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Fundamental Breach and Repudiatory Breach of Contract

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Case commented on: *John Barlot Architect Ltd. v 413481 Alberta Ltd.*, 2013 ABQB 388

Introduction

The doctrine of fundamental breach has caused much confusion, in part because of its relationship to the doctrine of repudiatory breach. The two are entirely different doctrines, but as I tell my students, it doesn't help that sometimes, the doctrines are merged and the terms used interchangeably.

In effect, the two doctrines are quite separate and the finding of one type of breach leads to a significantly different outcome than a finding of the other. The problem occurs when, as in this decision, the two doctrines are combined and there is no clear indication of the differences between the two. That does not necessarily render the judgment incorrect but it does make for inaccurate references and confusing terminology.

This post will focus on the doctrines of fundamental and repudiatory breach. A shortened version of the facts will be provided, as not all of them are necessary for the purpose of this post.

Facts

Mr. Luhur's company owned a parcel of land in Edmonton. The parcel became the subject of a re-zoning application, which led to the owner and the City of Edmonton having to negotiate a By-Law to regulate its development. The By-Law was ultimately passed by the City and a multi-disciplinary team was hired for the project.

Issues arose between the team and the architectural office of Mr. Barlot. Additionally, Mr. Luhur believed Mr. Barlot was failing to address difficult questions that had severe financial consequences to the project. On October 16, 2005, Mr. Luhur, on behalf of the numbered company Defendant, terminated the contract with Mr. Barlot's architectural company, alleging a fundamental breach of contract.

The case involved actions dealing with fundamental breach of contract, inducement to breach the contract or otherwise tortuously interfere with contractual relations, and the appropriate calculation of damages in the event there is no fundamental breach. I will only be dealing with the issue of fundamental breach in this post.

Fundamental Breach & Repudiatory Breach

In the decision, Macleod J. defines fundamental breach as "a breach [that] deprives the innocent party of the substantial benefit of the contract, or goes to the root of the contract" (para. 36). Technically, that is accurate. If a breach is so "fundamental", that the innocent party is deprived of the benefit of the contract, then the innocent party is entitled to stop performing and sue for damages. As a matter of legal terminology and supporting case law, however, Macleod J. is actually referring to the doctrine of "repudiatory breach"; the "doctrine of fundamental breach" is quite different and used in different circumstances. Adding to the confusion in the decision, Macleod J. relies on some cases that lay out the requirements for, and support, the doctrine of fundamental breach, but use the definition of repudiatory breach.

Fundamental Breach: UK

The doctrine of fundamental breach, which has recently been struck down by the Supreme Court of Canada (see *Tercon Contractors Ltd. v British Columbia (Transportation and Highways*), 2010 SCC 4 [*Tercon Conractors*]) has a long and varied history in Canadian and UK jurisprudence. Prior to its elimination in *Tercon Contractors*, the doctrine of fundamental breach was used to determine whether a party can rely on an exclusion of liability clause (also referred to as a "limitation of liability clause") in a contract. Essentially, if the limitation of liability clause allowed a party to fundamentally breach a contract, the court could strike down the clause under the doctrine of fundamental breach.

In the UK, there are a few important cases that have shaped the doctrine and its existence. One of the most important expressions of the doctrine is found in *Karsales (Harrow) Ltd. v Wallis*, [1956] 2 All ER 866 (CA) [*Karsales*], where Lord Denning maintained,

> The law about exempting clauses, however, has been much developed in recent years, at any rate about printed exempting clauses, which so often pass unread. Notwithstanding earlier cases which might suggest the contrary, it is now settled that exempting clauses of this kind no matter how widely they are expressed, only avail the party when he is carrying out his contract in its essential respects… They do not avail him when he is guilty of a breach which goes to the root of the contract (at 868-69).

The doctrine was popular in England, and courts applied it for years. But in 1967, the House of Lords questioned it. In *Suisse Atlantique Societe d'Armement Maritime S.A. v N.V. Rotterdamsche Kolen Centrale*, [1967] 1 AC 361, a case relied on in this present case, the House of Lords rejected the approach taken in *Karsales* and determined that the proper approach to determining whether an exemption clause applied was to look at the construction of the agreement. Lords Reid and Upjohn, however, created some confusion with their judgment in *Suisse Atlantique*, as they appear to have mixed the doctrine of fundamental breach with that of repudiatory breach in their judgment, maintaining that,

> If fundamental breach is established, the next question is what effect, if any, that has on the applicability of other terms of the contract…I do not think there is generally much difficulty where the innocent party has elected to treat the breach as a repudiation, bring the contract to an end and sue for damages. Then the whole contract has ceased to exist including the exclusion clause, and I do not see how that

> clause can then be used to exclude an action for loss which will be suffered by the innocent party after it has ceased to exist, such as loss of the profit which would have accrued if the contract had run its full term (at 397-98).

