CONSTRUCTION LAW LETTER

Volume 33 • Number 2 November/December 2016

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CASE SUMMARY

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CHANGING THE LEGAL LANDSCAPE OF THE INTERPRETATION OF BUILDER'S RISK INSURANCE POLICIES IN CANADA: LIFE AFTER *LEDCOR*

Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.

On September 15, 2016, the Supreme Court of Canada released its unanimous decision in *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co*.

The *Ledcor* case involved a claim under a builder's risk policy of insurance. The facts of the case involved a contractor who was hired to clean the windows of an office building under construction in Edmonton. The windows were scratched by these cleaners, and ultimately needed to be replaced. The replacement cost of the windows was claimed by the owner and the general contractor under the builder's risk policy in place on the project. The claim was denied based on the following exclusion in the policy: "the cost of making good faulty workmanship". The policy contained the words "that results" from the faulty workmanship as an exception to the exclusion for "physical damage".

Trial Decision

At trial, the judge determined that the work performed by the contractor amounted to faulty workmanship. The trial judge then applied the *contra proferentem* rule in interpreting the policy against the insurers and concluded that the faulty workmanship exclusion did not exclude from

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CONSTRUCTION
LAW LETTER

Construction Law Letter is published six times a year by LexisNexis Canada Inc., 111 Gordon Baker Road suite, Suite 900, Toronto, Ont., M2H 3R1, and is available by subscription only.

ISBN 0-433-40930-4 ISSN 433409304
ISBN 0-433-44380-4 (Print & PDF)
ISBN 0-433-44664-1 (PDF)

Subscription rates: $280
$380 (Print & PDF)

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coverage the damage that the contractor had caused to the building's windows. The policy was a builder's risk policy which insured against "all risks" of direct physical loss or damage. The relevant exclusion in the policy stated as follows:

> The Exclusion Clause excludes from coverage the "cost of making good faulty workmanship", but provides an exception for "resulting damage":
>
> 4(A) Exclusions
>
> This policy section does not insure:
>
> (a) Any loss of use or occupancy or consequential loss of any nature howsoever caused including penalties for non-completion of or delay in completion of contract or non-compliance with contract conditions;
>
> (b) *The cost of making good faulty workmanship*, construction materials or design *unless physical damage* not otherwise excluded by this policy *results*, in which *event this policy shall insure such resulting damage*. (emphasis added.)

The trial judge concluded the cleaning work that the subcontractor, Bristol Cleaning, had carried out constituted "workmanship" and that it had been faulty. He found, however, that the exclusion clause did not exclude from coverage the damage that Bristol's faulty workmanship had caused to the windows of the building. In particular, he found the exclusion clause ambiguous and the interpretations of "the cost of making good" advanced by the insureds and insurers equally plausible. He therefore applied the doctrine of *contra proferentem* against the insurers. The insureds argued that the "cost of making good" encompassed only the cost of redoing the cleaning work, whereas the insurer argued that the "cost of making good" encompassed both the cost of redoing the cleaning work and the damage to the windows, as the windows were the very thing in relation to which Bristol had performed the faulty workmanship. The exclusion clause was therefore interpreted narrowly.

Court of Appeal

On appeal, the court reversed the trial judge's decision and found that the damage to the building's windows was excluded from coverage. It applied a correctness standard

of review to the interpretation of the policy and held that the trial judge improperly applied *contra proferentem* because the exclusion clause was not ambiguous.

The Court of Appeal noted that policy covered "physical loss or damage". It stated that the exclusion clause had to exclude physical damage of some kind, otherwise the clause would be redundant. The key issue to be determined was therefore the "dividing line" between physical damage that was excluded as "the cost of making good faulty workmanship" and the physical damage that was covered as "resulting damage". To establish this dividing line, the court devised a new test of "physical or systemic connectedness". The three primary considerations to be applied in this test were articulated as follows:

> (1) the "extent or degree to which the damage was to a portion of the project actually being worked on at the time, or was collateral damage to other areas";
>
> (2) the "nature of the work being done, how the damage related to the way that work is normally done, and the extent to which the damage is a natural or foreseeable consequence of the work"; and
>
> (3) "[w]hether the damage was within the purview of normal risks of poor workmanship, or whether it was unexpected and fortuitous".

In applying this test, the Court of Appeal concluded that the damage to the windows was physical loss excluded as the "cost of making good faulty workmanship" because it was **not** accidental or fortuitous, but was directly caused by the scraping and wiping motions involved in Bristol's cleaning work, which was a core part of the work to be performed. The damage was not only foreseeable, but highly likely.

Supreme Court of Canada

On appeal to the Supreme Court of Canada, the Court reviewed two issues, being the standard of appellate review, and the proper interpretation to be given to the faulty workmanship exclusion clause and the resulting damage exception to that clause. In respect of the first issue, the Supreme Court of Canada determined that the applicable standard was one of correctness. The Court noted that the insurance policy was a standard form contract, sometimes referred to as a contract of adhesion, and, based on the analysis set out in *Sattva Capital Corp. v. Creston Moly Corp.*, applied a correctness standard.

