Revay and Associates Limited

The Revay Report

Project Management and Construction Claims Services

Published by Revay and Associates Limited
Volume 27 Number 2 August 2008

LIMITATION OF LIABILITY CLAUSES: MANUFACTURERS, SELLERS AND CONTRACTORS BEWARE

By Olivier F. Kott*

Senior Partner, Ogilvy Renault LLP / S.E.N.C.R.L., s.r.l.

Olivier F. Kott

Olivier F. Kott has over thirty years' experience in the management and resolution of complex business related litigation with a particular focus on construction law and product liability. Recent accomplishments include successfully pleading two landmark cases before the Supreme Court of Canada and acting as lead counsel for the plaintiff in 360-day trial before the Quebec Superior Court. Mr. Kott has negotiated and drafted numerous contracts and participated in the resolution of disputes pertaining to large national and international construction projects. He also acts as an arbitrator and mediator. He teaches construction law at l'Université de Montréal and regularly publishes articles and gives conferences on civil law, ADR and the drafting of contracts. He is coauthor of a 900 page book on contruction law entitled La Construction au Québec: Perspectives juridiques. Mr. Kott is a founding member of the Construction Law Section of the Canadian Bar Association (Quebec Division) and the Canadian College of Construction Lawyers. Mr. Kott's name is mentioned in The 2008 LEXPERT®/ American Lawyer Guide to the Leading 500 Lawyers in Canada, The International Who's Who of Business Lawyers, The Best Lawyers in Canada and Canadian Who's Who.

INTRODUCTION

On November 22, 2007, the Supreme Court of Canada rendered a landmark decision on the liability of sellers and manufacturers in Quebec. In *ABB Inc. vs. Domtar Inc.*[1] the Court upheld Domtar's action against ABB Inc. and Alstom Canada Inc. for nearly 39 million dollars (capital and interest). This judgment is of the utmost importance for all manufacturers and other professional vendors selling their products in Quebec. It confirms the difficulty they will have relying on exclusion or limitation of liability clauses to escape liability for the consequences of latent defects in their products, even when they are dealing with sophisticated buyers. Manufacturers in particular will rarely be able to rely on such clauses, even though they are commonly included in contracts of sale.

This decision is also of interest to contractors in the construction industry since under the Civil Code of Quebec, contractors who furnish "property" (materials and equipment) under a "contract of enterprise or for services" (construction contracts are generally included in this category) are bound, with respect to this property, to the same warranties as a seller.

THE FACTS

In the mid-1980's Domtar purchased a chemical recovery boiler for its new Windsor, Quebec pulp and paper mill from Combustion Engineering Canada Ltd ("C.E."). Just 18 months after the boiler was put into service, Domtar had to shut it down for an unscheduled inspection after detecting a leak in the boiler's "superheater" (a major component of the boiler). The inspection revealed several leaks and hundreds of cracks. Domtar repaired the superheater and, at its next scheduled shutdown, replaced it entirely.

Domtar instituted an action against C.E. (which later became ABB Inc. and Alstom Canada Inc.) alleging that the boiler was affected with a latent defect. C.E. initially contended that the cracking was due to the way Domtar had operated the boiler.

Domtar won its case before the Superior Court and the Court of Appeal. At the Supreme Court, ABB and Alstom no longer argued that the cracking was caused by Domtar's operations. Instead, relying on conclusions of the trial judge, they argued that the cracks were a "feature" of the design but not a defect. They also relied heavily on clauses in C.E.'s contract with Domtar which limited C.E.'s warranty to one year, placed a cap on the amount of direct damages that could be claimed and excluded the liability for consequential damages (e.g. the profits Domtar lost while the boiler was shut down for repairs and replacement, which constituted the major part of Domtar's claim).

* Senior partner, Ogilvy Renault LLP/S.E.N.C.R.L., s.r.l. who represented Domtar Inc. with Mtre Gregory B. Bordan before the Supreme Court, the Court of Appeal and the Superior Court. The author wishes to thank Mtre Bordan for his contribution to this article.

