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Precision Drilling Canada Limited Partnership v Yangarra Resources Ltd, 2017 ABCA 378: Fraud and Limitation of Liability Clauses

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Case Commented On: *Precision Drilling Canada Limited Partnership v Yangarra Resources Ltd*, 2017 ABCA 378 (CanLII)

Introduction

This is a case about the legal test for civil fraud and whether a limitation of liability clause in a contract can and should exclude liability for fraud. The Alberta Court of Appeal allowed the appeal of the summary judgment and sent it to trial (see earlier Ablawg posts about lower court decisions here and here).

A court can only find fraud after weighing the evidence and applying the proper legal test. Assuming there is fraud, the court will then have to determine whether a proper interpretation of the exclusion of liability clause excludes fraud. If so, can a party that has engaged in fraud be allowed the benefit of the clause? In my opinion, it cannot, as doing so would be contrary to public policy and it would breach the duties of honest performance and good faith articulated by the Supreme Court in *Bhasin v Hrynew*, 2014 SCC 71 (CanLII).

Facts

Yangarra Resources Ltd. (Yangarra) and Precision Drilling Canada Limited Partnership (Precision) entered into a drilling contract, under which Precision employees would carry out work for Yangarra. It was a standard form agreement, referred to as a "no-fault" or "knock for knock" contract. These types of agreements assign the risk of asset damage to the party that owns them, rather than allocating risk on the basis of fault.

On December 2, 2011, during the nightshift, a Precision employee poured sulfamic acid, instead of caustic potash, into drilling mud. No one told Precision about the mix-up. The next day, a drill string and bit became stuck in the hole and Precision could not remove it. The chambers judge assumed that the drill bit had become stuck because of the mix-up with the mud. Precision conceded that it had not told Yangarra about the mud mix-up until after the drill bit became stuck. Precision could not extract Yangarra's drill bit, and the well was abandoned. Yangarra lost its $300,000 equipment, which was stuck in the hole, and a replacement well had to be drilled at a cost of $2M.

Precision brought a claim against Yangarra for the work that had been performed on the abandoned well and for the equipment Precision had provided. Yangarra defended the action, maintaining that Precision had breached its contractual obligation to "drill the well in a good and

workmanlike manner in accordance with good drilling practices" (ABCA, para 5). Yangarra also alleged negligence, gross negligence, and fraudulent misrepresentation by Precision when it failed to tell Yangarra of the mix-up with the mud. Additionally, Yangarra brought an action for set-off and a counterclaim for its loss of equipment in the abandoned well and the cost of drilling the replacement well.

History of Legal Proceedings

In 2012, Precision brought an application for summary judgment against Yangarra, arguing there was no merit to Yangarra's defence or counterclaim and no genuine issue for trial, and that the counterclaim should be dismissed.

The Master granted Precision's summary judgment application. He found that the limitation of liability clause in the contract barred Yangarra's set-off defence and counterclaim (2015 ABQB 433 (CanLII)). He also found that there was no evidence that would prevent the exclusion of liability clause from being applied on the basis of public policy.

Yangarra unsuccessfully appealed the decision (2016 ABQB 365 (CanLII)). The chambers judge agreed that the contract excluded liability for the damages Yangarra was claiming, and that the exclusion of liability clause could be applied. Additionally, the chambers judge found that the exclusion of liability clause could protect again gross negligence, but not fraud, for public policy reasons. The judge, however, did not find any evidence of fraud.

This decision was appealed to the Alberta Court of Appeal. The majority found this was not an appropriate case for summary judgement, as there is a genuine issue requiring trial, and that it was a palpable and overriding error to find there was no evidence of fraud. It also determined the chambers judge had failed to apply the proper test for fraud. The court did not determine whether the contract excludes liability for fraud, leaving the matter for the trial judge to decide after hearing the evidence. The dissenting judge would have dismissed the appeal.

Alberta Court of Appeal Decision: Majority

Fraud

The biggest issue before the court was whether the chambers judge articulated and applied the proper test for fraud. The court relied on the test for civil fraud, most recently articulated in *Bruno Appliance and Furniture Inc v Hryniak*, 2014 SCC 8 (CanLII) at para 21, which requires the plaintiff to prove:

(a) a false representation made by the defendant;
(b) some level of knowledge of the falsehood of the representation on the part of the defendant (whether through knowledge or recklessness);
(c) the false representation caused the plaintiff to act; and
(d) the plaintiff's actions resulted in a loss.

