All E.R. 581, 584. It will not allow a party to exempt himself from his

> liability at common law when it would be quite unconscionable for him to do so. [Emphasis added.]

As I have noted, this is not the place for an exposition of the doctrine of unconscionability as it relates to inequality of bargaining power and I do not necessarily endorse the approaches taken in the cases to which I have just referred. I use them merely to illustrate the broader point that in situations involving contractual terms which result from inequality of bargaining power the judicial armory has weapons apart from strained and artificial constructions of exclusion clauses. Where, however, there is no such inequality of bargaining power (as in the present case) the courts should, as a general rule, give effect to the bargain freely negotiated by the parties. The question is whether this is an absolute rule or whether as a policy matter the courts should have the power to refuse to enforce a clear and unambiguous exclusion clause freely negotiated by parties of equal bargaining power and, if so, in what circumstances? In the present state of the law in Canada the doctrine of fundamental breach provides one answer.

To dispense with the doctrine of fundamental breach and rely solely on the principle of unconscionability, as has been suggested by some commentators, would, in my view, require an extension of the principle of unconscionability beyond its traditional bounds of inequality of bargaining power. The court, in effect, would be in the position of saying that terms freely negotiated by parties of equal bargaining power were unconscionable. Yet it was the inequality of bargaining power which traditionally was the source of the unconscionability. What was unconscionable was to permit the strong to take advantage of the weak in the making of the

contract. Remove the inequality and we must ask, wherein lies the unconscionability? It seems to me that it must have its roots in subsequent events, given that the parties themselves are the best judges of what is fair at the time they make their bargain. The policy of the common law is, I believe, that having regard to the conduct (pursuant to the contract) of the party seeking the indulgence of the court to enforce the clause, the court refuses. This conduct is described for convenience as "fundamental breach". It marks off the boundaries of tolerable conduct. But the boundaries are admittedly uncertain. Will replacing it with a general concept of unconscionability reduce the uncertainty?

When and in what circumstances will an exclusion clause in a contract freely negotiated by parties of equal bargaining power be unconscionable? If both fundamental breach and unconscionability are properly viewed as legal tools designed to relieve parties in light of subsequent events from the harsh consequences of an automatic enforcement of an exclusion clause in accordance with its terms, is there anything to choose between them as far as certainty in the law is concerned? Arguably, unconscionability is even less certain than fundamental breach. Indeed, it may be described as "the length of the Chancellor's foot". Lord Wilberforce may be right that parties of equal bargaining power should be left to live with their bargains regardless of subsequent events. I believe, however, that there is some virtue in a residual power residing in the court to withhold its assistance on policy grounds in appropriate circumstances.

Turning to the case at bar, it seems to me that, even if the breach of contract was a fundamental one, there would be nothing unfair or unreasonable (and even less so unconscionable, if this is a stricter test) in giving effect to the exclusion clause. The contract was made between two companies in the commercial market place who are of roughly equal bargaining power. Both are familiar and experienced with this type of contract. As the trial judge noted:

> Warranty cl. 8 was put forward by Syncrude. Presumably it provided the protection Syncrude wanted. Indeed, the first sentence thereof is sufficiently all-embracing that it is difficult to conceive of a defect which would not be caught by it. Syncrude freely accepted the time limitations; there is no evidence that they were under any disadvantage or disability in the negotiating of them. There is no reason why they should not be held to their bargain, including that part which effectively excludes the implied condition of s. 15(1) of the Ontario Sale of Goods Act. [(1985), 27 B.L.R. 59, at p. 77.]

There is no evidence to suggest that Allis-Chalmers who seeks to rely on the exclusion clause was guilty of any sharp or unfair dealing. It supplied what was bargained for (even although it had defects) and its contractual relationship with Syncrude, which included not only the gears but the entire conveyer system, continued on after the supply of the gears. It cannot be said, in Lord Diplock's words, that Syncrude was "deprived of substantially the whole benefit" of the contract. This is not a case in which the vendor or supplier was seeking to repudiate almost entirely the burdens of the transaction and invoking the assistance of the courts to enforce its benefits. There is no abuse of freedom of contract here.