In respect of the second issue, involving the interpretation of the insurance policy, the Court referred extensively to its decision in *Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada*. In *Progressive Homes*, the Court had noted that the "primary interpretive principle is that where the language of the insurance policy is unambiguous, effect should be given to that clear language, reading the contract as a whole". Where the language of a policy is ambiguous, general rules of contract interpretation must be employed to resolve that ambiguity, including: that the interpretation should be consistent with the reasonable expectations of the parties, as long as that interpretation is supported by the language of the policy; it should not give rise to results that are unrealistic or that the parties would not have contemplated in the commercial atmosphere in which the insurance policy was contracted; and it should be consistent with the interpretations of similar insurance policies. Only then, if ambiguity remains after these principles have been applied, can the *contra proferentem* rule be employed to construe the policy against the insurer. Also, according to *Progressive Homes*, coverage provisions in insurance

policies are to be interpreted broadly and the exclusion clauses are to be interpreted narrowly.

Furthermore, the Supreme Court of Canada confirmed that the insured has the onus of establishing that the damage or loss claim falls within the initial grant of coverage. The onus then shifts to the insurer to establish that one of the exclusions to coverage applies. If the insurer were to be successful, the onus shifts back to the insured to prove that an exception to the exclusion applies.

The Supreme Court of Canada concluded that the new physical or systemic connectedness test articulated by the Court of Appeal was unnecessary. The Court of Appeal had found that this test was necessary to establish a dividing line between "making good faulty workmanship" and "resulting damage". The Supreme Court of Canada found that the Court of Appeal's premise was flawed because the "faulty workmanship" exclusion need not encompass physical damage. In this regard, the Supreme Court of Canada again referred to *Progressive Homes*, noting that the Court had stressed that "perfect mutual exclusivity [between exclusions and the initial grant of coverage] in an insurance contract is not required".

The Court concluded that the language of the exclusion clause "slightly favours the interpretation advanced by the Insureds, but is nonetheless ambiguous". The insurers had taken the position that both the cost of redoing the faulty work and the cost of repairing that part of the insured's property that is the subject of the faulty work was excluded and the only coverage for resulting damage would be for consequential damage to some **other part** of the insured property or project The insureds, in contrast, argued that the cost of redoing the faulty work (*i.e.*, cleaning the windows) was excluded from the coverage, but the consequences of the faulty work (*i.e.*, the damage to the windows necessitating their replacement) was covered.

In applying the general principles of contract interpretation, the Supreme Court of Canada found that the interpretation that was consistent with the reasonable expectations of the parties and commercial reality was that faulty workmanship exclusion served to exclude from coverage **only** the cost of redoing the faulty work, and that the resulting damage exception covered costs or damages apart from the cost of redoing the faulty work. As a result, the Supreme Court of Canada concluded that the cost of re-cleaning the windows was excluded, but the damage to the windows and the cost of their replacement was covered. The Court therefore found that it was not necessary to turn to the *contra proferentem* rule in interpreting the policy.

In respect of the parties' reasonable expectations, the Court noted that it was "crucial" to review the purpose behind builder's risk policies, which it described as follows:

> In a nutshell, the purpose of these polices is to provide broad coverage for construction projects, which are singularly susceptible to accidents and errors. This broad coverage — in exchange for relatively high premiums — provides certainty, stability, and peace of mind. It ensures construction projects do not grind to a halt because of disputes and potential litigation about liability for replacement or repair amongst the various contractors involved. (para. 66)

The Court found that the purpose of this broad coverage in the construction context was furthered by an interpretation of the exclusion clause that excluded from coverage **only** the cost of redoing the faulty work itself, which on the facts of this case was only the cost of re-cleaning the windows.

The Court further noted that builder's risk policies are the norm on construction projects in Canada in relation to which contractors "believe indemnity will be available in the event of an accident or

damage on the construction site arising as a result of a party's carelessness or negligent acts" which are the most common sources of loss on construction sites.

The Court found that an interpretation of the exclusion clause that would preclude from coverage any and all damage resulting from a contractor's faulty workmanship merely because the damage results to that part of the project on which the contractor was working would undermine the purpose behind builder's risk policies. The Court stated that such an interpretation would "essentially deprive insureds of the coverage for which they contracted". This determination is an important one as it indicates a willingness to consider a wider ambit of the exception for resulting damage than has been applied in a number of previous Canadian decisions. The Court did review a number of these decisions and found its interpretation of the faulty workmanship to be consistent with those cases. The Court specifically noted that courts had generally interpreted the resulting damage exception as encompassing damages done to something other than the property which is "faultily" designed, but stated that this was not inconsistent with the Court's finding that the exclusion excludes only the cost of redoing the faulty work. The Court noted that the design in these other cases was "integral to the whole of that item".

The Court stated that its interpretation struck the right balance between two undesirable extremes, being: at one end of the spectrum allowing the insurer to pocket the premium without risk; and at the other end of the spectrum, allowing the insured to receive a recovery which could neither be sensibly sought nor anticipated at the time of the contract. In considering the context and the purpose of the builder's risk policy at issue, the Court noted that the insurers did not undertake to cover the "cost of making good faulty workmanship", but did promise to cover "physical damage [that] results" from that "faulty workmanship". The Court stated that its interpretation did not transform the insurance policy into a construction warranty and did not inappropriately re-allocate risk.

As noted by the Court, the cases are highly fact specific and the results reached will be largely dictated by the particular circumstances of each case. However, the Court's decision in *Ledcor* indicates that courts will take a much more expansive and purposive approach to the resulting damage exception than was applied in previous Canadian cases which addressed faulty design exclusions. The decision also indicates that insureds may not be required to resort to divisibility of property concepts to argue that a resulting damage exception applies to faulty workmanship, depending on the circumstances of the case.