THE JUDGMENT

The Supreme Court reaffirmed the principle that under Quebec civil law, a clause in a contract of sale which excludes or limits the seller's liability for latent defects is not enforceable against a buyer if, at the time of sale, the seller knew of the defect and failed to disclose it to the buyer. The fact of not disclosing the defect is considered a "dol", a civil fraud against the buyer.

It has long been established in Quebec civil law that manufacturers and other professional sellers are presumed by law to know of latent defects in the products they sell. A seller who is presumed to know of a defect is in the same legal position as a seller who has actual knowledge of the defect. In neither case will an exclusion or limitation of liability clause be enforceable against the buyer. In other words, a professional seller who sells a defective product is presumed to be in bad faith.

The presumption against a professional seller is rebuttable only by evidence that the defect could not have been discovered by the most diligent and competent person placed in the seller's position. The difficulty in rebutting the presumption will vary, therefore, on the circumstances. For example, a professional seller of pre-packaged goods who is merely an intermediary between the manufacturer and the buyer should be able to rebut the presumption.

In the case of the manufacturer, there had been some debate in the case law and among legal scholars as to whether the presumption was rebuttable or not. The *Domtar* decision resolves that debate. In principle a manufacturer can rebut the presumption but in practice, will rarely be able to do so. "Manufacturers are considered to be the ultimate experts with respect to the goods [they sell], because they have control over the labour and materials used to produce them." [2]

To defeat the presumption, a manufacturer must prove that the damage was not caused by a latent defect but rather by the buyer, a third party or a "superior force" *(force majeure)*, or that it had been "impossible to detect the defect given the state of scientific and technical knowledge at the time the good was put on the market"[3]. Certainly, it is no defence for a manufacturer to show that it did not know of the defect. Ignorance of an important characteristic of the good which one manufactures is in itself a fault. The Court notes that there are no known cases in which a manufacturer has succeeded in rebutting the presumption.

Manufacturers and professional sellers must only put on the market quality goods fabricated with quality materials using skilled workmanship. Otherwise, they will be answerable for their failings.

The principle that professional sellers cannot limit their liability for latent defects is now codified, notably in article 1733 C.C.Q.:

> "A seller may not exclude or limit his liability unless he has disclosed the defects of which he was aware or could not have been unaware and which affect the right of ownership or the quality of the property.
>
> An exception may be made to this rule where a buyer buys property at his own risk from a seller who is not a professional seller."

The Court affirmed that the presumption of knowledge of a latent defect by a professional seller applies regardless of the relative sophistication of the parties. "[T]he buyer's expertise does not nullify the presumption applicable to the manufacturer" [4]. A professional buyer cannot be expected to have the same level of expertise regarding the product as the manufacturer. The buyer's knowledge and sophistication are relevant in Quebec, but only with respect to the determination of whether the defect is apparent or latent.

The Court cautions buyers, however, that they cannot blindly purchase products. They have the obligation to inform themselves by conducting a reasonable examination of the goods. However, in contrast to professional sellers, they are presumed to be in good faith and it is up to the seller who wishes to establish that the buyer had knowledge of the defect at the time of the sale to make that proof.

Liability for latent defects is the corollary of the duty resting on professional sellers to disclose to potential buyers the existence of any non-apparent defects in the products offered for sale. This duty flows from the more general obligation to inform. In civil law, all parties to a contract are subject to a duty which requires the disclosure of any information of decisive importance for a party to a contract.

The duty to inform is considered today as an application of the broader obligation of good faith in contract law. This analysis was developed at some length by the Supreme Court in the 1992 case of *Banque de Montréal c. Bail* (hereinafter "Bail") [5]. After canvassing the growing number of cases which recognized a duty to inform in a variety of situations, Mr. Justice Gonthier wrote: "I believe that it is possible to outline a general theory of the obligation to inform, based on the duty of good faith in the realm of contracts […]" [6].

