Gibbs & Associates
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Gibbs Law
Summer 2007 Newsletter

A Commentary on Recent Cases and Relevant Legal Issues

1. Construction Contracts - Tenders – S.C.C. Ruling in *Double N Earthmovers Ltd. v. Edmonton* (City).

Earlier in 2007, the Supreme Court of Canada ("S.C.C.") upheld the dismissal of a tendering action against the City of Edmonton (the "City") in an interesting decision that sets out the obligations of owners and bidders in the tendering process.

In June 1986, the City issued a call for tenders on a thirty-month contract to supply equipment and operators to move refuse at a landfill site. The tender documents issued by the City required that all equipment be 1980 or newer.

The Plaintiff was not the successful bidder. Instead, the City awarded the contract to a rival bidder ("S.") and subsequently allowed S. to supply equipment that was manufactured prior to 1980 (contrary to the tender documents).

As a result, the Plaintiff sued the City and alleged that it had breached its contractual duties owed under Contract A (defined below). The Plaintiff also claimed entitlement to profits that would have been realized had it been awarded the contract.

At trial, the judge dismissed the action against the City. The dismissal was upheld by the Court of Appeal. On further appeal to the S.C.C., the Plaintiff's appeal was once again dismissed, and the dismissal of the action against the City upheld.

In general terms, a call for tenders involves a party (the "Owner") requesting the submission of bids to complete a particular project. Where the parties intend to initiate contractual relations, a submission in response to a call for tenders can lead to the formation of Contract A. The call for tenders is the offer by the owner to consider the bids it receives and to enter into the contract to complete the project where a bid is accepted. A bidder accepts that offer by submitting a bid that complies with the requirements set out in the tender documents.

The contractual rights and obligations of the parties to Contract A are governed by the express or implied terms of the tender documents.

A bid also constitutes an offer to enter into Contract B. This is the contract to complete the project for which bids were sought. Where a bid is accepted, the terms of the tender and bid documents become the terms and conditions of Contract B.

In this case, the City's conditions of tender provided that the serial number and the City's licence registration number were to be provided for every piece of equipment,

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that "failure to [comply] either in whole or in part may invalidate the bid", and that the "City reserves the right to reject any and all Tenders, and to waive any informality".

In its bid, S. listed a 1980 unit as Item 1 and a "1977 or 1980 Rental Unit" as Item 2. The City awarded the contract (Contract B) to S., but insisted on compliance with the 1980 requirement. When S. subsequently indicated that it would be supplying a 1979 unit, the City did not pursue the matter further. Although S. eventually replaced this unit, some of the work was performed by pre-1980 equipment through the duration of the thirty-month contract.

On appeal to the S.C.C., the Plaintiff's appeal was dismissed. In doing so, the Court reached several conclusions:

First, the bid accepted by the City was not non-compliant with the tender documents because S. had promised on the face of the bid to supply 1980 equipment for Unit 1. This is what the City accepted, and S. was obliged under the terms of its bid to supply a 1980 unit. That obligation was enforceable by the City.

With respect to Item 2, the conditions of tender specified that not every failure to comply with the tender requirements would invalidate a bid. The absence of licence and serial numbers for the 1980 rental unit in S.'s bid was the sort of informality that would not materially affect the price or performance of Contract B. Since the provision of such numbers was not an essential term of the tender documents, the requirement was capable of being waived by the City.

The bidding process represented a commitment to comply with what was bid. However, the tender documents did not prevent the City from accepting a promise to provide rental equipment or equipment not previously registered with the City. Since S.'s bid was compliant, the City's acceptance of it was not in breach of any obligation of fairness owed to rival bidders.

Second, the City did not breach any duties owed to the Plaintiff by failing to investigate S.'s bid. Each bidder was legally obliged to comply if its bid was accepted, and there was no reason why bidders would expect an owner to investigate whether or not a bidder would comply. There was also neither an express nor an implied obligation in the tender documents for the City to investigate the equipment bid prior to acceptance. Moreover, to imply such a duty would overwhelm and frustrate the tender process by creating unwelcome uncertainties. An owner was entitled (and required) to weigh competing bids on the basis of the information contained in the actual bid and not on the basis of subsequently-discovered information.