The court took note of the following additional facts. The packages containing caustic potash (the mixture that should have been poured into the mud) and sulfamic acid (the mixture that was in fact poured into the mud) were clearly marked and very different in appearance.

By 8:30am on December 3, one of Precision's employees noted the empty bag of sulfamic acid and corrected the results to reflect the mix-up. Precision's employees, however, did not advise Yangarra of the mix-up. Had they done so, Yangarra could have temporarily shut down the rig to address the issue.

During the rest of the shift in which the mix-up occurred (late December 2 and early December 3), and throughout the next day shift (on December 3), employees of Precision performed a number of mud tests and the results indicated the mud was suitable for drilling. The court noted, based on the mixing error, that the mud could not have had the properties indicated in the tests. The chambers judge had concluded that Precision's employees either did not test the mud, or carelessly tested the mud, as they wrongly advised Yangarra's supervisor that the drilling mud was fine.

At about 1:00pm on December 3, the drill string and bit became stuck in the hole. It was assumed that the bits became stuck because sulfamic acid was added to the mud.

The court determined these findings, contrary to the chambers judge's findings, suggested a failure to disclose and active steps to conceal, or possibly recklessness. Specifically, it noted that failing to tell Yangarra about the error was, at the very least, reckless, then proceeding to convey false information to Yangarra about the properties of the drilling mud, suggested fraud. It also noted that Precision had failed to provide an explanation to rebut the suggestion of fraud. However, as credibility must be assessed when fraud is in issue, the court determined that this issue requires a trial.

In addition to the chamber judge's erroneous assessment of the facts regarding fraud, the court also found that he had applied the wrong test. The chambers judge had concluded fraud was not present by stating, "there is no evidentiary basis to suggest that there was any intentional concealment, never mind fraud…" (2016 ABCA 365 at para 28). Even though the judge had not laid out the test for fraud in his decision, based on that statement, the court concluded that he was applying *a* test for fraud, and specifically, one requiring a defendant to have *intentionally* concealed the relevant facts. The court took issue with that articulation because neither the test he had applied, nor the legal test for fraud, are certain. Although the court in *Bruno* determined that the motive of the guilty party, or intention to deceive, should not be considered (*Derry v Peek*, [1889] UKHL 1, 14 App Cas 337, cited in *Bruno* at para 18), uncertainty arose on this point in subsequent cases. The court determined that the trial judge's use of "intentionally" might mean he imported a requirement for motive. The uncertainty surrounding the test, and the facts, raise issues that should not have been decided on summary judgment.

Additionally, the chambers judge had failed to consider that the test for fraud can be met in one of two ways. Knowledge of the falsehood is not required if the perpetrator's recklessness as to the truth of a statement can be proved. There was ample evidence to consider whether Precision had been reckless, which the chambers judge failed to do.

Exclusion of Liability Clause

The chambers judge had determined that Precision was entitled to rely on the exclusion of liability clause in response to Yangarra's claims. The court refrained from deciding on whether a proper interpretation of the clause did exclude a fraudulent misrepresentation claim. Additionally, if a proper interpretation of the clause included fraud, the court would need to consider whether it would be contrary to public policy. The court agreed with the chambers judge that, if fraud is present, the decision of *Roy v Kretschmer*, 2014 BCCA 429 (CanLII), would apply, to prevent the fraudulent party from hiding behind the exclusion clause, but ultimately determined that public policy can only be considered after the factual record is established, which would occur at trial.

Alberta Court of Appeal Decision: Dissent

The dissenting judge did not see a palpable and overriding error in the chambers judge's conclusion that the evidence presented before him did not meet the test for fraud.

The dissenting judge accepted the facts and legal tests put forward by the majority but took the view that the chambers judge must be taken as knowing the correct legal test for fraud, as the matter had been argued before him, and the arguments included the proper tests. He was owed deference on his assessment of the evidence as not meriting a trial. Additionally, the dissenting judgment, in agreeing with the chambers judge, determined that the evidence amounted to simple negligence, not fraud. Given that conclusion, the dissenting opinion did not discuss whether the agreement excluded liability for fraudulent misrepresentation.

