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Principles of Contract Law for Mariners – Obligations to Perform & Fundamental Breach

Costly consequences can flow from incorrectly assuming that another person's failure to abide by a contract relieves you of your obligations under the same agreement.

Whether you manage a multi-million dollar ship repair business, you own and operate a single independent coastal tug, or you sell marine gaskets over the telephone, it pays to understand when, as party to a contract, you must honour your obligations under the contract even though the other party appears not to be honouring theirs. Failing to have this understanding, and saying “they didn’t hold up their end of the bargain, so I’m not going to hold up my end”, can have significant economic consequences even though your position may appear reasonable. To this end, this month’s Legal Desk will discuss the principle of “fundamental breach of contract” and describe how in most cases a fundamental breach of contract is necessary in order for a party to be relieved of obligations under an agreement that is breached by another party.

An Example: Purchase of a Vessel -

In explaining fundamental breach, it is useful to start with a common example, the purchase and sale of a vessel. Hypothetically, Mr. Jones is looking to buy a landing craft on which he can load fuel and supplies for delivery to various customers along the coast. Mr. Jones locates a used landing craft for sale by Mr. Smith, who is selling it “in seaworthy condition” for \$300,000. Smith had bought the vessel from his brother only a month earlier for \$200,000. Jones, in dire need of the vessel, completes a basic visual inspection at the dock and offers to purchase the vessel for \$300,000 with delivery of the vessel to occur at Smith’s dock the following week. Jones pays the \$300,000 to Smith and upon taking delivery of the vessel learns the auxiliary engine requires a rebuild, and several areas of the hull need replating – Jones is quoted \$150,000 to repair the engine and plating. Frustrated by the cost and inconvenience, Jones offers to buy a different but similar vessel the next day, calls Smith to tell him he has left the landing craft at Smith’s dock, and demands the return of his \$300,000.

From Mr. Jones’ perspective, he was being forced to spend \$450,000 for a vessel he had originally agreed to pay \$300,000 – the extra expense is a deal breaker for him. Jones would rather have his money returned and spend it on another vessel than undertake the repairs on the vessel. From Mr. Smith’s perspective, a deal is a deal – he had delivered the vessel and it was capable of transporting goods. Jones had his inspection and decided he wanted the vessel. Smith is faced with having to take back the vessel and find a new buyer, and return the \$300,000 to Jones. If he is unable to find a new buyer for the vessel

at \$300,000, and is forced to sell it for the \$200,000 he bought it for, he would lose the \$100,000 he would have made on the deal with Jones. Smith also has the additional expense of marketing the vessel and paying the insurance and moorage in the meantime.

The Law Supports Enforcement of Contracts -

The law of contract generally supports the enforcement of contracts made between people because the purpose of contract law is not to interfere with business transactions, but to support and encourage them. The law recognizes that bargains may be struck that are more beneficial to some parties than to others, and the fact they are not equally beneficial is no reason to set the agreement aside. The law will be slow to protect someone who, by their own action, strikes a bad bargain.

The law has little sympathy for bad negotiators and careless purchasers.

For the law to take a different approach would mean almost every agreement could be challenged because it was not equally fair to both parties – it would be difficult to rely on the terms of any agreement if this were the case.

In most cases, where a party breaches a term of a contract it is not open to the other party to refuse to complete on their obligations under the contract. There is no “you didn’t hold up your end of the bargain so I am not holding up mine”. The remedy of the person who finds another party breaching is to complete on the contract and sue for the damages suffered as a result of the other party’s breach. In the above example, the remedy of Jones, the purchaser, is not to refuse to take delivery of the vessel and demand his money back, but rather he must take possession of the vessel and sue Smith for the cost of the repairs.

The Exception to the Obligation to Perform: Fundamental Breach -

“Fundamental breach” of a contract is an exception to the rule that a party cannot refuse to complete their obligations under a contract simply because the other party breaches the contract. Courts have said a *fundamental breach* is a breach that “goes to the root of the contract”, “significantly affecting the very thing contracted for”, and “depriving the innocent party of substantially all of the benefit of the contract”.

The leading cases in Canada on fundamental breach is the Supreme Court of Canada’s 1989 decision in *Hunter Engineering v. Syncrude*. In that case, Syncrude sued Hunter Engineering for supplying faulty gear boxes that were used to drive the conveyors that carried sand at Syncrude’s tar sands project. The gear boxes were supplied as part of a larger system of 14 conveyors provided by Hunter Engineering. The gear boxes worked properly for about one year after which they began to fail one by one, affecting four of the conveyors. A design fault in the gear boxes was identified and Syncrude sued to keep monies paid for the equipment. The Court found that the failure of the gearboxes was not

a fundamental breach because Syncrude had taken substantially all of the benefit of the conveyor system despite the failure of the gear boxes, and because the gear boxes could be repaired.

In another example of faulty equipment, a Court refused to find a vendor in fundamental breach of a contract for sale of a used \$12,000 car when the car was delivered requiring an engine rebuild costing \$4,000 – in that case the court found that the vehicle was still substantially what had been contracted for, and purchaser was forced to sue for damages to repair the engine rather than return the car and demand their money back.

In the example of the landing barge, it is unlikely the court would view the delivery of the vessel with engine and hull plate damage to be a fundamental breach allowing Jones to refuse delivery of the vessel. While the vessel required repairs to be in good shape, it could be operated after repairs, and possibly before the repairs were to be made. The vessel was not substantially different from what Jones had bargained for – therefore, there was likely no fundamental breach.

The remedy available to Jones would be to have the repairs made and sue Smith for the cost of the repairs. Undoubtedly, the parties would then argue about whether the re-conditioning of the engine and hull plate were necessary to make the vessel in seaworthy condition, but it would not be open to the Jones to refuse to take the vessel. If Mr. Smith were to buy the second vessel in expectation he would have his \$300,000 returned, he would likely end up owning two vessels, and having to sue for the cost of repairing the first one.

The lesson here is, do not assume that because someone breaches a term of an agreement with you, that you are not bound to complete your obligations. Misjudging the significance of their breach, and wrongfully refusing to complete on your obligations under the agreement, can result in an even bigger problem than simply dealing with the other person's breach.

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