The Supreme Court of Canada has provided clear guidance that the purpose of builder's risk policies, which is to provide key coverage for fortuitous and accidental losses on construction sites, must be taken into consideration in evaluating the applicability of exclusions in these policies.

Supreme Court of Canada
McLachlin C.J.C., Abella, Cromwell, Moldaver, Karakatsanis, Wagner, Gascon, Côté & Brown JJ.
September 15, 2016

CASE SUMMARY

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COMPARING APPLES TO INVISIBLE ORANGES: ASSESSING DAMAGES IN TENDER CASES

Elan Construction Ltd. v. South Fish Creek Recreational Assn.

In its recent decision in *Elan Construction Ltd. v. South Fish Creek Recreational Assn.*, the Alberta Court of Appeal once more re-affirmed the importance of protecting the integrity of the tendering process. In so doing, the court agreed with the trial judge that the discretionary provisions in the bidding documents in question did not protect the project owner from liability for evaluating bids in a manner inconsistent with the tender documents. The court further clarified a second principle regarding the assessment of damage with respect to loss of profits on a contract awarded in breach of Contract A (the bidding contract): the burden is on the defendant-owner to show that the winning contractor's actual losses would also have been incurred by the plaintiff that should have been awarded Contract B (the construction contract).

In summary, Elan was the lowest bidder on a Calgary arena expansion project of the South Fish Creek Recreation Complex (now Cardel Rec South) tendered in the summer of 2010. The bid documents stressed the importance of substantial completion by August 1, 2011 twinned with significant daily liquidated damages against the general contractor who failed to achieve this milestone.

Bids were to be evaluated under a matrix which provided for a maximum of 100 points to be allocated as follows:

Criteria	**Points**
Price	35
Date of Completion	35
Previous Community and Arena Experience	20
References for above Projects	10

The tender attracted 10 bids from well-known large general contractors. The bids were opened immediately post-tender, at which time it was publicly disclosed that Elan was the lowest bidder. The balance of the bid information was kept confidential and the South Fish Creek Recreation Association (SFCRA) building committee spent the following month evaluating and scoring the bids. In early September, 2010, the SFCRA awarded Contract B to the second lowest bidder, Chandos Construction. Elan knew that it had the lowest price and had committed to the August 1, 2011 completion date. It also heard that the Chandos bid had a later completion date. This was enough information for Elan to sue SFCRA for having breached Contract A.

It was discovered during the litigation that, as expected, the SFCRA awarded Elan maximum

points, 35, for Price. Chandos was awarded 24 points for Price. However, Chandos was awarded higher points, 34, for a substantial completion date of September 1, 2011 than was Elan, 25, for committing to substantial completion a month earlier, August 1, 2011. At trial, it was evidenced that the SFCRA's architect created a scoring methodology based on proximity to an average completion date of some but not all of the 10 bids submitted.

The trial judge found that SFCRA breached Contract A by departing from the evaluation matrix in several material respects including and, in particular, the unexpected scoring of the Date of Completion category. The SFCRA scored the bids as follows:

	Bid Price	Bid Price Points	Completion Date	Completion Date Points	Previous Experience	References	Total Score
Elan	$13,150,000	35	Aug. 1, 2011	***25***	12	7	***79***
Chandos	$13,548,000	26	Sep. 1, 2011	***34***	19	8	***87***

The trial judge would have scored the bids as below:

	Bid Price	Bid Price Points	Completion Date	Completion Date Points	Previous Experience	References	Total Score
Elan	$13,150,000	35	Aug. 1, 2011	***35***	12	7	***89***
Chandos	$13,548,000	26	Sep. 1, 2011	***24***	19	8	***77***

It is noted that the trial judge found that there was a breach of Contract A in other respects, including reliance on undisclosed criteria, but did not need to adjust scoring under the Previous Experience category to satisfy himself that Elan should have won the tender.

The trial judge also agreed that Elan had proved damages in the form of lost expected profit of $705,000. Elan did so by evidencing the profit built into its bid and by historical profit margins on similar general contracts.

However, the SFCRA called to trial a Chandos witness who testified that Chandos did not complete the project on time and lost approximately $400,000 due to several factors including unexpected underground piping, design errors and a brutal winter. The trial judge accepted this testimony as a negative contingency that Elan, too, would have suffered and reduced Elan's award to $1,000 in nominal damages.

Elan appealed the damages award. The SFCRA cross-appealed on liability.

The appeal was heard on June 16, 2015, by the Alberta Court of Appeal, led by Chief Justice Catherine Fraser. The panel issued its unanimous

judgment less than a month post-hearing on July 11, 2016.

The court dismissed the SFCRA's cross-appeal. In so doing, the court reiterated that the integrity and credibility of the bidding process must be "scrupulously preserved". The court saw no error in the trial judge's conclusion that how the SFCRA actually evaluated the bids was such a departure from the reasonable expectations of bidders that it constituted a breach of Contract A. The court also rejected the SFCRA argument that the discretion clause in the tender documents gave it free licence to evaluate the bids as it saw fit:

> There is no doubt that the language of "sole and unfettered discretion" allows owners considerable room to manoeuvre when it comes to assessing bids. This is properly so, since it is not possible to assess with complete precision criteria that include a degree of subjectivity. … a reference to an owner's being entitled to evaluate criteria in their sole and unfettered discretion cannot include the right to depart from fundamental contents of the Instructions to Bidders on which bidders would properly and reasonably place reliance in composing their bids.

