Product Liability **February 2008**

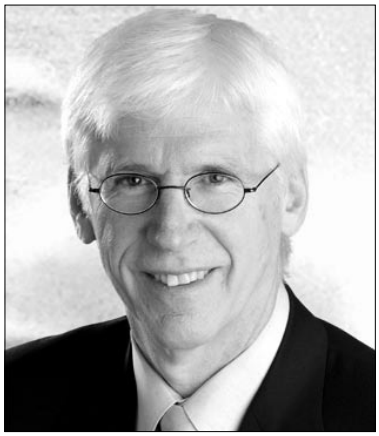
The Manufacturer-Seller's Warranty in Québec: Still "Distinct"!

by Ian Rose

In late November 2007, the Supreme Court rendered a judgment on the law of sale in Quebec in the case of ***ABB Inc. v. Domtar Inc.***[1] *in which it pointed out important differences between Quebec law and the law of the other Canadian provinces regarding limitation of liability clauses. It also clarified its thinking on the scope of the presumption of knowledge of the defect and the defences available to the manufacturer/seller and it dealt with the manufacturer/seller's duty to inform and the extent of the buyer's duty to inform himself.*

The Facts

Domtar purchased a recovery boiler from Combustion Engineering (which subsequently became ABB and Alstom, hereinafter "C.E.") to be erected at its pulp and paper mill in Windsor, Québec. This huge ten-storey boiler is a massive and complex piece of equipment, which contained nearly 75 miles of cooling tubes connected by some 48,000 tie welds. The boiler was designed for continuous use except during scheduled maintenance periods.



At the time of the call for tenders, two suppliers submitted bids. C.E. proposed tie welds while the competitor submitted a bid that used flexible hinge-pin attachments. There was a controversy in the industry at the time regarding the use of the two types of attachments. C.E. had already had problems with a previous version of tie weld but had modified its design to a less rigid one, believing that it had solved the problem. Domtar had asked whether it was possible for C.E. to use flexible hinge-pin attachments and C.E. said it could, adding that this solution would involve an additional cost of $500,000. Domtar decided not to make a change but still accepted C.E.'s bid that included tie welds.

About 18 months after the boiler was put into service, Domtar shut it down for an unscheduled inspection after an unusual noise was detected near the upper region of the superheater. The inspection revealed a few leaks and hundreds of cracks in the superheater tubes, which were repaired. C.E. also replaced some of attachments with flexible hinge-pin attachments and the boiler was returned to service.

Subsequently, Domtar and C.E. continued discussions concerning the cause of the problem in an attempt to resolve it permanently. The parties were unable to come to an agreement, so Domtar decided to replace the entire superheater with another which incorporated flexible hinge-pin attachments and claimed all the costs from C.E.

The Superior Court

The Superior Court had concluded that the cracking of the tubes and the leaks which could result did not constitute a design defect but rather a particular technical feature of the superheater because it could be used as it was despite the cracks. It should be noted that the Superior Court judge stated that a superheater of the same design installed in another Domtar mill operated for its expected lifetime despite the presence of cracks of this kind.

[1] 2007 SCC 50.

However, the Superior Court concluded that C.E. had not fulfilled its duty to inform because it had never disclosed the information it possessed about the respective characteristics of the tie welds and hinge-pins to Domtar. This conclusion was reached even though C.E. proved that Domtar had been advised by consultants specializing in this field and that both these consultants and an employee responsible for the project at Domtar knew of the existence of the controversy regarding the use of tie welds as opposed to hinge-pins.

The Court of Appeal

Without really questioning the trial judge's findings of fact, the Court of Appeal nonetheless reached a different inference regarding C.E.'s liability with respect to the legal warranty against latent defects. It concluded that the evidence clearly established that Domtar was looking for a reliable boiler that would operate without interruption, that C.E. knew this, and that Domtar would not have purchased this boiler had it known that the tie welds could cause unscheduled shut-downs.

As for the duty to inform, the Court of Appeal upheld that C.E. had breached its duty because it knew or was presumed to have known about the defect. C.E. could therefore not rely on the limitation of liability clause either.

The Supreme Court of Canada

The Supreme Court upheld the Court of Appeal's decision that the manufacturer was bound by the legal warranty against latent defects and that it had not rebutted the presumption of knowledge applicable to it. The Court was of the opinion that, in this case, the seller involved here fell within the category of a manufacturer and that manufacturers must be considered to be the "ultimate experts" with respect to the goods because they have control over the labour and materials used to produce them. Consequently, buyers are entitled to expect manufacturers to guarantee the quality of the products they design and be subject to the strongest presumption of knowledge and the most exacting obligation to disclose latent defects[2].