Article 1375 C.C.Q., one of the introductory general provisions of the book on Obligations of the Civil Code, provides:

> "The parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished."

The opening articles of the Civil Code express a similar concept. Articles 6 and 7 provide:

> "Every person is bound to exercise his civil rights in good faith."
>
> "No right may be exercised with the intent of injuring another or in an excessive and unreasonable manner which is contrary to the requirements of good faith."

In *Domtar*, the Court states that "the development of Quebec's law of obligations has been marked by efforts to strike a proper balance between, on the one hand, the individual's freedom of contract and, on the other, adherence by contracting parties to the principle of good faith in their mutual relations" [7]. The principle of good faith in contractual relations has become increasingly important in Quebec law. The Court underlines that parties to a contract of sale must take this into account in the exercise of their rights and the execution of their obligations.

The obligation of good faith, from a civil law point of view, requires that professional sellers reveal what they know or should reasonably know about the characteristics of the goods they sell. This rule applies to the characteristics which the seller should consider to be relevant for the buyer, either by reason of the normal use of the goods, or the intended use specified by the buyer. The duty to inform does not apply, however, to the characteristics of the goods which the professional seller can reasonably consider are known by the buyer.

Consequently, a professional vendor who sells a product which is unfit for the purpose for which it is intended, will rarely be able to invoke an exclusion or limitation of liability clause to escape liability for the prejudice suffered by the buyer.

THE DISTINCTION BETWEEN CIVIL LAW RULES AND COMMON LAW RULES

The Supreme Court indicates in the *Domtar* decision that it may be of interest to consider the extent to which the Quebec civil law rules on latent defects resemble the rules that are applied in the rest of Canada.

A brief review of the common law rules indicates that they differ significantly from the applicable rules of Quebec law.

In Canada, the common law rule is that a latent defect must affect an essential characteristic of the good and make that good unfit for its intended use. The onus is on the buyer to prove that the latent defect was known to the seller or that the seller showed reckless disregard for what he or she should have known. However, when it has been established that the seller could have obtained information about an essential characteristic of the good, the seller cannot simply allege an honest belief.

With some exceptions, provincial and territorial statutes of common law jurisdictions generally allow sellers to limit the warranty against latent defects by contract. In principle, a limitation of liability clause in a contract between two merchants will be valid unless it is declared to be unenforceable either for unconscionability or because failure to discharge the obligation to which it applies would amount to a fundamental breach of contract.

Under the doctrine of unconscionability, a limitation of liability clause will be unenforceable where one party to the contract has abused its negotiating power to take undue advantage of the other. The doctrine is generally applied in the context of a consumer contract or contract of adhesion.

Under the doctrine of fundamental breach, parties with equal bargaining power can, in certain circumstances, apply to have an unreasonable clause declared unenforceable on the basis that it does not reflect the intent of the parties. For this purpose, the breaching party's failure to perform its obligations under the contract must be such that it deprives the non-breaching party of substantially the whole benefit of the agreement. The existence of a latent defect does not automatically amount to a fundamental breach of contract. The latent defect must be irreparable or the goods must be unusable.

Once the existence of a fundamental breach has been established, the court must still analyse the limitation of liability clause in light of the general rules of contract interpretation. If the words can reasonably be interpreted in only one way, it will not be open to the court, even on grounds of equity or reasonableness, to declare the clause to be unenforceable, since this would amount to rewriting the contract negotiated by the parties.

The Supreme Court concludes that owing to certain of its characteristics, the common law cannot easily be grafted on to the Quebec civil law.

The validity of exclusion or limitation of liability clauses therefore depends on the law which applies to the contract. Only in rare cases can such clauses be successfully invoked by manufacturers and professional sellers under Quebec civil law whereas their validity will generally be recognized under the common law.