It is suggested that this passage is an important takeaway from this judgment. It appears that that the owners will be afforded less latitude in assessing more objective bidding criteria regardless of a broadly worded discretionary provision.

The court allowed Elan's appeal for two reasons. As a threshold matter, the court agreed that because the defence of negative contingency was not raised by the SFCRA in its pleadings, the defence could not be the basis of the trial judge's decision on damages. More substantively, the court ruled that the SFCRA failed in its onus to prove that Elan would have suffered the same monetary losses as did Chandos.

The limited evidence at trial was that many of the issues which caused Chandos to lose money were or should have been compensable pursuant to the terms of Contract B, a CCDC-2 Stipulated Price Contract. Chandos did pursue extra compensation from the SFCRA post-completion of the project. The Chandos witness testified to an easily negotiated settlement with the SFCRA and its architect, motivated, at least in part, by Chandos' preference to avoid litigation. The court noted that to assume that Elan would not (or could not) have pursued its full contractual rights was an error. Similarly, the court found that it was an error to assume Elan would have compromised its claims as did Chandos.

Ultimately, the court found that the Chandos losses were evidenced in a superficial manner and that there was a lack of evidential ability to compare the actual Chandos outcome and a predictable outcome for Elan:

> In sum, Fish Creek was not just attempting to have the trial judge compare an apple and an orange. It was an attempt to get the trial judge to compare a visible apple and an invisible orange.

The relevance to damages of what, in fact, became of Contract B in this type of bidding case means that litigants are obliged to, effectively, simulate or re-do the construction project with the plaintiff as contractor. This would call for the discovery of actual project records for consideration by experts to opine on what would have been. A plaintiff-contractor could claim for not only the foregone expected profit on Contract B as bid, but on the additional profit it would have earned, for example, on change orders. For its part, a defendant-owner could argue, for example, that inflated material costs on a fixed-price contract would have undermined the plaintiff's profit expectations.

It is suggested that this is the second important takeaway from this case: the defendant-owner must both plead and prove that the plaintiff-

bidder who should have been awarded the contract was spared a loss instead of denied a gain. On the other side of the coin, the plaintiff-contractor seeking damages beyond the expected profit in its bid price needs to plead and prove that the scope and price of the general contract increased post-tender.

Alberta Court of Appeal
Catherine Fraser C.J.A., Peter Martin, Jack Watson JJ.A.
July 11, 2016

CASE SUMMARY

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McInnes Cooper, St. John's

Bryinne McCoy
McInnes Cooper, St. John's

WHAT DOES SUBSTANTIAL COMPLIANCE LOOK LIKE? NL SUPREME COURT TAKES A GANDER

Penney v. Eastern Region Integrated Health Authority

R.J.G. Construction Ltd. v. Newfoundland and Labrador (Transportation and Works)

It's clear that owners are obligated to treat all bidders in the tender process fairly, and the standard to which a court will hold an owner's bid evaluation is substantial compliance with the tender. But what exactly does "substantial compliance" entail? In two recent Newfoundland and Labrador Supreme Court decisions, the court takes a gander and gives both bidders and owners practical insight into the obligations of owners in evaluating tender bids and what "substantial compliance" can look like — and should make unsuccessful bidders considering a claim against an owner based on non-compliance blink before forging ahead.

Penney v. Eastern Region Integrated Health Authority

The issuer of a tender can only determine if a bid is compliant based on the information it did review (or ought to have reviewed) during the bid evaluation process; information it subsequently discovers is irrelevant to determine bidder compliance and doesn't negate it, and an issuer has no obligation to verify the compliance of any bid submitted absent an express commitment in the tender documents to do so. If all bidders are treated fairly and equally under Contract A, an owner's obligations to unsuccessful bidders is fully discharged upon the creation of Contract B.

The Case: The Health Authority issued a tender for interested parties to bid on a contract for the provision of courier, freight, and linen transportation services on four routes; the tender required each bidder to provide their own vehicles meeting the tender specifications. After closing, the Authority evaluated the bids and determined all were compliant — but its evaluation didn't include an investigation of the vehicles each bidder proposed. R.M.S Pope Inc. was the lowest bidder on three of the four routes; 10488 Newfoundland and Labrador Ltd. was the lowest bidder on the fourth by only $3.84. The Authority had the power to award the contract in whole or in part, and sent R.M.S. an award letter for all routes. Shortly after R.M.S. started work, another bidder advised the Authority that the vehicles R.M.S. was using didn't meet the mandatory tender specifications; the Authority informed R.M.S. it wouldn't waive the specifications and R.M.S. complied. That bidder and another made a claim on the basis the R.M.S. bid was non-compliant; the Authority applied to the court to dismiss the claim on the basis it was.

The Decision: The Newfoundland and Labrador Supreme Court agreed with the Health Authority, deciding the R.M.S. bid was indeed compliant. The court based its decision on these key principles the Supreme Court of Canada enunciated:

- A "Contract A/Contract B" analysis applies to the tendering process. Contract A comes into existence when a contractor submits a compliant bid in response to an owner's invitation to tender. Contract A's terms and conditions are governed by the terms and conditions of the call for tender; this usually includes a term that if the owner accepts a contractor's bid, that contractor will be obliged to enter Contract B (the construction contract). Contract A can also impose other obligations on the parties, the nature and extent of which is determined by examining the tender terms and conditions in each case.

- An implied term of Contract A is that the owner will only accept a compliant bid, although an owner can, by clear and explicit words, reserve the right to accept a non-compliant bid.

