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CONTRACTS: WHAT'S NEW (AND OLD) FOR LOCAL GOVERNMENTS

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I. INTRODUCTION

COVID-19 has created quite a buzz around one of those "boilerplate" provisions that you've all seen at the end of a contract, and probably didn't fully understand why it was there, but accepted as important because it was always there, the one titled "force majeure". In this paper, we first canvas the legal issues that you should understand about the operation of contractual "force majeure" provisions and the related concept of frustration of contract.

COVID-19 has also highlighted the importance of the ability to rely on contractual security when a contractor is unwilling or unable to fulfill contractual obligations. In this paper, we highlight the differences between two types of contractual security, letters of credit and surety bonds, and discuss the pros and cons of each.

Finally, in this paper, we discuss some of the considerations that local governments should take into account when engaging in social procurement.

II. FORCE MAJEURE AND FRUSTRATION OF CONTRACT

There's no denying that the COVID-19 pandemic and related fallout have been a disruptive force in many areas, and, as result, many corporations, organizations, and individuals have found themselves to be a party to a contract where one side is unable to fulfil its contractual obligations. To avoid liability associated with these failures, parties faced with defaulting under a contract may find legal relief in two places: a force majeure clause or the common law doctrine of frustration.

A. Force Majeure

First, the force majeure clause. The term force majeure roughly translates to "superior force", and it's the name given to a type of clause that is often included in Canadian contracts. The Supreme Court of Canada described the general idea behind force majeure clauses in *Atlantic Paper Stock Ltd. v. St. Anne-Nackawic Pulp and Paper Company Limited*, noting that such clauses generally operate to "discharge a contracting party when a supervening, sometimes supernatural event, beyond control of either party, makes performance impossible", with the common element of such clauses "is that of the unexpected, something beyond reasonable human foresight and skill."

An important thing to remember about force majeure clauses is that, as the name suggests, they are contractual clauses that have certain common elements. There is no magic to the words "force majeure"; what's important is the ultimate effect of a clause and not necessarily the words used to describe or label it. As a result, a contract may include headings such as "delay" or "unavoidable delay" and accomplish the same result as a clause headed "force majeure". The term force majeure, however, is often used as shorthand for clauses that

operate in certain situations and have a specific effect. In this paper, we use "force majeure" as a catch-all term for this type of clause. Another equally important takeaway is that force majeure clauses are a type of contractual clause, meaning they can only be relied upon if they're included in the contract at issue, and the extent of the availability and helpfulness to a party of such a clause is almost entirely dependent on the wording of the clause itself. As a result, a party's first step when determining if a force majeure clause may be available to it is to review the relevant contract to determine if it includes such a clause.

As mentioned, all force majeure clauses have common elements and generally operate in accordance with the following simple formula:

1. A triggering event occurs;

2. The triggering event, due to circumstances beyond the reasonable control of the party seeking to invoke the clause, impacts the invoking party's ability to perform its contractual obligation; and,

3. The invoking party is relieved from performing its impacted obligation.

This formula is somewhat simplistic, but it gets to the heart of how force majeure works.

The foregoing being said, because a force majeure clause is a contractual mechanism, its specific effects are determined by the wording of the clause itself, which will likely outline:

- What constitutes a triggering event;

- The extent to which the invoking party's ability to perform its obligations must be impacted in order for the clause to operate (i.e., does the party need to be prevented, hindered, delayed, affected in its performance?);

- The relief the invoking party is entitled to if it successfully relies on the clause (i.e., is the party excused from performance of its impacted obligations for a set period of time, or can the invoking party terminate the contract entirely?); and,

- Other potentially relevant factors, such as any notice requirements imposed on the parties.

To make this scenario more concrete, let's explore a simple scenario in which a force majeure clause may come into play:

Party A has agreed to provide Party B with a certain number of widgets by a certain date. The contract between Party A and Party B contains the following clause:

> ***Unavoidable Delay***
>
> *Except as otherwise expressly provided in this Agreement, if and whenever and to the extent that either Party A or Party B is prevented, delayed, or restricted in the fulfilment of any obligations under this Agreement in respect of the supply or provision of any service, the doing of any work or any other thing (other than paying the Fee or any other amount due) by reason of civil commotion, war-like operation, invasion, rebellion, hostilities, sabotage, strike, or work stoppage, or being unable to obtain any material, service, utility, or labour required to fulfil such obligation or by reason of any statute, law, or regulation of, or inability to obtain any permission from, any government authority having lawful jurisdiction preventing, delaying, or restricting such fulfilment, or by reason of other unavoidable occurrence other than lack of funds, the time for fulfilment of such obligation will be extended during the period in which such circumstance operates to prevent, delay, or restrict the fulfilment of it, and the other party to this Agreement will not be entitled to compensation for any inconvenience, nuisance, or discomfort thereby occasioned.*

Due to COVID-19, Party A is unable to get material that it needs to produce the widgets, and it won't be able to provide the widgets to Party B by the agreed upon delivery date. Missing this deadline would constitute a breach of the contract by Party A, and wishing to avoid this breach, Party A will seek to rely on the Unavoidable Delay clause above.