It was also noted that allegations raised by rival bidders prior to awarding the contract did not compel owners to investigate the bids made by others.

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Third, by permitting S. to supply equipment manufactured prior to 1980, the City did not violate its duties owed to the Plaintiff under Contract A. The owner's obligation to unsuccessful bidders, and its implied obligation to treat bidders fairly, did not survive the creation of Contract B with the successful bidder. In this case, the conduct complained of by the Plaintiff (i.e., the waiver by the City of the 1980 requirement) occurred after the award of Contract B.

Finally, the S.C.C. concluded that where an owner undertakes a fair evaluation and enters into Contract B on the terms set out in the tender documents, Contract A is fully performed. Once that has occurred, any obligations on the part of the owner to unsuccessful bidders have been fully discharged. Contract B is a separate and distinct contract, and those bidders who are unsuccessful in the tendering process are not privy to it.

2. Insurance - Insurer ordered to Indemnify for Losses due to Blackout - "Mechanical Breakdown Exclusion".

In June 2007, the Ontario Superior Court of Justice granted summary judgment to a food processing company (the "Plaintiff") on a motion to compel its Insurer to indemnify it for lost raw materials, clean-up expenses, and costs for equipment repairs at one of its plants as a result of the "great blackout" of August 14, 2003 (the "Blackout").

The Blackout interrupted power to the Plaintiff's pickle processing plant for approximately twenty-seven hours. It caused the refrigeration system and processing equipment to cease operating, with the result that a large quantity of cucumbers and pickles at various stages of processing were spoiled and had to be thrown away. Costs were also incurred to clean up the mess caused by the spoilage. Further, when power was restored, the lower-than-normal voltage caused damage to some equipment. The Plaintiff also suffered a loss of profits as a result of the four to five day shut-down.

The Insurer denied coverage under a Comprehensive Business Policy issued to the Plaintiff (the "Policy"), relying on an exclusion for "Mechanical Breakdown" (as defined below).

The Plaintiff sued the Insurer and brought a motion for summary judgment, seeking a declaration that the Insurer was liable to indemnify it for its losses.

On the hearing of the motion, the Insurer clarified that coverage was being denied by reason of the excluded perils described in the Policy, as follows:

> This form does not insure against loss or damage caused directly or indirectly…
>
> by centrifugal force, *mechanical or electrical breakdown or derangement in or on the premises*, but this exclusion does not apply to

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loss or damage from any ensuing fire or 'accident to an object' as defined and limited in Section 20.i. of this form… (emphasis added)

(the "Mechanical Breakdown Exclusion")

The main issue before the Court was the interpretation of the Mechanical Breakdown Exclusion. The Insurer conceded that the Plaintiff's claim fell within the insuring agreement, and that the Blackout was one of the causes of the loss. However, the Insurer submitted that an excluded peril - mechanical or electrical breakdown or derangement - was also a cause of the loss, such that the Insurer was not required to indemnify the Plaintiff. For its part, the Plaintiff disputed that any loss resulted from a mechanical or electrical breakdown or derangement, as defined in the Policy.

In his analysis, the motions judge set out the well-established principles underlying the interpretation of insurance contracts, as follows:

(i) A court should search for an interpretation which, from the whole of the contract, would appear to promote the true intent of the parties at the time of entry into the contract. As such, literal meanings should not be applied where this would bring about an unrealistic result or a result which would not be contemplated in the commercial atmosphere in which the insurance was contracted;

(ii) Policies are to be interpreted based on the plain and ordinary meaning of the language they use;

(iii) Coverage provisions should be construed broadly and exclusion provisions narrowly; and

(iv) All-risks policies of insurance cover damages due to some fortuitous circumstance or casualty.