Lord Upjohn had a similar remark (at 428).

However, the doctrine of fundamental breach essentially met its demise a little over a decade later, and its end was ultimately spelled out in another House of Lords judgment. In 1977, the English Parliament enacted the *Unfair Contracts Terms Act 1977* ((UK) 1977, c. 50), which put an end to the doctrine of fundamental breach as it applied to consumer contracts. For commercial settings, situations in which the legislation would not apply, the courts further reduced the application of the doctrine in *Photo Production Ltd. v Securicor Transport Ltd*., [1980] A.C. 827 (HL) [*Photo Production*] where they determined that the construction approach was the proper approach. The approach was explained by Lord Diplock:

> Since the obligations implied by law in a commercial contract are those which, by judicial consensus over the years or by Parliament in passing a statute, have been regarded as obligations which a reasonable businessman would realise that he was accepting when he entered into a contract of a particular kind, the court's view of the reasonableness of any departure from the implied obligations which would be involved in construing the express words of an exclusion clause in one sense that they are capable of bearing rather another, is a relevant consideration in deciding what meaning the words were intended by the parties to bear (at 850-1).

Lord Wilberforce, with Lords Keith and Scarman concurred (at 843).

Fundamental Breach: Canada

In Canada, this area has been unclear and fraught with inconsistency, as the application of the doctrine of fundamental breach has varied between courts. After *Suisse Atlantique* was decided in the UK, a number of Canadian courts applied its reasoning, the construction approach, including a majority of the Supreme Court of Canada in *B.G. Linton Construction Ltd. v C.N.R. Co*, [1975] 2 SCR 678 [*B.G. Linton*]. But the doctrine of fundamental breach was a powerful one, as it gave courts the ability to strike down exclusion clauses where it appeared fair to do so. Judges liked it, and regardless of the attempt to dispense with it, it continued to pop up in different places.

When the doctrine again reached the Supreme Court in *Hunter Engineering Co. Inc. v Syncrude Canada Ltd*., [1989] 1 SCR 426 [*Hunter Engineering*], it was another opportunity for the Court to reaffirm its position on the doctrine, which it had earlier articulated in *B.G. Linton*. Unfortunately, even though the Court unanimously dismissed the plaintiff's claims, two decisions were rendered, and neither had majority support. Wilson J. would not dispense with the doctrine of fundamental breach and maintained that the doctrine would apply in situations where it would be unfair or unreasonable to apply the exclusion clause in the event of a breach. Dickson C.J.C., on the other hand, maintained that the doctrine of fundamental breach should be "laid to rest" (at 462) and replaced with the doctrine of unconscionability.

As a result of the two judgments from *Hunter Engineering*, the doctrine of fundamental breach continued to be unresolved and its application was still unclear. Some courts would interpret the two judgments to effectively mean the same thing, in that the doctrine has been rejected and

replaced by the doctrine of unconscionability, while others would apply both judgments to the facts before them. This continued to be the case until the Supreme Court released its *Tercon Contractors* decision, in which a unanimous court decided to "lay [the doctrine of fundamental breach] to rest" (Cromwell J., at 62) and to "again attempt to shut the coffin on the jargon associated with 'fundamental breach'" (Binnie J., at para 82). There was a 5:4 split in the *Tercon Contractors* court but Cromwell J., for the majority, agreed with the analysis of Binnie J., for the minority. Binnie J. articulated a three-step test to determine the validity of exclusion clauses, to replace the doctrine of fundamental breach. The split in the court was as a result of the application of the test to the facts, not in the articulation of the test.

To conclude, the doctrine of fundamental breach no longer exists in Canada, as *Tercon Contractors* did away with it and replaced it with a three-pronged test to be applied to determine the enforceability of an exclusion clause. However, given the durability of the doctrine in Canada prior to *Tercon Contractors*, some question whether it is truly gone (see Angela Swan and Jakub Adamski, "Fundamental Breach is Dead; Or Is It - *Tercon Contractors Ltd. v British Columbia (Transportation and Highways*)" (2010) 49 Can Bus LJ 452).