THE CHOICE OF THE APPLICABLE LAW

Since the principles relating to liability for latent defects expressed by the Supreme Court in the *Domtar* decision only apply to contracts governed by the laws of Quebec, certain manufacturers and professional sellers may be tempted to choose the law of a common law jurisdiction to govern their obligations under a contract of sale, even if the goods are manufactured and sold in Quebec. It is important to note that the Civil Code contains certain imperative provisions which apply in such a case.

Indeed, even if the Civil Code recognizes the right of the parties to choose the law applicable to their contract, it imposes certain restrictions on that right. For example, article 3111 C.C.Q. provides that a contract which does not present any foreign element remains subject to the mandatory provisions of the law which would apply if none were designated. Article 1733 C.C.Q. which stipulates that the seller cannot exclude or limit his liability if he has not disclosed the defect of which he was aware or could not have been unaware constitutes a mandatory provision of Quebec law.

Furthermore, article 3128 C.C.Q. stipulates that the liability of the manufacturer of a movable is governed at the choice of the victim by the law of the jurisdiction where the manufacturer has his establishment (or residence) or by the law of the jurisdiction where the movable was acquired. This public order provision takes precedence over any choice of law provision contained in the contract.

IMPACT OF THE *DOMTAR* DECISION FOR PROFESSIONAL SELLERS

The presumption of knowledge of latent defects only applies to manufacturers and professional vendors, that is those who sell goods of the trade that is their profession.

The non-professional seller who has no expertise is not subject to the presumption of knowledge. He will be responsible for the damages caused by the goods only to the extent that he had actual knowledge of the defect.

Professional sellers in Quebec must be conscious of the fact that the buyer does not have to prove the origin of the defect in order to be successful in a claim based on latent defects. A defect is considered to be any characteristic of a product which seriously compromises the practical and economic utility of the good acquired by the buyer.

> "However, the defect does not have to render the good completely unstable but simply has to reduce its usefulness significantly in relation to the legitimate expectations of a prudent and diligent buyer." [8]

In order to prove a latent defect, the buyer only has to establish that the good which he purchased does not function according to his reasonable and legitimate expectations and that the characteristic of the good invoked as a latent defect reduces its usefulness in an important fashion. Once the buyer has demonstrated that the good is defective, the professional seller will have the heavy burden of proving that he could not reasonably have become aware of the defect. Manufacturers in particular will only be able to make this evidence in very exceptional circumstances.

Therefore, professional vendors, and in particular manufacturers, should know that in the majority of cases, they will not be able to invoke exclusion or limitation of liability clauses to escape liability for latent defects affecting their products. This rule applies even in the case of knowledgeable buyers who benefit from the assistance of engineers and lawyers.

However, the presumption of knowledge of a latent defect only arises once the buyer has proven the existence of a defect, that is that the good is not suitable for its intended purpose. The best defence for professional vendors is therefore to refute the allegation that the good is defective. Professional vendors can escape liability by proving that the damages result from the fault of the buyer or a third party, or a superior force.

Professional vendors must ensure that they adequately advise buyers of the characteristics of their products, especially the features which affect the operation or the durability of the goods. The buyer who is adequately informed of the characteristics of a good and accepts them cannot afterwards allege a latent defect.

Since the existence of a defect is determined by comparison to the normal use or the declared use of goods, professional sellers should inform purchasers in writing of any restriction to the eventual use of the goods, as well as any particular measures to be observed for the operation or maintenance of the product.

Furthermore, if a professional seller knows

that the buyer is acquiring a product for a particular use, the parties should take care to stipulate this in the contract of sale and set out the anticipated conditions of use.

IMPACT OF THE *DOMTAR* DECISION FOR CONTRACTORS

The *Domtar* decision confirms that professional sellers are presumed to have knowledge of the latent defects which affect the products they sell and consequently, that they cannot invoke an exclusion or limitation of liability clause in the contract of sale unless this presumption of knowledge is rebutted.