In deciding to enforce the exclusion clause the trial judge relied in part on the fact that the exclusion clause limited but did not completely exclude the liability of Allis-Chalmers (p. 77). In relying on this fact the trial judge was supported by some dicta of Lord Wilberforce in the House of Lords in *Ailsa Craig Fishing Co. v. Malvern Fishing Co.*, [1983] 1 All E.R. 101 (H.L.), at pp. 102-3. It seems to me, however, that any categorical distinction between clauses limiting and clauses excluding liability is inherently unreliable in that, depending on the circumstances, "exclusions can be perfectly fair and limitations very unfair": Waddams, *The Law of Contracts* (2nd ed. 1977), at p. 349. It is preferable, I believe, to determine whether or not the impugned clause should be enforced in all the circumstances of the case and avoid reliance on awkward and artificial labels. When this is done, it becomes clear that there is no reason in this case not to enforce the clause excluding the statutory warranty.

(iv) *The Trust Fund*

This issue arises from a cross-appeal by Syncrude against the Court of Appeal's decision to award the fund to Hunter U.S., minus administration expenses and the cost -- $200,000 plus interest -- of repairing the gearboxes built under the Aco contract. Hunter U.S. does not contest this latter aspect of the Court of Appeal's decision. Aco has been paid and the balance of $0.5M left in the fund after the payment of Aco represents Hunter Canada's profit margin on its contract with Syncrude plus the income earned on that profit margin. In my view it was not correct to hold, as the trial judge did, that the fund should only be disposed of according to the terms of the

trust agreement. The trust terms were not agreed upon by these parties. The trust was unilaterally established by Syncrude on a kind of interpleader basis, the object of creating the trust being to avoid pre-judging the outcome of the litigation between Hunter Canada and Hunter U.S. Syncrude was perfectly prepared to acknowledge in 1978 that the profit margin was payable to one of these two parties. The only question was which one. It is no longer prepared to acknowledge this. In such circumstances I agree with the Court of Appeal that the entitlement to the trust fund should be decided on the equitable principles governing unjust enrichment.

In *Pettkus v. Becker*, [1980] 2 S.C.R. 834, Dickson J., as he then was, said at pp. 847-48:

> "Unjust enrichment" has played a role in Anglo-American legal writing for centuries. Lord Mansfield, in the case of *Moses v. Macferlan* put the matter in these words: ". . . the gist of this kind of action is, that the defendant, upon the circumstances of the case, is *obliged by the ties of natural justice and equity to refund* the money". It would be undesirable and indeed impossible, to attempt to define all the circumstances in which an unjust enrichment might arise . . . . The great advantage of ancient principles of equity is their flexibility: the judiciary is thus able to shape these malleable principles so as to accommodate the changing needs and mores of society, in order to achieve justice . . . .
>
> . . . there are three requirements to be satisfied before an unjust enrichment can be said to exist: an enrichment, a corresponding deprivation and absence of any juristic reason for the enrichment. This approach, it seems to me, is supported by general principles of equity that have been fashioned by the courts for centuries . . . .

These principles were unanimously affirmed by this Court in *Sorochan v. Sorochan*, [1986] 2 S.C.R. 38. Although both *Pettkus v. Becker* and *Sorochan v. Sorochan* were "family" cases, unjust enrichment giving rise to a constructive trust is by no means confined to such cases: see

Deglman v. Guaranty Trust Co., [1954] S.C.R. 725. Indeed, to do so would be to impede the growth and impair the flexibility crucial to the development of equitable principles.

It is necessary to ask first whether Syncrude will be enriched if allowed to retain the trust fund. Clearly it will, because it will receive interest income on money that it intended initially to pay to Hunter Canada. One need only look to the terms of the fund itself to appreciate this. I reproduce clause 7 which states:

> 7. Following the payments made pursuant to clauses 5 and 9, the trustee shall hold the remainder of the trust funds and trust income for payment pending determination by agreement between Hunter Canada and Hunter Engineering, or by a decision of a Court of competent jurisdiction in Canada as to the identity of the holder of a valid and lawful interest in the remainder of trust funds as between Hunter Engineering and Hunter Canada, or upon determination of certain issues in Canada, currently the subject of legal proceedings between Hunter Engineering and Hunter Canada by settlement agreement or by a decision of a Court of competent jurisdiction in Canada. [Emphasis added.]

As already mentioned, Syncrude in 1978 considered itself bound to pay the Hunter Canada profit to either Hunter Canada or Hunter U.S. Syncrude's entitlement is limited to working gearboxes at the price agreed upon and, provided repair costs are paid out of the fund, it will get precisely that. Any additional money arising out of the circumstances surrounding the contract with Aco will constitute an enrichment.

