Exclusion or Exemption Clauses:
Their Nature, Interpretation and Enforceability

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Gary D. Young, Q.C.
Introduction:

1. Exclusion or exemption clauses (herein “exclusion clauses”) are contractual provisions designed to limit or exclude the liability that a contracting party might otherwise face for its breach of contract. The effect of such a clause is to allocate to one party a risk of loss which, but for the clause, would rest with the other.

2. I propose to briefly examine this area, under the following headings:

   a) The principles of interpretation for those exclusion clauses that attempt to exclude or limit liability for failure to perform contractual obligations and the historical attitude of the courts to these clauses;

   b) The recent decision of the Supreme Court of Canada in *Tercon Contractors Ltd. v. British Columbia (Transportation and Highways)*\(^1\), and other case law;

   c) Clauses that attempt to exclude the liability of a party for its own negligence; and

   d) The principle of immunity or implied release: an exception to the rule that negligence must be expressly released.

The Principles of Interpretation for Those Exclusion Clauses that Attempt to Exclude or Limit Liability for Failure to Perform Contractual Obligations and the Historical Attitude of the Courts to These Clauses

3. Historically, courts have tended to be hostile to exclusion clauses. This is especially so for clauses that purport to exempt a contracting party from liability for its own negligence.

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\(^1\) Tercon; [2010] 1 S.C.R. 69 (S.C.C.)
Hostility has been less where the clause merely limits, rather than excludes a parties liability. However, it appears as though any distinction between these two types of clauses is “a distinction without a difference.”

4. In the past, this hostility led to the creation of special interpretive rules that were inconsistent with the principles of contractual interpretation generally. These principles have always centered around the search for the intention of the parties, to be gathered from the words they have used. When dealing with exclusion clauses, the courts sometimes adopted an attitude towards interpretation that increased the risk that the words used by the parties would not be effective in achieving the result that the parties intended.

5. It was this judicial hostility that, in the 1950s, led the English courts to create the doctrine of fundamental breach, which held that when one party breaches its contract in a fundamental way, then, by operation of law, that party could not rely on an exclusion clause in its favour.

6. There were a number of problems with the doctrine of fundamental breach. Firstly, it did not give effect to the intention of the parties, as expressed in their contract. Secondly, the doctrine failed to recognize that exclusion clauses are often validly used as a means by which to allocate risk. These problems led to the rejection of the doctrine in 1980, in England. In Canada, the doctrine lingered until 1989, when the Supreme Court of Canada rejected the notion of fundamental breach in *Hunter Engineering Co. v. Syncrude Canada*

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2 Canadian Contract Law, Lexis Nexis, 2nd Ed., by Angela Swan, at para. 9.79
3 Canadian Contractual Interpretations Law, Lexis Nexis, 2nd Ed., by Geoff R. Hall, at para. 8.11.1
However, *Hunter Engineering Co. v. Syncrude Canada Ltd.* [1989] SCJ No. 23, and cases that followed it, left uncertainty about the appropriate legal test. This continuing uncertainty led the Supreme Court of Canada to revisit the doctrine in its 2010 decision in *Tercon Contractors Ltd. v. British Columbia (Transportation and Highways)*.\(^7\)

**The Recent Decision of the Supreme Court of Canada in *Tercon Contractors Ltd. v. British Columbia (Transportation and Highways)* and Other Case Law**

7. In *Tercon*, the Court was faced with a dispute between a construction contractor and the Province of British Columbia, arising from a request for a proposal (RFP) for highway construction by the Province. During the bid process, the Province accepted a bid from an ineligible bidder. At issue was whether the Province could rely on an exclusion clause that was worded as follows:

> Except as expressly and explicitly permitted … *(no proponent shall have any claim for compensation of any kind whatsoever)*, as a result of participating in this RFP, and by submitting a Proposal each Proponent shall be deemed to have agreed that it has no claim.\(^8\)

*[italics added]*

The Court determined that the concept of fundamental breach in relation to exclusion clauses should be “laid to rest,”\(^9\) while the majority concluded that the “no claims” clause did not cover the breach in question, whether on its plain meaning or, if ambiguous, via *contra proferentem*.\(^10\)

8. In *Tercon*, Mr. Justice Binnie discussed the judicial history leading to the Court’s final rejection of fundamental breach, as follows:

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\(^7\) See: *Tercon*, supra, at note 1.
\(^8\) *Tercon*, supra, note 1, at para. 60
\(^9\) *Tercon*, supra, note 1, at para. 62
\(^10\) Ibid.
106 This doctrine was largely the creation of Lord Denning in the 1950s (see, e.g., Harrow Karsales Ltd. v. Wallis, [1956] 1 W.L.R. 936 (Eng. C.A.)). It was said to be a rule of law that operated independently of the intention of the parties in circumstances where the defendant had so egregiously breached the contract as to deny the plaintiff substantially the whole of its benefit. In such a case, according to the doctrine, the innocent party was excused from further performance but the defendant could still be held liable for the consequences of its “fundamental” breach even if the parties had excluded liability by clear and express language. See generally S. M. Waddams, The Law of Contracts (5th ed. 2005), at para. 478; J.D. McCamus, The Law of Contracts (2005), at pp. 765 et seq.

107 The five-judge Hunter (Engineering) Court was unanimous in the result and gave effect to the exclusion clause at issue. Dickson C.J. and Wilson J. both emphasized that there is nothing inherently unreasonable about exclusion clauses and that they should be applied unless there is a compelling reason not to give effect to the words selected by the parties. At that point, there was some divergence of opinion.

108 Dickson C.J. (La Forest J. concurring) observed that the doctrine of fundamental breach had “spawned a host of difficulties” (p. 460), the most obvious being the difficulty in determining whether a particular breach is fundamental. The doctrine obliged the parties to engage in “games of characterization” (p. 460) which distracted from the real question of what agreement the parties themselves intended. Accordingly, in his view, the doctrine should be “laid to rest”. The situations in which the doctrine is invoked could be addressed more directly and effectively through the doctrine of “unconscionability”, as assessed at the time the contract was made:

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. [p. 462] [Italics added]

Dickson C.J. explained that “[t]he courts do not blindly enforce harsh or unconscionable bargains” (p. 462), but “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” (p. 462). To enforce an exclusion clause in such circumstances could tarnish the institutional integrity of the court. In that respect, it would be contrary to public policy. However, a valid exclusion clause would be enforced according to its terms. [italics added]

113 The law was left in this seemingly bifurcated state until Guarantee Co. of North America v. Gordon Capital Corp., [1999] 3 S.C.R. 423 (S.C.C.). In that case, the Court breathed some life into the dying doctrine of fundamental breach while nevertheless affirming (once again) that whether or not a “fundamental breach prevents the breaching party from continuing to rely on an exclusion clause is a matter of construction rather than a rule of law” (at para. 52). In other words, the question was whether the parties intended at the time of contract formation that the exclusion or limitation clause would apply “in circumstances of contractual breach, whether fundamental or otherwise” (para. 63). The Court thus emphasized that what was important was not the label (“fundamental or otherwise”) but the intent of the contracting parties when they made their bargain. “The only limitation placed upon enforcing the contract as written in the event of a fundamental breach”, the Court in Guarantee Co. continued,

would be to refuse to enforce an exclusion, of liability in circumstances where to do so would be unconscionable, according to Dickson C.J., or [note the disjunctive “or”] unfair, unreasonable or otherwise contrary to public policy, according to Wilson J. [Emphasis added; para. 52.]
(See also para. 64.)

What has given rise to some concern is not the reference to “public policy”, whose role in the enforcement of contracts has never been doubted, but to the more general ideas of “unfair” and “unreasonable”, which seemingly confer on courts a very broad after-the-fact discretion. [italics added]

9. The Supreme Court in Hunter Engineering had emphasized that there was nothing unreasonable about exclusion clauses and that they should be applied unless there is a compelling reason not to give effect to the words of the parties. In Guarantee Co. of North America, the Court emphasized that what was important was not the label (“fundamental or otherwise”), but the intent of the contracting parties when they made their bargain. However, the concern that had remained after Hunter Engineering and Guarantee Co. was that there was no adequate test to allow a court to determine when it could rely upon unfairness or unreasonableness in departing from these fundamental principles of interpretation. It was this uncertainty that was addressed in Tercon.

10. The three part test outlined in Tercon, to be used to determine whether an exclusion clause applies, is as follows:

1. As a matter of ordinary contractual interpretation, does the exclusion clause apply to the circumstances established in the evidence?

2. If yes, was the exclusion clause unconscionable at the time the contract was made? This issue has to do with contract formation, not breach.