C.E. had pleaded that Domtar was, at the very least, an informed buyer. The Supreme Court agreed that this was a relevant factor in the analysis but the Court applied this factor at a different level. **The seller's expertise is to be considered when determining the extent of his obligation to disclose, while the buyer's expertise is considered when deciding whether the defect is latent or apparent.** Thus, the more knowledge a buyer has about the good being purchased, the more likely it is that a defect in that good will be considered apparent, since an apparent defect is one the buyer has or could have detected at the time of the sale on the basis of his knowledge[3]. The buyer's expertise results in his having an obligation to inform himself by carrying out a reasonable inspection of the good.

As for the presumption of knowledge on the part of a manufacturer, the Supreme Court was of the view that the position it had already expressed in *General Motors Products of Canada* v. *Kravitz*[4] was clear: a manufacturer and a professional seller **are always presumed to be in bad faith** and the buyer's expertise does not eliminate the presumption applicable to them.

Regarding the limitation of liability clause, the Court was of the opinion that if a defect is latent the manufacturer will be unable to rely on such a clause unless it can rebut the presumption of knowledge of the defect[5].

Application of these Principles to the Facts

The Supreme Court recalled the four characteristics essential to the application of the seller's warranty: the defect must be latent, must be sufficiently serious, must have existed at the time of the sale and must have been unknown to the buyer at the time of purchase. The Court also noted that, contrary to the presumption of knowledge imposed on the seller by law, no such presumption applies to the buyer.

Presumption of the Seller's Knowledge of Latent Defects

When a buyer has proven the existence of a latent defect, the seller will be held liable unless it was stipulated that he was selling without any warranty. Even then, the seller will not always be able to invoke such a stipulation because presumed or actual knowledge of the defect can, in certain circumstances, prevent him from relying on such a clause. Since actual or presumed knowledge of a defect on the seller's part results in his being equated to a seller acting in bad faith, the seller, in such a case, is required not only to repay the sale price but also to compensate the buyer for any damage caused by the latent defect. The presumption of knowledge thus plays a decisive role in determining not only whether a seller can limit the warranty against latent defects but also the extent of his liability regarding other damages[6].

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2 para [41].

3 para [42], article 1523 C.C.L.C. and 1726 2nd paragraph C.C.Q.

4 [1979] 1 S.C.R. 90.

5 para [44].

6 para [56].

Rebuttable Nature of the Presumption of Knowledge

In earlier rulings[7], the Supreme Court had already decided that manufacturers and professional sellers are subject to the presumption of knowledge but that they could rebut it. However, the *Kravitz* case had shaken this assertion. In the *Domtar* case, the Court has now upheld the majority view in Quebec law to the effect that the presumption of knowledge is rebuttable, even by manufacturers[8].

It points out that the new wording in the *Civil Code of Québec* had confirmed this majority view, because the legislature had kept the word "presumed" in article 1728 C.C.Q. rather than using "deemed".

As for the ways of rebutting the presumption of knowledge applicable to the manufacturer, the Court has clearly affirmed that **it is never possible for a manufacturer to rely on its own ignorance of the defect as its sole defence**[9]. It has added that the high standard of diligence that manufacturers are required to meet limits the defences available to them to a narrow range. The first of these possible defences is to prove causal fault on the part of the buyer or a third person, or an event of *force majeure* (superior force). The second is of the "state of the art", or "development risk" defence which remains the subject of debate in contractual matters, although it is now partially codified in respect of extra-contractual matters[10]. As C.E. had invoked neither of these defences, it was unable to rebut the presumption of knowledge imposed on it by law.

The Limitation of Liability Clause

The result of the application of the above principles was that C.E. was unable to rebut the presumption of knowledge and was thus unable to contract out of its liability. It therefore could not rely on the limitation of liability clause and was obliged to pay all damages resulting from the latent defect[11].

Comparative Aspects

As the Court was aware of the severity of this position and the fact that the solution may be different in the rest of Canada and even in French law, it carried out a comparative analysis of the rules of Quebec, French and common law regarding latent defects.