- Contract A includes an implied term that the owner will treat all bidders fairly and equally in the assessment of bids, having regard to the tender terms; but an owner can reserve certain privileges in the tender documents, provided the implied duty of fairness is not breached.

- The test for bid compliance in the tendering process is "substantial", rather than strict, compliance. If an owner reserves the right, it can waive an informality — something that doesn't materially affect the price or performance of Contract B — without breaching Contract A with the other bidders. Substantial compliance requires that all material conditions of a tender, objectively determined, be complied with; the determination of substantial compliance requires an analysis of the tender terms and conditions, including any "privilege clauses" and material conditions. And even if a bid contains non-compliant options, where the owner accepts only the compliant option, there's no breach of the obligation of fairness owed to other bidders.

The court concluded that without an express commitment to do so, owners aren't required to investigate whether a bidder will comply with the terms of the tender because each bidder is legally obliged to comply if their bid were to be accepted. Allegations of non-compliance raised by rival bidders don't require owners to investigate the bids; this would encourage unwarranted and unfair attacks and invite unequal treatment. An owner can only determine compliance based on the information it did review (or ought to have reviewed) during the bid evaluation process; information it subsequently discovered but didn't know during evaluation isn't relevant in determining whether a bid was compliant. There's only an obligation to inspect the bidder's property (like vehicles in this case) when the owner has specifically and clearly stated that compliance with certain tender specifications will be investigated; in this case, there was no express commitment in the tender to inspect bidder's vehicles so no obligation on the Authority to investigate compliance of R.M.S.'s bid before accepting it and entering into Contract B. The Authority fully discharged any obligations it owed unsuccessful bidders, including those making the claim, when it entered Contract B with R.M.S. Contract B is a distinct contract to which the unsuccessful bidders aren't a party; any obligation the Authority owed to a claimant as a result of it submitting a compliant bid didn't survive the creation of Contract B

between the Authority and RMS. So even though it didn't, the Authority could have waived vehicle compliance after entering into Contract B in any event.

R.J.G. Construction Ltd. v. Newfoundland and Labrador (Transportation and Works)

Before making a claim based on non-compliance, beware: the standard in Contract A between the owner and bidder is substantial, not strict, compliance — even if clauses of the tender contain mandatory terminology suggesting strict compliance is required. Successful bids won't be rejected based on defects that don't affect the contract price, the work to be done or the owner's ability to determine whether the bidder in question has complied with the tender call in a manner that wasn't unfair to the other bidders.

The Case: The Government of Newfoundland and Labrador issued an Invitation to Tender for construction of a new wharf. The instructions to bidders contained the following instructions: tenders not submitted on the tender form provided will not be considered; incomplete tenders will be rejected; and incorrectly prepared tenders may be rejected. Amendments to the bids could be made by telegram, fax or telex as per the instructions to bidders. The tender's supplementary general conditions also stipulated that "failure to acknowledge receipt of addenda in the tender form will be considered an incomplete tender"; the Government issued five addenda with respect to the invitation to tender. Several companies, including B&R Enterprises Ltd. and R.J.G. Construction Ltd., submitted bids. B&R's bid acknowledged receipt of Addenda 1, 2 and 3 on its tender form as required; it confirmed receipt of Addenda 4 and 5 by way of email to the Government's representative.

The Government awarded B&R the contract as the lowest compliant bidder. R.J.G. Construction Ltd. filed a claim against the Government. R.J.G. claimed B&R's bid was non-compliant based on its email acknowledgment of Addenda as per the instructions to bidders and supplementary general conditions and thus the acknowledgments weren't submitted on the proper tender form and the tender was incomplete and incorrectly prepared; the Government should have awarded the contract to R.J.G. as lowest compliant bidder. The parties agreed the applicable standard was substantial compliance, but R.J.G. argued B&R's errors were material and the bid was non-compliant. The Government argued the bid was compliant because the failure to acknowledge the Addenda on the tender form was immaterial and didn't affect the contract price or the work to be done, and it wasn't unfair to the other bidders.

The Decision: The Newfoundland and Labrador Supreme Court agreed. As in *Penney*, the court reviewed the key principles around resolving disputes in the tendering process, concluding the applicable standard is substantial compliance based on an objective determination of whether the alleged bid defect is material in the sense it would affect the contract price or the work to be done and the Government's (or its consultant's) ability to fairly determine whether the tender call had been complied with. Relying on the Newfoundland and Labrador Court of Appeal's recent decision in *Cougar Engineering and Construction v. Newfoundland and Labrador*, in which the tender documents reflected the language in this case mandating that: "Tenders not submitted on the Tender form provided will not be considered" and "Incomplete tenders will be rejected", the court confirmed that "even with the use of the mandatory word 'will'... the test is still substantial, not strict compliance". As in *Cougar*, which found

"a bid should not be declared defective unless the error or omission is material", the court decided B&R's email acknowledgment of the Addenda constituted a "mere irregularity" — and its bid should not be rejected.