Repudiatory Breach

In contracts, there are two types of provisions: conditions and warranties. Conditions are important provisions, breach of which deprives the innocent party of the substantial benefit of the contract and therefore entitles it to stop performing and sue for damages. Warranties are less important contractual provisions. If breached, the innocent party is not entitled to stop performing; it must continue performing but it can sue for damages.

The determination of whether a term was a condition or warranty used to be made by looking at the contract and attempting to determine what the parties must have intended at the time they entered into it. And if the parties had stipulated that one term was a condition, breach of it put the contract at an end, regardless of how inconsequential the effect of the breach. It was for that reason that the condition/warranty dichotomy was problematic – it was too rigid and could lead to absurd consequences.

The dichotomy was eventually expanded in *Hong Kong Fir Shipping Co. Ltd. v Kawasaki Kisen Kaisha Ltd*., [1962] 2 QB 26 (CA) [*Hong Kong Fir*], where it was determined that another classification should be developed. The categories of condition and warranty remained the same but the timing at which terms should be categorized was expanded. Specifically, it was determined that for some terms, the classification as to whether they are conditions or warranties should come at the time of the breach, in order to see the consequences of the breach before making the determination. Diplock L.J. developed the category of "innominate" or "intermediate" terms, which he described as follows:

> There are, however, many contractual undertakings of a more complex character which cannot be categorized as being "conditions" or "warranties"… Of such undertakings, all that can be predicated is that some breaches will, and others will not, give rise to an event which would deprive the party not in default of substantially the whole benefit which it was intended that he should obtain from the contract; and the legal consequences of the breach of such an undertaking, unless provided for expressly in that contract, depend on the nature of the event to which the breach gives rise and do not follow automatically from a prior classification of the undertaking as a "condition" or a "warranty".

Later cases clarified that the need for certainty meant that the *Hong Kong Fir* analysis did not mean that any term not classified as a condition or warranty automatically became an innominate term; on a proper construction of the contract, a term might be found to be an "implied condition" (see *Bunge Corp., New York v Tradax Export S.A., Panama*, [1981] 1 WLR 711 (HL).

The breach of a term that is a "condition" or a term initially classified as an innominate term that deprives the party substantially of the benefit of the contract, is a repudiatory breach.

Fundamental Breach and Repudiatory Breach: The Current Case

These two concepts have sometimes been seen to be interchangeable, due to the similarity in language. It is important, however, to keep them separate, as the question of whether an exclusion clause can be relied upon in the event of a breach is quite different than whether a breach of a contract is so significant as to entitle the other party to stop performing.

The confusion, however, is not unexpected, as several cases have fused the two concepts. In Lord Diplock's judgment in *Photo Production*, the two concepts are merged in his analysis of primary and secondary obligations under the agreement. In *Hunter Engineering*, Wilson J. relies on that part of Lord Diplock's judgment when she says "A fundamental breach occurs 'Where the event resulting from the failure by one party to perform the 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" (at 499) and it is that part of *Hunter Engineering* that Macleod J. relies on in this case.

In *Hunter Engineering*, Wilson J. is referring to the doctrine of fundamental breach as it applies to exclusion clauses, but is using the definition of repudiatory breach. In this current case, Macleod J. is referring to the doctrine of repudiatory breach but relying on a case about the doctrine of fundamental breach as it relates to exclusion clauses, but which used the definition of repudiatory breach. Doing so does not make Macleod J.'s analysis incorrect; indeed, the judgment is clearly about whether the breach at issue was repudiatory, and there are several references throughout that correctly state the definition of repudiatory breach. This case does not involve an exclusion of liability clause. The problem lies in the use of the term "fundamental breach", the doctrine that applied only to exclusion clauses.

This confusion does not change the analysis or render it inaccurate. There is, by definition, a significance, a fundamentality, to the concept of repudiatory breach. The breach must be fundamental enough to deprive the innocent party of the benefit of the contract and entitle it to stop performing. But it is not accurate to refer to it as "fundamental breach", given that there is an entire doctrine of fundamental breach, through which courts used to determine the enforceability of exclusion clauses. Keeping those two concepts separate would only enhance the clarity in these areas going forward. Hopefully, there will be fewer references to the doctrine of fundamental breach altogether, given its demise in *Tercon Contractors*, but I have my doubts, both about the actual demise of the doctrine (like Swan and Adamski) and about the referral to it in discussions about repudiatory breaches.