3. If no, should the court decline to enforce the exclusion clause because of an overriding public policy concern which outweighs the very strong public interest in the enforcement of contracts? 11

11. It can be seen that the Tercon test begins with an application of the basic principles of contractual interpretation. It is therefore reconcilable with these principles. 12

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11 Tercon, supra, at paras 121-123
12 Canadian Contractual Interpretations Law, supra, para. 8.11.2
application of this three part test will generally give effect to the words chosen by the parties. At the same time, through the application of parts two and three of the test, the Court has the power not to enforce the parties’ words, where the exclusion clause is abusive, because it is unconscionable, or where its application would be contrary to public policy.

12. In the result, it appears as though Tercon is simply a clearer statement of the law that was first articulated in Hunter Engineering. Thus, Canada’s pre-Tercon case law will likely retain much of its precedential value.13

13. Justice Binnie helpfully provides some examples of exclusion clauses that should not be enforced for public policy reasons. In this regard, he referred to the following:

118 … Take the case of the milk supplier who adulterates its baby formula with a toxic compound to increase its profitability … (this is an extreme example) but the contract breaker’s conduct need not rise to the level of criminality or fraud to justify a finding of abuse.

119 … where the defendant Dow knowingly supplied defective plastic resin to a customer who used it to fabricate natural gas pipelines … Dow chose to protect itself by relying upon limitation of liability clauses in its sales contracts. … The public policy that favours freedom of contract was outweighed by the public policy that seeks to curb its abuse.

120 Conduct approaching serious criminality or egregious fraud … are … examples of … considerations of public policy that may override the countervailing public policy that favours freedom of contract … But, a plaintiff who seeks to avoid the effect of an exclusion clause must identify the overriding public policy that it says outweighs the public interest in the enforcement of the contract … 14

14. One of the few cases in Saskatchewan to consider and apply Tercon is Houweling Nurseries Oxnard Inc. v. Saskatoon Boiler Mfg. Co. Ltd.15 In this case, the Plaintiff had purchased four boilers from the Defendant, for use by the Plaintiff in its nursery business.

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13 See: Assessing Exclusion Clauses by Shannon O’Byrne, 35 Dalhousie L.J. 215
14 Tercon, supra, at paras. 118-120
15 Houweling Nurseries Oxnard Inc. v. Saskatoon Boiler Mfg Co. Ltd. [2011] SKQB 112
The boilers did not work as intended, and the Plaintiff sustained substantial loss. The Defendant argued that its liability to the Plaintiff should be restricted to the amount of its liability insurance coverage, by reason of the following clause:

6. Liability

SASKATOON BOILER MFG. CO. LTD. carries $2,000,000.00 Liability Insurance and its liability is to be limited to the terms and amount of this insurance

(hereinafter the “Limitation Clause”)

In Houweling, R.S. Smith J., after reviewing the contract as a whole, refused to allow the Defendants to rely on the limitation clause as, to do so, in the circumstances, would result in an interpretation that was commercially absurd. Smith J., in effect, applied the first part of the Tercon test, that the exclusion clause did not apply to the circumstances in question.

15. In the pre-Tercon case of UMA/B&V Ltd. v. SaskPower International\textsuperscript{16}, the Saskatchewan Court of Appeal reached a conclusion similar to that of the Court in Houweling. In UMA/B&V Ltd., the Court declined to apply the following limitation clause, on the basis that to apply it would not be commercially reasonable, and the parties could not have intended such a result:

11.4 Limitation

Notwithstanding any other provision of this Agreement, Engineer’s aggregate limit of liability for any and all claims arising or allegedly arising as a result of the Engineering Services, whether based in contract, tort, negligence, strict liability or otherwise shall not exceed:

(a) in cases where and to the extent that Owner’s insurance under Article 13 applies, the amount of the applicable insurance deductible(s); and

(b) in all other cases, the aggregate amount of all payments and compensation received by the Engineer from the Owner for the Engineering Services under this Agreement.

\textsuperscript{16} UMA/B&V Ltd. v. SaskPower International [2007] SKCA 40
16. In *UMA/B&V*, the Court described the following process of contractual interpretation, in what was an ambiguous contract:

[23] The process of contractual interpretation entails ascribing meaning to the terms employed by the parties in formulating their agreement. The object of the process is to ascertain the true intention of the parties along the lines of the general principle aptly summarized by Lord Bingham in the recent case of *BCCI v. Ali*, [2002] 1 A.C. 251 [H.L.] p. 259:

[8] … To ascertain the intention of the parties the court reads the terms of the contract as a whole, giving the words used their natural and ordinary meaning in the context of the agreement, the parties’ relationship and all the relevant facts surrounding the transaction so far as known to the parties. To ascertain the parties’ intention the court does not of course inquire into the parties’ subjective states of mind but makes an objective judgment based on the materials already identified.