Newfoundland and Labrador Supreme Court (Trial Division)

Penney v. Eastern Region Integrated Health Authority
George L. Murphy J.
August 10, 2016

Newfoundland and Labrador Supreme Court (Trial Division)

R.J.G. Construction Ltd. v. Newfoundland and Labrador (Transportation and Works)
James P. Adams J.
March 2, 2016

GUEST ARTICLE

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PRICING LUMP SUM DELETIONS: PRINCIPLES AND GUIDANCE

Pricing deductive changes to a lump sum contract can be like trying to unscramble an egg. Contracts frequently provide detailed requirements for valuing extra work, but all too often omit a methodology for pricing scope deletions. Deletions to lump sum contracts are particularly problematic because owners are rarely entitled to look behind the total lump sum price, at a contractor's actual costs. Notwithstanding the inherent difficulty in pricing these types of changes, Canadian case law provides surprisingly little guidance for dealing with this kind of dispute.

Due to the dearth of Canadian jurisprudence on this issue, this article canvases American case law to provide an overview of the commonly accepted guiding principles that courts have relied on when weighing disputes related to deductive changes to lump sum contracts.

Bruner and O'Connor on Construction Law has said that the general approach "is to price deductive changes based on the reasonable cost of performing the deleted work". Thus, the starting point for the analysis should be the contractor's actual costs.

In *Appeals of Fru-Con Construction Corp.*, the court found that any contract price deduction should be based on the amount the contractor reasonably would have spent to perform the deleted work**,** *i.e.*, the contractor's net savings. The overriding principle appears to be that the contractor should be left in the same position it would have been in had the deductive change not occurred. This requires that the cost to the contractor, not the price to the owner, be the basis of the credit.

Where available, it is tempting for owners to use a project's "schedule of values", or similar breakdowns in bid documents, to price deletions of work packages that appear in that document. Courts, however, have recognized that such practice is inherently problematic, as these imperfect work breakdowns (generally used for progress payments) contain all kinds of costs included in the contractor's overall price, such as time related indirects and overhead, that may not relate to the deleted scope. For example, in *Contracts Management Inc. v. Babcock and Wilson Technical Services Y–12 LLC*, the court found that even where a subcontractor was required to provide a balanced bid, its cost breakdown could not be relied upon:

> … the court finds that CMI distributed its key personnel, labour, and management costs among the five proposed waterline sections in order to avoid an unbalanced bid. These costs related to the total duration

> of the project, but CMI plan to work on multiple water lines at the same time. As a result CMI could not and did not isolate these costs for each of the five
>
> water lines individually. Instead, CMI distributed the overall management and labour cost of the entire project between the five line items.

So how do you determine "actual cost" for work that has necessarily not been performed? Certainly, if the parties are dealing with unit price work, this would be uncontroversial. But for non-unit price work, determining a contractor's actual costs often leads to disputes.

Where the deleted work involves repetitive work — similar work that has already been performed on the project — the contractor's actual cost records provide the best evidence for the contractor's reasonable cost to complete the deleted work. In this circumstance, determining a contractor's reasonable cost to complete the deleted work is relatively straightforward. However, it is not always this easy.

Disputes about a contractor's reasonable cost to complete deleted work arise when documents, like a contractor's bid or schedule of values, conflict with a contractor's proposed credit, an issue the court addressed in *M.J. Paquet, Inc. v. New Jersey Department of Transportation*.

In *M.J. Paquet*, the government, acting as the owner in a bridge rehabilitation project, deleted all bridge painting work from the general contractor's scope of work, and sought a credit based on the cost shown in the bid documents for painting work. In response, the contractor admitted that its bid was unbalanced, and that using the bid documents would result in a credit much higher than its actual cost to complete the deleted work.

The court found as a fact that, just prior to executing the contract, the contractor received an estimate from its painting subcontractor to paint the bridge for half the price listed in the bid documents. Due to time constraints, the contractor lowered the bid price of mobilization to compensate for the now inflated cost of the bridge painting, instead of adjusting the painting bid item. The court found that the contractor's estimate of the cost to perform the bridge painting, based on the estimate of the subcontractor, was the correct value for the deleted scope credit, as it reflected the contractors actual net savings.

As *M.J. Paquet* shows, complications arise when a contractor uses a "plug number" to estimate a portion of the work for its lump sum bid, and subsequently gets a more favourable price, after award, when it actually subcontracts the work.

In situations where the general contractor has subcontracted the deleted work, intuitively the general contractor's cost to perform the deleted work is equal to the value of its contract with the subcontractor to perform the work. In the *Appeal of J.A. Jones Construction Co.*, a contractor submitted its subcontractor estimate for the deleted work as evidence of its reasonable cost to perform the deleted work. In determining whether the subcontractor's estimate was a good indication of the cost to perform the work, the court stated that:

> [I]t appears almost self-evident that the source that would have the best and most current information on the probable costs of installing the deleted rock bolts would be the subcontractor that was already engaged in performing similar work in the same location. Thus, we regard the subcontractor's estimate … to be the best evidence of the reasonable cost to Jones of the rock bolt deletion …

Of course, the converse must also be true in situations where a contractor's subcontract price exceeds its bid value for the deleted work. In this situation, contractors must accept the risk that the credit for the deleted work should reflect the actual higher subcontract cost.

American case law puts the burden on the owner to disprove the contractor's "would have cost" estimate, and where the contractor performs the work on a unit-price basis, has cost records for the same or substantially similar work, or relies on the estimate of its subcontractor, these will be difficult for an owner to overcome. Of course, if the contractor's actual costs prove to be higher than estimated, as happened in *Appeal of Arctic Corner, Inc.*, or circumstances change resulting in a "would have been higher" cost for the contractor to perform the deleted work, the credit to the owner will be larger.