ANALYSIS

I. *Civil Fraud or Fraudulent Misrepresentation: The Test and the Facts*

The Supreme Court has recently stated the test for fraud, in *Bruno*. For ease of reference, I will restate what the plaintiff must prove:

(a) a false representation made by the defendant;
(b) some level of knowledge of the falsehood of the representation on the part of the defendant (whether through knowledge or recklessness);
(c) the false representation caused the plaintiff to act; and
(d) the plaintiff's actions resulted in a loss.

The ABCA took issue with the chambers judge's definition of fraud, because he had not set out the *Bruno* test and because he implied that intention to conceal the critical facts was a necessary element of fraudulent misrepresentation. The ABCA then considered whether intention is, in fact, necessary for a finding of fraud. It determined that it was not, but that some uncertainty remained in the case law, as it is possible to interpret some cases as requiring an intention to deceive for a successful action. The ABCA noted that his use of *intention* was to qualify *concealment*, but that his failure to articulate a test for fraud left open the question of whether he

understood the test as nonetheless requiring an intention to deceive. If so, he would be setting a higher bar for finding fraud. Additionally, the chambers judge had not considered the possibility of recklessness as to the truth of a statement as a means to finding fraud.
The test for civil fraud as set out in *Bruno* does not require that the defendant have an intention to induce reliance, otherwise stated as an intention to deceive, or an intention that the false representation be acted on. *Bruno* only requires that the false representation cause the plaintiff to act. In fact, in *Bruno*, the SCC quotes Lord Herschell's classic statement from *Derry v Peek* prior to setting out its own test, where Lord Herschell specifically said, "Thirdly, if fraud be proved, the motive of the person guilty of it is immaterial. It matters not that there was no intention to cheat or injure the person to whom the statement was made" (p 374). However, subsequent cases, including an SCC case, referring to *Bruno*, have implied that an intention that the fraudulent statement be relied upon, is part of the test for civil fraud. See, for example, *Bhasin* at para 88.

In short, there is uncertainty as to what the test entails. If the test does require an intention to deceive, it raises the bar for a finding of fraud, since it is clearly difficult to prove what is in a person's mind at the time of making a statement. As Bowen L.J. noted in *Edgington v Fitzmaurice* (1885), 29 Ch. D. 459 at 476, "the state of a man's mind is as much a fact as the state of his digestion". As a result, intention to deceive will usually be inferred from the evidence (*HSBC Bank Canada v Dillon Holdings Ltd*., [2005] O.J. No. 2331, 2005 CanLII 19834 (ON SC) at para 211).

In this case, the ABCA noted that Precision had failed to provide a credible explanation about the false representation as to the state of the drilling mud. It had told Yangarra, through the reporting, that the mud was satisfactory. At the time of reporting, Precision knew about the mix-up, and because of the mix-up, the mud *could not* have been satisfactory. In short, the reporting to Yangarra was false. The knowledge of the mix-up could satisfy the less onerous test (requiring knowledge of the falsehood of the representation, or recklessness as to its truth), as it appears evident that Precision knew of the mix-up when the results were corrected by a Precision employee on December 3 at 8:30am. But the subsequent testing and false reporting could satisfy the higher test, as the false statements in the reports that were submitted to Yangarra could be construed as intention to deceive. "Belief or intention or state of mind is proverbially difficult to prove but inferences may be drawn from the facts and circumstances of the case," (*Perodeau v Hamill*, [1925] SCR 289, 1925 CanLII 78 (SCC)). Here, assuming Yangarra was relying on the reports to continue drilling, the submission of false reports suggests an intention to induce reliance. This, however, is an issue for trial, as the ABCA noted, and these conclusions can only be made after all the evidence has been considered.

II. *Exclusion of Liability Clauses: Can they Exclude Liability for Fraud?*

If the trial court finds fraud, it will need to determine whether the limitation of liability clause, properly interpreted, would exclude a claim for fraudulent misrepresentation. If so, the court will need to consider whether a fraudulent party should be able to hide behind the clause. In short, it should not, for several reasons. First, it would be contrary to public policy. Second, it would be contrary to another provision within the contract. And third, it would be contrary to the duty to perform the contract in good faith and the contractual duty of honest performance.