I am likewise of the opinion that, if Syncrude is permitted to keep the entire fund, Hunter U.S. will be correspondingly deprived of the interest income it would have earned on the contract for

the supply of the additional 11 mining gearboxes. I agree with the Court of Appeal that there need not be a contractual link for the causal connection between contribution and enrichment to be proved. This is a question to be decided on the facts of each case since the remedy of constructive trust is a discretionary one imposed as and when equity requires it. In this case there is sufficient causal connection in the fact that Hunter U.S. first offered to assume the whole Hunter Canada contract and later, after it won its case, was prepared to offer Syncrude the warranty terms under which the original 32 gearboxes were supplied. Its latter offer was not unreasonable in the circumstances even though I believe that it should be held in equity to the warranty clause in the Hunter Canada contract. In any event, the arguments over warranties are now irrelevant, given that Hunter U.S. would be liable under both the Hunter Canada warranty and the implied statutory warranty.

In his presentation before this Court, Mr. Kirkham, counsel for Syncrude, contended that Hunter U.S. had not suffered a deprivation because it did nothing to facilitate the supply of the gearboxes. Aco fabricated them from the designs in Syncrude's possession, the designs having been obtained from Hunter U.S. at the time of the first contract. Syncrude, because it supplied the designs, had to accept a very limited warranty from Aco, one that did not extend to any aspect of the design or specifications. Unfortunately, there is no finding of fact below as to the ownership of these designs and the evidence on the matter is contradictory. I believe, however, that Mr. Kirkham's arguments can be refuted without deciding that issue. The main difficulty with his argument is that they are based on an *ex post facto* view of the various circumstances.

Whether or not Syncrude "owned" the designs when it contracted with Hunter Canada, the fact is that Syncrude willingly entered into that contract at the time. It was also prepared to pay a profit margin to Hunter U.S. after the passing-off litigation had been resolved. It may be the case, as counsel for Syncrude submitted, that Hunter U.S. made no contribution to the Aco contract. But Syncrude was ready in 1978 to pay the principal contractor's portion to Hunter U.S. and cannot now argue that it had no need of Hunter U.S.

Except for the point about ownership of the drawings counsel for Syncrude suggested no juristic reason for the enrichment and I can think of none. I would therefore agree with the Court of Appeal that, provided Hunter U.S. accepts the warranty terms of the Hunter Canada contract and pays for the cost of repairing the 11 gearboxes, the trust fund minus administration expenses belongs in equity to Hunter U.S.

5. Disposition

I would dispose of the appeal and cross-appeal as follows:

(i) The appeal of Hunter U.S. against the finding of liability for design default is dismissed. Hunter U.S. breached its statutory warranty under s. 15(1) of the *Sale of Goods Act* in respect of the design default in the 32 mining gearboxes and must pay to Syncrude the sum of $750,000 in respect thereof plus pre-judgment interest in the amount of $250,000.

(ii) The appeal of Allis-Chalmers against the finding of fundamental breach is allowed. The breach was not fundamental but, even if it were, Allis-Chalmers was insulated from liability for it by the exclusion clause. Since Allis-Chalmers incurs no liability to Syncrude in respect of the design default in the four extraction gearboxes, it has no claim over against Hunter U.S. in respect thereof and its third party claim is accordingly dismissed.

(iii) The cross-appeal by Syncrude claiming ownership of the trust fund is dismissed. Hunter U.S. is entitled to the balance in the trust fund after administration costs and the cost of repairs to the 32 mining gearboxes have been satisfied out of it.

6. Costs

Allis-Chalmers should have its costs against Syncrude both here and in the Court of Appeal. As between Hunter U.S. and Syncrude success in this Court was divided. Hunter U.S. lost on the main issue of its liability for design default in respect of the 32 mining gearboxes but shared success with Allis-Chalmers on the issue of fundamental breach and the effect of the exclusion clause in the Allis-Chalmers contract. It was also successful in its claim to the balance in the trust fund. I would make no order as to costs as between Hunter U.S. and Syncrude.

Appeal of Hunter U.S. dismissed with costs.

Appeal from that part of the judgment of the Court of Appeal which imposed liability on Allis-Chalmers Canada Limited allowed and the third party claim against Hunter U.S. dismissed with costs.

Cross-appeal of Syncrude allowed with costs, WILSON *and* L'HEUREUX-DUBÉ JJ. *dissenting.*

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Solicitors for the appellant Allis-Chalmers Canada Limited: Russell & DuMoulin, Vancouver.

Solicitors for the respondents: Owen, Bird, Vancouver.