Finally, certain questions will continue to plague this analysis. For example, how should parties treat anticipated profit on scope deletions under a contract that prohibits a contractor from claiming profit on deleted scope? In the context of a lump sum project, this may not be straightforward. How should one evaluate profit on mid-contract change when the contractor is already in a loss position? Arguably, profit may only be assessed on the basis of a contractor's total cost versus the total contract price. This does not lend itself to a tidy solution when the project is only partially completed.

Until Canadian courts grapple with these issues, the authors regard American jurisprudence as a reasonable guide to a fair and equitable approach to pricing lump sum scope deletions. Given the underdeveloped nature of the law here, owners and contractors would be wise to keep this issue in mind when negotiating contracts and should as far as possible address these issues ahead of time, in the contract, rather than after the fact.

CASE SUMMARY

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A NEW (JUDICIAL) ERA FOR ALBERTA ARBITRATION AGREEMENTS: A SHIFT CONTINUED BY *SASKATCHEWAN POWER CORP. v. ALBERICI WESTERN CONSTRUCTORS LTD.*

Saskatchewan Power Corp. v. Alberici Western Constructors Ltd.

Arbitration clauses in construction contracts are intended to streamline disputes and give parties control over their own processes. However, in practice, it can be increasingly difficult for such provisions to accomplish these goals, particularly since many construction disputes reverberate up and down the contractual chain and involve subcontractors, consultants, vendors or other entities who are not part of the agreement to arbitrate. If these additional actors do not consent to take part in arbitration, the parties to an arbitration clause seeking to include them in the dispute have no choice but to commence a parallel litigation action; instead of streamlining dispute proceedings, the parties end up multiplying them.

This issue is compounded by the fact that provincial arbitration legislation generally does not permit parties to a binding arbitration agreement to litigate against each other: s. 7(1) of Alberta's *Arbitration Act*, for example, provides that "[i]f a party to an arbitration agreement commences a proceeding in a court in respect of a matter in dispute to be submitted to arbitration under the agreement, *the court shall… stay the proceeding*". This mandatory stay of litigation proceedings is subject *only* to a limited set of exceptions in

s. 7(2), which allows the court to refuse a stay "in *only*" a select set of severe circumstances largely tied to the validity of the arbitration agreement, the arbitrability of the dispute or the capacity or conduct of the parties. Section 7(5) of the Alberta *Arbitration Act* also allows the court to stay the litigation in part with respect to those issues subject to mandatory arbitration and allow the action to continue with respect to other issues if it finds that "the [arbitration] agreement deals with only some of the matters in dispute" and "it is reasonable to separate the matters in dispute dealt with in the agreement from the other matters".

However, s. 7(5) is silent as to what happens if the court does *not* find it reasonable to bifurcate the proceeding, particularly one where some but not all parties involved are bound by an arbitration provision, and split what may be an identical dispute into multiple parts heard in different forums, with the consequent possibility of different results. For over a decade in Alberta, this silence was filled by the Court of Appeal's 2004 decision in *New Era Nutrition Inc. v. Balance Bar Co.*, which made use of two further provisions of the *Arbitration Act*, s. 7(4) and s. 6(*c*), to read in a judicial power permitting the court to stay the *arbitration* in such multi-party scenarios and allow the entire dispute to be resolved by way of litigation despite the binding arbitration agreement. Section 7(4) comes after the mandatory stay obligation in s. 7(1) and the limited possible exceptions to such duty in s. 7(2), stating that if the court refuses to stay the proceeding (presumably but not explicitly as a result of one of the listed exceptions), "no arbitration of the matter in dispute shall be commenced" and any arbitration that has already been commenced "shall not be continued". Section 6(*c*) more generally provides that "[n]o court may intervene in matters governed by this Act, except for the following purposes", including "to prevent manifestly unfair or unequal treatment of a party to an arbitration agreement".

The Court of Appeal in *New Era*, faced with multiple arbitration and litigation proceedings and potentially conflicting findings of fact and law in a multi-party dispute where only two of the parties were bound to arbitrate, relied on the manifest unfairness concerns raised by s. 6(*c*) to interpret s. 7(4) as being the answer to what happens if the court declines to grant a partial stay under s. 7(5). The court found that it is *not* reasonable to separate matters in a dispute that is only partially arbitrable, the result under s. 7(4) is that the *arbitration* of the arbitrable portion of the dispute cannot continue and is stayed. Since it would be absurd for parties seeking a stay of arbitration to have to commence dual proceedings, apply for a litigation stay under s. 7(1) and then argue against their own application under s. 7(5) in order to trigger s. 7(4), the court in *New Era* held that such a stay application could proceed instead pursuant to the more general s. 6(*c*):

> I take all of these factors to mean that the Legislature intended that the courts use subsection 6(c) to provide a remedy to cure unfairness arising from matters not covered by the specific language of the legislation. In my view, it would be manifestly unfair to deny the remedy contemplated by section 7 which is designed to protect against the dangers inherent in duplicitous proceedings. ... Frequently the dangers inherent in duplicitous actions arise when some parties are covered by an arbitration clause and others are not. I am satisfied that subsection 6(c) allows a party, faced with both a statement of claim and a notice to arbitrate, to apply to stay the arbitration on the basis that the matters in the two proceedings overlap and cannot be reasonably separated.