1. *Public Policy*

Before the ABCA, the respondent argued that it would be a rare occurrence to allow the intervention of public policy, and that regardless, there was no basis here to consider it. In fact, while serious criminality and fraud would prevent the operation of an exclusion clause on the basis of public policy, less serious conduct would also prevent these clauses from operating.

In *Tercon Contractors Ltd v British Columbia (Transportation and Highways)*, [2010] 1 SCR 69, 2010 SCC 4 (CanLII), the Supreme Court considered when the benefit of an exclusion of liability clause would be denied to a party. Justice Ian Binnie (who wrote the dissent but who set out the test for the enforceability of an exclusion clause, a test that was adopted by the majority), determined that a court might refuse to enforce an exclusion of liability clause on the grounds of public policy.

There is a longstanding debate between freedom to contract and the freedom to have those contracts enforced (see a more general discussion about public policy here). The *Tercon* court discussed this tension in its decision, noting, "[t]he residual power of a court to decline enforcement exists but, in the interests of certainty and stability of contractual relations, it will rarely be exercised" (at para 117). The *Tercon* Court did go on to state, however, that "[t]here are cases where the exercise of what Professor Waddams calls the 'ultimate power' to refuse to enforce a contract may be justified, even in the commercial context. Freedom of contract, like any freedom, may be abused" (at para 118).

In *Tercon*, Justice Binnie determined that public policy would intervene to prevent the enforcement of exclusion clauses where there is "criminality or egregious fraud" but that those were "but examples of well-accepted and 'substantially incontestable' considerations of public policy that may override the countervailing public policy that favours freedom of contract" (at para 120). Rather, "the contract breaker's conduct need not rise to the level of criminality or fraud to justify a finding of abuse" (at para 118). It went on to use *Plas-Tex Canada Ltd. v Dow Chemical of Canada Ltd*., 2004 ABCA 309 (CanLII), as an example of a party that had knowingly supplied defective goods to the customer and rather than disclosing the defect, it chose to rely on the limitation of liability clause.

The ABCA relied on *Roy v Kretschmer*, 2014 BCCA 429 (CanLII), where the British Columbia Court of Appeal prevented the contract breaker from relying on the limitation of liability clause where the fraud occurred "during the currency of the contract", as opposed to a situation involving fraudulent misrepresentation. *Tercon* was considered in *Roy* to show that behaviour need not reach the level of serious criminality or fraud to engage public policy (*Roy* at para 71).

There are strong arguments indicating public policy would override freedom of contract if a fraudulent party is seeking to rely on an exclusion clause. These situations require a careful examination of all the circumstances by the court, which will occur now that this case has been sent to trial.

2. *The Contract*

The contract between Yangarra and Precision contained a commitment maintaining that Precision would drill the well "in a good and workmanlike manner". (This clause is not quoted anywhere in the three judgments, but it is mentioned many times, and the Master specifically refers to it as a promise in the contract (2015 ABQB 433 at para 51).) In addition to this promise, the contract also contained a limitation of liability clause:

> Precision and Yangarra acknowledge and agree that… such allocation shall prevail in the place and stead of any other allocation of risks, responsibilities, or potential losses or liabilities that might be made on the basis of the negligence or other fault of either party or howsoever arising or any other theory of legal liability and notwithstanding the breach or alleged breach by either party or any provision of the drilling program not included in this Article X (10.13(b)). (ABCA at para 6)

Yangarra argued that interpreting the contract to allow Precision to rely on the limitation of liability clause would render this promise meaningless. This would not be the case if Precision sought to rely on it for negligence; clauses such as these are found in most contracts and they protect parties that have been negligent. It is an altogether different scenario, however, to allow a party to hide behind them for fraud. The Master assumed fraud would be allowed under the clause (2015 ABQB 433 at para 49), though this was *obiter*, as he did not find that Precision had acted fraudulently. The chambers judge disagreed (2016 ABCA 365 at paras 26-30), finding that the clause would not exclude liability for fraud. The chambers judge did not find fraud.