A trier of fact is entitled to ask whether the apparent intention of the parties is consistent with commercial reality…

[27] … commercial reality often provides a useful indication of contractual intention, for the assumption, absent good explanation to the contrary, is that rational commercial actors do not intend absurd results when making their bargains: *Guarantee Co. of North America v. Gordon Capital Corp*, [1999] 3 S.C.R. 423.

[26] This is not to be taken as suggesting that the court should do otherwise than give effect to a contract, or a term of contract, that is plainly worded and free of ambiguity, for the parties are presumed to intend the effect or legal consequences of their words: *Eli Lilly & Co. v. Novopharm Ltd.* (supra).

[28] It is ambiguity that so often bedevils the process of interpretation, and not just ambiguity attended by potentially absurd or repugnant consequences. Hence, it is necessary to be mindful of the considerations mentioned in *Consolidated-Bathurst Export Ltd. v. Mutual Boiler and Machinery Insurance Co* …:

[T]he normal rules of construction lead a court to search for the interpretation which, from the whole of the contract, would appear to promote or advance the true intent of the parties at the time of entry into the contract. Consequently, literal meaning should not be applied where to do so would bring about an unrealistic result or a result which would not be contemplated in the commercial atmosphere in which the [contract was entered into]. Where words may bear two constructions, the more reasonable one, that which produces a fair result, must certainly be taken as the interpretation which would promote the intention of the parties. Similarly, an interpretation which defeats the intentions of the parties and their objective in entering into the commercial transaction in the first place should be discarded in favour of an interpretation … which promotes a sensible commercial result.

17. Although *UMA/B&V* was decided pre-*Tercon*, its application is consistent with the first step in the *Tercon* analysis, and would therefore not be decided any differently today.
Clauses that Attempt to Exclude the Liability of a Party for Its Own Negligence

18. Clauses of this nature seek to exempt a contracting party from liability for its own negligence. The interpretation of such a clause is governed by a specific rule that was first set out by the Judicial Committee of the Privy Council, in the case, *Canada Steamship Lines Ltd. v. The King*,\(^\text{17}\) which laid out a three part test that had to be satisfied in order for such a clause to be enforceable. The three criteria that must be satisfied were expressed, in the context of the case, in the following terms:

1. If the clause contains language which expressly exempts the person in whose favour it is made … from the consequence of the negligence of his own servants, effect must be given to that provision…

2. If there is no express reference to negligence, the court must consider whether the words used are wide enough, in their ordinary meaning, to cover negligence on the part of the servants of the *proferens*. If a doubt arises at this point, it must be resolved against the *proferens* … (As) "In cases of doubt, the "contract" is interpreted against him who has stipulated and in "favour of him who has contracted the obligation."

3. If the words used are wide enough for the above purpose, the court must then consider whether "the head of damage may be based on some ground other than that of negligence," to quote again Lord Greene in the *Alderslade* case. The "other ground" must not be so fanciful or remote that the *proferens* cannot be supposed to have desired protection against it; but subject to this qualification, which is no doubt to be implied from Lord Greene's words, the existence of a possible head of damage other than that of negligence is fatal to the *proferens* even if the words used are prima facie wide enough to cover negligence on the part of his servants.

19. Geoff R. Hall, in *Canadian Contractual Interpretation Law*, comments on *Canada Steamship*, at page 285, as follows:

As the *Canada Steamship* test makes clear and as numerous other cases have subsequently reiterated, explicit reference to "negligence" is not required for an exemption clause to apply to liability in negligence: "The rule is not that an explicit reference to negligence is necessary. All that is required is that the intention be adequately expressed." However, there is authority suggesting that **absolving a party of its own negligence can only be achieved by language which**

\(^{17}\) *Canada Steamship Lines Ltd. v. The King* [1952] 212 LR 786 (P.C.)
is in "the clearest terms". (See: Consumers Gas v. Peterborough (City) [1981] 2 SCR 613 at 616 (S.C.C.). 18 [italics added]

and at page 286:

(The application of the test) makes the exercise of interpreting an exemption clause to determine whether it covers negligence an exercise of interpretation like any other – it is to ascribe meaning accurately to the intentions of the parties by considering the language of the contract contextually. “There is no express mention of negligence so the question is: Do the words extend to include it? This is a question of construction and the answer must be found in the context of the whole contract.” This also means that the Canada Steamship test is an aid to revealing the parties’ intentions, it is those intentions which govern. 19

20. Contractual wording that has been found to exclude liability for negligence, without explicit reference to it are:

a) “The carrier shall not be liable in any capacity whatsoever for any … loss of … the goods occurring before loading and/or after discharge …” 20

b) “… shall apply to damage ‘howsoever caused’ …”

c) (All towing is done) “at the sole risk of such vessel or craft and of the owners.” 21

d) Words such as “at sole risk”, “at customers’ sole risk”, “at owner’s risk”, and “at their own risk” will normally cover negligence; and 22

e) “The customer “bears all the risks of loss or damage … and the company shall not be liable for any loss … or damage (howsoever caused) to the goods …” 23

18 Canadian Contractual Interpretation Law, supra, at p. 285
19 Canadian Contractual Interpretation Law, supra, at p. 286
21 See: St. Lawrence Cement Inc. v. Wakeham & Sons Ltd. [1995] O.J. No. 3230
22 See: Chitty on Contracts – General Principles (27th Ed.) at pgs. 642-643
21. The issue is whether the words of the exclusion clause are broad enough to include negligence. This is a question of construction, with the answer to be found in the context of the whole contract. If the limitation clause is worded widely enough to include negligence as being within the reasonable contemplation of the parties in formulating the agreement, then the clause will limit liability for negligence.24

22. Two cases that have refused to apply an exclusion clause for liability for negligence, on the basis of the third branch of the *Canada Steamship* test, are described below:

a) Where a claim arose from the loss of goods on an ocean voyage, a carrier by sea was said to be subject to strict liability for an implied undertaking of seaworthiness. This created a potential head of liability other than negligence, leaving the court to find that the exclusion clause did not apply to the negligence of the carrier.25

b) Where an indemnification clause read:

5.1 *Indemnification by shipper or supplier*

If Rail is made a party to any litigation in connection with any cargo handled or stored, shipper or supplier shall pay all Rail’s judgments, awards, costs and expenses, including reasonable attorney’s fees, that Rail may be liable or compelled to pay in connection with such litigation. [italics added]

as the clause could also be said to apply to claims arising out of disputes over ownership of the cargo being stored.26

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24 See: *International Terminal Operators Ltd.*, supra, footnote 20
The Principle of Immunity or Implied Release: An Exception to the Rule That Negligence Must be Expressly Released

23. This exception to the general rule arises at common law through the application of the principle of immunity or implied release. The principle was developed in commercial tenancies where landlords undertake in the lease to obtain fire insurance. In such cases, the tenant cannot be sued, even where the fire occurs by reason of the negligence of the tenant. Where it is the tenant who undertakes to obtain the insurance, this principle will protect the landlord from suit.27

24. This principle has also been applied in cases where one party to a lease contributes to the cost of insurance, whether or not that party had agreed to purchase the insurance.28

25. The principle of immunity does not appear to be limited to commercial tenancies, as it has been applied by the Alberta Court of Appeal in Bow Helicopters Ltd. v. Bell Helicopter Textron (1981). In this case, the lessee of a helicopter suffered damages through the negligent manufacture by the lessor of the helicopter. The covenant to insure required the lessee to provide “insurance coverage against loss or damage to the helicopter as equipped at the time of delivery to the lessee.” The Court applied the principle of immunity in favour of the lessor manufacturer, and dismissed the claim.29

26. This principle also arises in construction contracts where parties regularly allocate risk by obligating one of the parties to provide insurance for part or all of a construction project.

The seminal case in this area is *Commonwealth Construction Co. v. Imperial Oil Ltd.*,\(^{30}\) where an insurer was prevented from subrogating against a party to the construction contract. If subrogation had been allowed, it would have undone the allocation of risk that the contracting parties had agreed to.

**Summary:**

The attitude of the Courts to exclusion clauses remains such that they will be narrowly construed. A degree of caution is needed, however, in order to be sure that the tests set out in Tercon and Canada Steamship are properly used as interpretive aids towards the ultimate goal of giving effect to the intentions of the parties.

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\(^{30}\) *Commonwealth Construction Co. v. Imperial Oil Ltd.* [1978] 1 S.C.R. 317 (S.C.C.)