The Court of Appeal in *New Era*, in seeking to avoid a multiplicity of proceedings and the legal dangers that could result, instead interpreted a statute whose primary stated purpose was to enshrine the legitimacy of a party's choice of arbitration as a dispute resolution process (and to limit judicial interference with that choice) in a way that gave courts an unwritten power to intervene and prevent access to that very process. The dissonance arising from such a construction of the *Arbitration Act* rendered it not overly surprising that *New Era* (after being followed in multiple instances in Alberta and Ontario) eventually began to be questioned by subsequent decisions.

In the 2013 Alberta Court of Queen's Bench case of *UCANU Manufacturing Corp. v. Graham Construction and Engineering Inc.*, which involved a construction dispute on a municipal infrastructure project featuring duelling arbitration and litigation proceedings and only two of many parties bound by an arbitration clause, the court acknowledged the "inevitable difficulties" and inefficiencies associated with multiple proceedings and the binding nature of *New Era* but still came to the opposite conclusion, refusing to allow the arbitration to be stayed:

> Section 7(1) [of the *Arbitration Act*] sets out the basic provision that if a party proceeds with the court action with respect to matters which are governed by an arbitration agreement, the Court 'shall' stay the proceeding. Section 7(5) then grants a partial exception to this general provision by providing that the Court may allow proceedings to continue with respect to matters not covered by the arbitration agreement provided it is reasonable to separate those matters from the matters that are covered by the arbitration agreement. *Nothing in the words of section 7(5) appears to give the Court jurisdiction to allow the entire action to proceed where it is not reasonable to separate the matters in dispute and then say* section 7(4) permits a stay of arbitration. … The language used in the section does not give the Court the discretion to override the mandatory language in section 7(1) and to permit the proceeding to continue because the matters cannot reasonably be separated … simply on the grounds that it would be more efficient and beneficial to have the entire dispute determined in court proceedings.

In 2015, *New Era* was then flatly rejected by the Saskatchewan Court of Queen's Bench in *Alberici Western Constructors Ltd. v. Saskatchewan Power Corp.* In another construction dispute involving an owner and contractor bound by an arbitration provision and subcontractors not similarly compelled to arbitrate, the court stated that, "absent a compelling reason, parties with relatively equal bargaining power should generally be bound to resolve their disputes by the means they have freely chosen". In response to an argument seeking to stay the arbitration based on the *New Era* line of cases, the court refused to follow it, holding that "the reasoning in *New Era* is not consistent with the underlying theme of the current legislation, which is that arbitration, freely chosen, takes primacy over litigation". The application to stay the arbitration in *Alberici* was therefore denied.

The *Alberici* decision was unanimously upheld by the Saskatchewan Court of Appeal in April 2016, where the court again questioned and discarded the interpretive approach in *New Era*, focusing largely on the Alberta court's conclusion that s. 6(*c*) of the *Arbitration Act* (s. 7(*c*) in Saskatchewan's Act) allowed courts to stay arbitrations to avoid a multiplicity of proceedings in the name of preventing "manifestly unfair" treatment of a party. The Court of Appeal in *Alberici* held that this provision is principally concerned with, and should be limited to, questions of procedural fairness within an arbitration proceeding itself, with "ensuring the *internal* integrity of arbitration pro-

ceedings, not at displacing such proceedings in favour of litigation". In addition, the court's powers to respond to manifest unfairness must be read harmoniously with the later provision of the Act dealing specifically with stays, which imposes a mandatory obligation on the court to stay the litigation proceedings, not the arbitration proceedings, subject to a narrow list of exceptions in limited circumstances. "Significantly, those circumstances do not include the risk of multiple proceedings … falling outside the scope of the arbitration. Such a provision would have been easy to include if, in fact, the Legislature had intended a multiplicity of proceedings to be a permissible reason for denying a stay". The Court of Appeal concluded by noting that, if the contrary *New Era* interpretation were correct, then,

> [51] … a party to an arbitration agreement could readily defeat the operation of the agreement by the simple expedient of raising the same or a factually-related issue in a claim against a third party and then claiming "unfairness" within the meaning of s. 7 [s. 6(c) in Alberta] of the *Arbitration Act*. It is difficult to reconcile this practical reality with the overall scheme of the *Act* which, as noted, is aimed at ensuring and securing the place of arbitration in the realm of dispute resolution.

Although *New Era* has not yet been fully overruled by binding authority in Alberta, recent case law, cemented by the latest Court of Appeal ruling in *Alberici*, has exposed the difficulties with its interpretation of the *Arbitration Act* and raised clear questions about its future precedential value. Lawyers in the province faced with drafting arbitration provisions in construction contracts should therefore consider taking steps to ensure that all parties in the contractual chain are made expressly subject to the identical arbitration obligations and that these duties contemplate participation in multi-party proceedings with other project actors where these types of larger project-wide disputes arise.

Saskatchewan Court of Appeal
Richards C.J.S., Caldwell, Whitmore JJ.A.
April 1, 2016

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Harvey J. Kirsh is a recognized authority in construction law, and has over 40 years of experience in the arbitration, mediation and litigation of complex construction claims and disputes arising out of infrastructure, energy, transportation, industrial, commercial, and institutional projects. He is certified by the Law Society of Upper Canada as a Specialist in Construction Law. Harvey has also been designated as a Chartered Arbitrator (C. Arb.), is included in the *Chambers Global* list of Canada's top arbitrators, and is the recipient of the Ontario Bar Association's Award of Excellence in Alternative Dispute Resolution. Harvey is the Founding President and Governor of the Canadian College of Construction Lawyers, and also has the distinction of having been elected a Fellow of both the American College of Construction Lawyers and the College of Commercial Arbitrators.

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