The covenant requiring Precision drill the well "in a good and workmanlike manner" is akin to a provision imposing a duty to act in good faith in the carrying out of the contract. In the case of fraud, Yangarra's argument would be correct, as a party cannot behave "in a good and workmanlike manner" while acting fraudulently. Additionally, the Supreme Court's decision, *Bhasin*, recently made two important findings on this issue, about good faith and the duty of honest contractual performance. Even if this covenant had not been included in the contract, the *Bhasin* decision applies here to impose obligations that could not co-exist with an exclusion clause that precludes liability for fraud.

Yangarra did not argue *Bhasin* before the Master but it did argue the case before the chambers judge (who noted that if the parties specifically drafted an exclusion clause to release a claim of fraud, "the theoretical possibility of contracting out of the duty of honest performance" would have to be considered) (2016 ABCA 365, para 31). The ABCA decision, however, did not mention *Bhasin*. I cannot say why, though Yangarra may not have argued *Bhasin* at the appellate level.

3. *The Duty of Good Faith and the Duty of Honest Performance*

In *Bhasin*, the SCC took "two incremental steps in order to make the common law less unsettled and piecemeal, more coherent and more just" (at para 33). First, it recognized an "organizing principle" of good faith in carrying out contractual obligations. Second, it recognized a common law duty of honest performance of contractual obligations. These incremental steps, and in

particular, the duty of good faith, have rendered this decision "seminal". Prior to *Bhasin*, the duty of good faith was imposed in specific circumstances but there was no defining principle to determine why and when it would be imposed (Geoff Hall, "*Bhasin v. Hrynew*: Towards an Organizing Principle of Good Faith in Contract Law" 30 B.F.L.R. 335 at 335).
The duty of honest performance is relatively straightforward and unsurprising. It means, "parties may not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract" (*Bhasin* at para 73). This is not an implied term; it is doctrine that "imposes as a contractual duty a minimum standard of honest contractual performance" (at para 74). Parties cannot exclude the duty of honest performance in their contract (at para 75) but they can modify it, provided they do so expressly (at para 78) and they "respect its minimum core requirements" (at para 77).

Although it may seem that breaching the duty of honest performance would be commensurate with fraudulent misrepresentation, Justice Thomas Cromwell maintained there were differences between the two claims, one being that the duty of honesty "does not require the defendant to intend that the false statement is to be relied on" (*Bhasin* at para 88), unlike the tort of civil fraud. Aside from this being the point at which Justice Cromwell imports a requirement of reliance in the test for fraud, a requirement that was absent in *Bruno*, it also shows that the duty of honesty prevents a fraudulent party from relying on an exclusion of liability clause.

The duty of good faith is not quite as straightforward. The court did not define good faith, leaving it open for lower courts to set the boundaries (*Bhasin* at para 90) and for the principle's continued development (*Bhasin* at para 66). The court did say that the principle would vary depending on the context of the contract, but that it fundamentally requires a party to have "appropriate regard" for the interests of the other party and that a party cannot "seek to undermine those interests in bad faith" (*Bhasin* at para 65). Later, the court maintained that good faith necessitates "a highly context-specific understanding of what honesty and reasonableness in performance require" (*Bhasin* at para 69).

The duties from *Bhasin* prevent a party from relying on limitation of liability clause for fraud. A duty to perform the contract in good faith and a duty of honesty cannot co-exist with a contractual provision that excludes liability for fraud, especially since a contract cannot exclude the duty of honest performance. Even a modified duty of honesty requires "a minimum standard of honest contractual performance" (*Bhasin* at para 74). In addition, the duty of good faith has yet to be defined and it will depend on the context of the contract, but, at the very least, a party cannot act in bad faith, which would include acting fraudulently and expecting to be able to rely on the exclusion of liability clause. Additionally, a party must act reasonably, which arguably restricts parties even more so than a duty of honesty does (see Shannon O'Byrne and Ronnie Cohen, "The Contractual Principle of Good Faith and the Duty of Honesty in *Bhasin v Hrynew*" (1015-2016) 53 Alta. L. Rev. 1 at 10).

Conclusion

If the evidence before the trial court shows that Precision engaged in fraud, the court will have to determine whether a proper interpretation of the exclusion of liability clause offers protection. If so, the bigger issue will be to determine whether a party that has engaged in fraud can have the

benefit of the clause. In my opinion, it cannot, as doing so would be contrary to public policy and it would breach the duties of honest performance and good faith recently articulated in *Bhasin*.

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