Will Party A succeed? We'll have to work through the clause to find out. The first question is, has a triggering event occurred? The clause includes a long list of occurrences that constitute triggering events (noted in red), but note that "pandemic", "epidemic", "public health emergency" and similar terms aren't listed here. However, inability to obtain any material required to fulfil an obligation is listed, so provided that Party A can show that it was actually unable to obtain the material to construct the widgets, it likely has a triggering event that it can rely on.

Next, as highlighted in blue, the clause sets out the triggering event threshold, being the triggering event's effect on Party A's ability to perform its obligation: it must have prevented, delayed or restricted Party A from providing the widgets to Party B. If the triggering event occurred but Party A had the ability to source the widget material from elsewhere (even at a higher price than it would have otherwise paid) in time to complete the order, the clause won't operate and Party A's non-performance won't be excused.

If Party A establishes that it was actually prevented, delayed, or restricted in delivering the widgets due to the pandemic, the language highlighted in green indicates the effect of the clause, which is that Party A's deadline for delivering the widgets would be extended for a period of time equivalent to the period the prevention, delay, or restriction caused by the triggering event continues.

With that, we can see the path party A must follow in order to rely on the force majeure clause and avoid being in breach of contract by failing to fulfil its obligations. In addition to the steps outlined above, it's important to note that, in order to successfully rely on the force majeure clause, there must have been no reasonable steps Party A could have taken to mitigate the effects of the triggering event. In other words, Party A is required to make alternative arrangements to deliver the widgets if it can, and its required to fulfil its obligations to the extent it can, even if only partial fulfilment of Party B's order is possible.

The scenario above demonstrates that determining the effect of force majeure clauses is largely an exercise in contractual interpretation. That doesn't mean, however, that interpretation will always be so straightforward, and the Canadian courts have offered some principles that can guide interpretation. For instance, a change in market conditions or circumstances affecting the profitability of a contract or the ease with which a party's obligations can be performed is generally not regarded as a force majeure event. Generally, force majeure is resorted to where an event beyond the control of a party makes performance of that party's obligations under the contract impossible, and it isn't appropriate to resort to them where an event makes performance of that party's obligations "commercially impractical" unless the parties have expressly agreed to this. In our scenario, this means that, as a result of the pandemic, Party A could only produce the widgets at a cost much higher to itself, it is unlikely that it could rely on the force majeure clause to suspend its obligations until production prices normalized. This also means that parties can't rely on force majeure clauses to excuse their payment obligations under a contract. In our scenario, this means that Party B likely can't rely on the force majeure clause even if the pandemic renders it unable to pay for the widgets, or if it can no longer use them. This is particularly relevant for local governments because they are often procuring the services of contractors, and a force majeure clause is unlikely to offer any relief from a government's contractual obligation to pay for such services, even if it no longer needs them.

B. Frustration

If a force majeure clause doesn't apply to a specific triggering event or situation, a party may seek to rely on the common law doctrine of frustration of contract to excuse the party's inability to perform its contractual obligations. As you'll see in this section, one of the necessary ingredients of the doctrine of frustration is the occurrence of an event that is not contemplated by the contract and that was unforeseeable to the parties making the contract. As a result, a contract can't be frustrated by an event that falls within the list of triggering events in a force majeure clause because, by nature of its inclusion, such an event was contemplated by the parties when they drafted the contract, evidencing that it was foreseeable.

Unlike force majeure, frustration is a legal doctrine, not a contractual clause or arrangement. Thus, it can potentially apply to any agreement provided its requirements are met. If a party successfully argues that a contract has been frustrated, the contract is effectively terminated, and the parties are relieved from their obligations going forward. Per the Canadian courts, the doctrine applies "when a situation has arisen for which the parties made no provision in the contract, and performance of the contract becomes 'a thing radically different from that which was undertaken by the contract'". At law, a contract is frustrated if the following criteria are satisfied:

1. A qualifying supervening event (one for which the contract makes no provision, which is not the fault of either party, which was not self-induced, and which was not foreseeable) occurs; and,

2. The event causes a radical change in the nature of a fundamental contractual obligation.

Does the fallout from COVID-19 constitute a "qualifying supervening event"? A party advancing a frustration argument would likely argue that a reasonable person in the position of the parties would not have contemplated the COVID–19 pandemic nor the resulting fallout. In the past, the courts have found that events such as a local government's director of planning submitting an application, on his own motion, to rezone property and the imposition of the Foreign Buyer's Tax on contracts of purchase and sale already in existence were not reasonably foreseeable. This suggests that the pandemic arguably qualifies as a supervening event under part 1 of the test.