It must therefore be determined to what extent the presumption of knowledge of latent defects applies to contractors who furnish goods to a client under a contract of enterprise (construction contract).

Firstly, it is necessary to qualify the contract entered into by the contractor in order to determine whether it is a contract of sale or a contract of enterprise. This qualification will determine which rules of the Civil Code will apply.

Article 2103 C.C.Q. stipulates that the distinction between a contract of sale and a contract of enterprise resides in the relative value of the work or service and the property supplied. This article reads as follows:

> "The contractor or the provider of services furnishes the property necessary for the performance of the contract, unless the parties have stipulated that only his work is required.
>
> He shall furnish only property of good quality; he is bound by the same warranties in respect of the property as a seller.
>
> A contract is a contract of sale, and not a contract of enterprise or for services, where the work or service is merely accessory to the value of the property supplied."

Contracts in virtue of which a contractor furnishes the labour and materials and delivers the final product are considered *a priori* to be contracts of enterprise. They are considered contracts of sale when the work or service is only an accessory in relation to the value of the property supplied.

Decisions rendered by the Court of Appeal of Quebec and the Superior Court of Quebec, since the adoption of the new Civil Code in 1994, have applied this criteria to distinguish the contract of sale from the contract of enterprise.

In the case of *Picard Équipement de Boulangerie v. 2883643 Canada inc. (Aliments Lloydies)*[9], the Court took into consideration the value of the goods furnished, which represented 40% of the total cost of the machine, compared to the value of the work which resulted from the manpower furnished by the contractor in order to conclude that the contract should be qualified as a contract of enterprise.

The Court adds that the expression "property" mentioned in the second paragraph of article 2103 C.C.Q. must be interpreted as referring to the property incorporated in the work. Consequently, this expression does not include the final machine which is covered by the warranty against poor workmanship provided for in article 2120 C.C.Q. The concept of "work" must be interpreted as referring to the global and final result.

In the case of *Silo Supérieur (1993) Inc. v. Ferme Kaeck & Fils Inc.*[10], the Court of Appeal of Quebec analyzed the criteria applicable to the qualification of a contract for the erection of a silo. The Court concluded that the contract was not a contract of sale within the meaning of article 2103, paragraph 3 C.C.Q. since, considering the importance of the work performed, it was obvious even in the absence of evidence as to the value of the goods furnished, that the value of the work performed did not simply constitute an accessory to the sale of the materials which composed the silo.

In the case of *Centre d'auto Lavigne Inc. v. Services de gestion de carburants M.T.L. Inc.* [11], the Superior Court applied the rules relating to contracts of enterprise as well as the rules applicable to contracts of sale in order to find a contractor who had supplied and installed an underground reservoir liable for the damages suffered by the client.

This decision illustrates the difficulty in certain cases in assessing whether the liability of a contractor who furnishes goods under a construction contract is determined according to the rules which apply to a contract of enterprise, the rules which apply to a contract of sale, or a combination of both regimes.

In cases where the Court concludes that the contract is a contract of sale, then the rules applicable to the liability

of a professional seller as set out in the *Domtar* decision will apply. The professional seller will therefore be responsible for the damages caused by the latent defects without being able to exclude or limit his liability unless the presumption of knowledge is rebutted or proof is made that the damages result from the fault of the buyer, a third party or a superior force.

In the case of latent defects affecting goods furnished by a contractor under a construction contract, which are incorporated in the work, the contractor will be responsible for the quality of the goods to the same extent as a professional seller.

If the Court decides that the rules applicable to contracts of enterprise apply, it will then proceed to determine which articles of the Civil Code will receive application.