The motions judge rejected the Insurer's argument that the sudden cessation of the Plaintiff's equipment constituted a "breakdown" within the meaning of the Policy. In doing so, the judge reviewed several cases dealing with the interpretation of the "Mechanical Breakdown Exclusion" and concluded that the exclusion denoted a failure in the operation of a piece of equipment due to some mechanical or electrical defect internal to some part or parts of the equipment. It therefore followed that where a machine ceased to operate because of an interruption to its power supply due to a regional blackout (for example), a mechanical or electrical breakdown of the machine could not be said to have occurred.

The motions judge concluded that the Blackout caused the Plaintiff's loss and that while it may have caused the Plaintiff's equipment to cease functioning (thereby spoiling produce), the cessation of functioning did not constitute mechanical or electrical breakdown or derangement in or on the premises within the meaning of the Policy.

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In the result, the Court granted summary judgment to the Plaintiff, declaring that the Insurer was liable to indemnify it for the losses identified in its proof of loss (with the quantum to be determined on an appraisal pursuant to section 128 of the *Insurance Act*).

Incidentally, the motions judge observed that if the Insurer had truly intended to exclude blackouts from perils covered by the Policy, it would have been a simple matter to specifically do so, rather than trying to rely on the Mechanical Breakdown Exclusion in order to deny coverage.

This case proves, once again, that coverage issues are never as simple as they may appear to be at first glance.

3. Construction Law 101 – Part I. - The Construction Pyramid.

In order to properly understand the corresponding lien rights and obligations arising between various parties involved in any large or small construction project, it is important to understand the parties' respective roles in the construction pyramid.

At the top of the pyramid is the lender or mortgagee who finances the project. Next is the "owner" who is either the registered owner of the land or a tenant. Owners have two basic kinds of obligations; i.e., "trust" and "holdback" obligations.

The trust obligation requires the owner to use funds received from the lender to pay its contractor on the project before paying anyone else. The holdback obligation requires the owner to hold back at least ten percent of the value of the work in place and to deduct it from progress draws.

Next in line is the contractor. Anyone who has a contract with the owner to improve the land is a contractor. However, for most projects there is a general contractor who organizes the construction and a chief consultant engineer or architect who designs the building and who may also have a supervisory role in the construction. Like owners, contractors also have trust obligations to ensure that monies received from the owner are applied to paying their subcontractors on the project before paying any other parties. Contractors also have an obligation to hold back monies from their subcontractors.

A subcontractor refers to anyone who has a contract with a contractor to improve the land. Subcontractors have the same trust and holdback obligations as contractors and owners vis-à-vis their own sub-subcontractors.

Everyone below the sub-contractor has the same trust and holdback obligations until the lender's money has reached the actual workers and suppliers, who are at the bottom of the construction pyramid. Workers and suppliers benefit from the trust obligations of those higher up in the construction pyramid and are entitled to register liens under the *Construction Lien Act* (the "*Act*"). However, they themselves do not have any

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trust or holdback obligations imposed upon them.

There are three kinds of statutory holdbacks; namely, the basic holdback, the notice holdback and the finishing holdback. The basic holdback requires the owner to retain from each progress draw ten percent of the value of the goods and services supplied to the site by the contractor (s. 22(1) of the *Act*). The basic holdback can only be released by the owner forty-five days after "substantial completion" (as defined in the *Act*), provided that no liens are registered on title at that time.

The notice holdback (s. 24) relates to the owner's duty to maintain an additional holdback when he/she receives written notice of a lien from one of the trades. Where an owner has received such notice, the owner must increase the holdback retained from the contractor by the face amount of the lien until the lien has been discharged or vacated from title.

The finishing holdback is a separate holdback for work done after "substantial completion. The finishing holdback is released forty-five days after "completion" of the project (as defined in s. 2(3) of the *Act*), again provided that no liens are registered on title as of that time.

The three statutory holdbacks are intended for the benefit of the sub-trades who work on the project and not the owner. As a result, the owner often includes a contractual holdback for deficiencies, which gives the owner the right to retain a separate holdback for deficient work on the project.

Please look out for "Construction Law 101 – Part II – Labour and Material Bonds" in our next edition of Gibbs Law.

For more information on construction liens and/or holdback and trust obligations, please contact Kris Hutton or Jennifer Roberts-Logan.

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