It pointed out that French law imposes the same presumption of knowledge of the defect on the seller and also makes it almost irrebuttable. The analysis of the presumption of knowledge on the part of professional sellers also applies to the review of limitation of liability clauses. While such clauses may be valid in principle, they are inapplicable to cases involving professional sellers. The only exception is the situation in which the buyer is also a professional in the same area of expertise who could have detected the defect. A professional seller will always be liable when it would have been impossible for the buyer to detect the defect, regardless of the buyer's status[12].

It states that in Canada, the common law rule is that a latent defect must affect an essential characteristic of the good sold 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, where it is established that the seller could have obtained information about an essential characteristic of the good, the seller cannot simply allege an honest belief that the defect did not exist[13]. With some exceptions, the Canadian provincial and territorial statutes generally allow sellers to limit the warranty against latent defects by contractual clauses. Contrary to French and Quebec law, the common law has no specific rule for the special case of professional sellers and buyers having the same expertise. In principle, a limitation of liability clause negotiated between two commercial enterprises 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[14].

The Court recognized that certain characteristics of the common law of the other Canadian provinces make it difficult to graft onto Quebec civil law. Nor, despite the connections between Quebec civil law and French law, does it appear any more desirable to import the rules of the French system into Quebec law. It concludes therefore that only the rules of the *Civil Code of Québec* must be applied in such cases.

The Court thus concluded that C.E. must be held liable under Quebec law. The existence of the defect resulting in serious potential loss of use, the fact that the defect was caused by the use of tie welds and the fact that the cracking which could result from this was unknown to Domtar at the time of the sale made this a latent defect. The cracking was a latent defect and the latency of this defect had to be analyzed based on the degree of expertise of the buyer, Domtar. However, despite the knowledge Domtar might have had of the problems and the controversy related to the use of tie welds as opposed to flexible hinge-pins, and despite the professional skills of Domtar's consultants, simply having an honest belief in the adequacy of its new version of tie weld was not enough to relieve C.E. of its warranty obligation. It concludes that the good sold was affected by a latent defect of which C.E. had or should have had knowledge and C.E. could thus not invoke its limitation of liability clause.

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7 *Samson and Filion* v. *Davie Shipbuilding and Repairing,* [1925] S.C.R. 202 and *Touchette* v. *Pizzagelli,* [1938] S.C.R. 433.

8 para [66]; also see *Manac Inc./ Nortex* v. *Boiler Inspection and Insurance Co. of Canada,* [2006] R.R.A. 879 (C.A.).

9 para [69].

10 para [72].

11 para [73].

12 para [79].

13 para [80].

14 para [81].

The Duty to Inform

The trial judge concluded that C.E. had breached its duty to inform and the Court of Appeal upheld that conclusion. The Supreme Court recognized that that the duty to inform and the seller's warranty are two overlapping concepts, but said that it is important to distinguish them in order to identify the circumstances in which each rule will be applied.

The duty to inform encompasses any information that is of decisive importance for a party to a contract and it is therefore easy to imagine a situation in which a seller would be in breach of this duty even though no latent defect exists [15].

However, where a seller fails to discharge the duty to disclose a defect of which he has or is presumed to have knowledge, it can be said at the same time that the seller has also breached the general duty to inform the buyer of a factor of decisive importance in respect of the good sold. Thus, when a party invokes the seller's warranty against latent defects, the duty to inform is in a sense subsumed in the analysis of the seller's liability for latent defects and there was no need for the court to conduct a separate analysis of the seller's duty to inform [16].

Comments

This judgment is certainly a landmark decision, because it clarifies the *Kravitz* decision and older rulings concerning the rebuttability of the presumption of knowledge. It also makes a clear distinction between the rules applicable in the common law provinces and those applicable in Quebec.

All manufacturers and professional sellers who sell products in Quebec will be affected by this decision. It will be difficult for them to invoke a clause excluding or limiting liability unless they have succeeded in establishing that the presumption of knowledge and bad faith applicable to them has been rebutted by the rare admissible defences. These are the buyer's own fault, the fault of a third person, an event of *force majeure* (superior force), or the existing state of technical knowledge at the time the good was manufactured. One may now have to consider the potential impact that a detailed disclosure of a product's characteristics may have on establishing the state of technical knowledge at the time of manufacture.

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[15] para [8], also see *Bank of Montreal* v. *Baile Limited*, [1992] 2 S.C.R. 554, p. 586.

[16] para [109].

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