In the case of the loss of the work which occurs within five (5) years after completion due to faulty design, construction or production of the work or the unfavourable nature of the ground, then article 2118 C.C.Q. will apply. This article reads as follows:

> "Unless they can be relieved from liability, the contractor, the architect and the engineer who, as the case may be, directed or supervised the work, and the subcontractor with respect to work performed by him, are solidarily liable for the loss of the work occurring within five years after the work was completed, whether the loss results from faulty design, construction or production of the work, or the unfavourable nature of the ground."

In the case of poor workmanship existing at the time of acceptance of the work, or discovered within one (1) year after acceptance, article 2120 C.C.Q. will apply. This article provides the following:

> "The contractor, the architect and the engineer, in respect of work they directed or supervised, and, where applicable, the subcontractor, in respect of work he performed, are jointly liable to warrant the work for one year against poor workmanship existing at the time of acceptance or discovered within one year after acceptance."

The juxtaposition of the provisions of the Civil Code which apply to contracts of sale and contracts of enterprise raises certain interesting questions. For example, in the case of defective materials or a functional deficiency which manifests itself more than one (1) year after acceptance of the work, will it be possible for a client to argue successfully that the defect constitutes a latent defect affecting goods incorporated in the work rather than poor workmanship covered by article 2120 C.C.Q. in order to justify a recourse against the contractor notwithstanding the expiry of the one (1) year warranty?

Will a client be able to successfully argue that the loss of the work which occurs more than five (5) years after completion was due to a latent defect affecting a product incorporated in the work in order to justify a recourse against the contractor notwithstanding the expiry of the five (5) year period provided for in article 2118 C.C.Q.?

Will a client be able to base his recourse on the liability for latent defects in order to avoid the application of an exclusion or limitation of liability clause in a construction contract?

Our Courts will certainly have the occasion to decide such questions in the future according to the particular facts of each case.

CONCLUSION

The Supreme Court confirmed in the *Domtar* decision that under Quebec civil law, professional sellers will rarely be able to invoke exclusion or limitation of liability clauses in order to escape liability for damages caused by latent defects which they are presumed to know and which affect the goods sold. This rule also applies to contractors who are held to the same warranty as professional sellers under the provisions of the Civil Code.

In order to successfully contest a claim for latent defects, professional sellers and contractors who are held to the same warranty have the burden of rebutting the presumption of knowledge. They can also prove that the damages were caused by the fault of the buyer, a third party, or a superior force.

Professional sellers and contractors may also exercise the recourse which they themselves have against the manufacturer of defective goods since ultimately, it is the manufacturer which must assume responsibility for the latent defects affecting the goods.

In this context, it is important to note that the choice of law applicable to the rights of the parties under a contract becomes very important. Indeed, the principles set out by the Supreme Court in the *Domtar* decision apply to contracts governed by the laws of Quebec.

Consequently, professional vendors and contractors should, to the extent possible, ensure that the rights that they have against the manufacturer of goods are governed by the same law as applies to the obligations they have towards their clients.

In light of the decision in the *Domtar* case, it can be stated that the warning *caveat venditor* is now as appropriate as the warning *caveat emptor!*

[1] 2007 SCC 50
[2] *Domtar*, para. 41
[3] *Ibid*, para. 72
[4] *Ibid*, para. 44
[5] [1992] 2 S.C.R., 554, at p. 586
[6] *Bail*, p. 586
[7] *Domtar*, para. 1
[8] *Ibid*, p. 52
[9] 2006 QCCS 2873, J.E. 2006-1402 (S.C.).
[10] J.E. 2004-1358 (C.A.)
[11] J.E. 2000-51, (C.S.), désistement d'appel, C.A. Montréal, 500-09-009078-999, le 27/4/2000

The Revay Report is published by Revay and Associates Limited, a national firm of Construction and Claims Specialists, assisting owners and contractors in achieving profitable and trouble-free construction projects.

Edition française disponible sur demande.

Please advise the Montreal office of any change of address.

CONTACT INFORMATION

Please visit **www.revay.com** for current office locations.
If you would like to subscribe for **The Revay Report**, click here.

Publications #40042162