On part 2 of the test, frustration analyses are fact specific, with the determination of the fundamental nature of the contract at issue being crucial. In some cases, the nature and purpose of the contract is simple and general. For instance, in *Wilkie v. Jeong*, the supervening event (the imposition of the Foreign Buyer's Tax), imposed a significant additional financial burden on a purchaser of land, raising her tax burden on closing from $58,040 to $458,240. The Court found that, despite the steep tax increase, the fundamental purpose of the contract, which was to transfer title of the property in exchange for the purchase price, was entirely unaffected. Explaining its decision, the Court noted that while lack of money may affect a party's *ability* to perform a contractual obligation, it does not normally alter the *nature or purpose* of the contractual obligation itself.

On the other hand, the purpose of a contract may be situation specific and informed by the circumstances of the deal. In *KBK No. 138 Ventures Ltd. v. Canada Safeway Limited*, prior to the completion of a purchase and sale, the subject lands were rezoned and the floor space ratio was changed from 3.22 to 0.3. Instead of finding that the purpose of the contract was simply the sale and purchase of the subject land, the Court concluded, aided by contract terms and

other circumstances surrounding the transaction, that the buyer was purchasing the land to develop as prime commercial and residential property. As the change in floor space ratio rendered the land essentially useless for commercial and residential use, the contract was found to be frustrated.

As the court noted in *KBK*, it can sometimes be a very complex matter to ascertain the foundation, basis, or purpose of a contract or the implicit undertaking of the parties. To make a determination, you may need to examine both the contract and the relevant circumstances surrounding the contract. The principle is illuminated further by *Krell v. Henry*, which enumerated three conditions that must be satisfied in order for the doctrine of frustration to apply, the first of which is "What, having regard to all the circumstances, was the foundation of the contract?".

Thus, the argument regarding the fundamental purpose of a contract again comes down to interpretation: is the purpose simple (such as the purchase and sale of property), or does it contain additional, unique elements (such as the purchase and sale of property for commercial development)? Based on the current case law, it seems one can look both to the contract at issue and the circumstances in which it was made to find an answer.

Bringing things back to the pandemic, determining if frustration applies to a given contract, again, is very fact specific. While there may be an argument that the fallout of the pandemic constitutes a qualifying supervening event (at least to contracts made prior to the pandemic), a close review of the contract and the circumstances in which it was made is required to determine both what the fundamental nature of the contract is and if the pandemic radically changed that nature.

Ultimately, making out a claim to frustration of contact is a very high bar to clear, and, like force majeure, arguments based on increased economic difficulty or commercial unviability seem unlikely to succeed.

Bringing this back to practical application, in the context of COVID-19, local governments should ensure, going forward, that force majeure clauses are drafted in such a manner to provide them the protection that they require. If a local government is concerned about being able to fulfil its obligations under a contract due pandemic-related issues, it should ensure that the force majeure clauses in its agreements include COVID-19 and related issues as triggering events. Additionally, if a local government requires relief from certain obligations (such as payment) that aren't normally subject to force majeure clauses, it should specifically include the situations in which it would be entitled to such relief, the type of relief it would be entitled to, and the extent of that relief. As a general practice, it is best to deal with any potential issues expressly in the contract itself as relying on a generic force majeure clause or the doctrine of frustration to excuse performance may be unhelpful or impossible, depending on the situation.

III. CONTRACTUAL SECURITY

Local governments often require contractors to provide security for the fulfilment of contractual obligations. Security offers local governments protection such that, if a contractor is unwilling or unable to provide what was agreed under the contract, the local government can use the security to obtain what was agreed under the contract elsewhere. One situation where security is common is where, as a condition of subdivision, a local government requires the subdivider to enter into a servicing agreement under which the subdivider agrees to construct certain works and services. Such agreements often also require the subdivider to provide security for the same such that, if the subdivider fails to construct the works and services, the local government can use the security to ensure that the works and services are completed and the subdivision isn't left without the services it requires.

The COVID-19 pandemic has left many contractors unable to perform their contractual obligations, and as a result, local governments may be trying to determine if they're entitled to utilize their contractual security. In this paper, we discuss two forms of contractual security, letters of credit and surety bonds, and how they may operate in the context of the COVID-19 pandemic. For a more thorough discussion of contractual security, please refer to the paper titled "Is Your Security Worth the Paper it's Written On?" (https://www.younganderson.ca/images/seminar_blogs/Is_your_security_worth_the_paper_its_written_on-RY-CR.pdf).

A letter of credit is a formal written undertaking issued by a financial institution, usually a bank, to pay money to a designated person, in this case the local government, on demand. The local government can cash or draw down on the full value of the letter of credit, or portions of it, in accordance with the terms and conditions set out in the letter of credit itself. While there's more than one type of letter of credit, we're interested in the "stand-by" letter of credit, which is used to secure the obligations of one party to another, and is cashed only when the obliged party defaults. Properly drafted letters of credit permit the local government to draw down on the letter of credit, in whole or in part, without proof that the local government has the right to do so. It imposes an absolute obligation upon a bank to pay, regardless of any dispute between the local government and the contractor. For example, while a local government and a developer can agree that a letter of credit is required to protect the local government from the developer's default under a construction contract, the question of whether default under that contract has actually occurred, along with any defence for such default raised by the contractor, is irrelevant to the issuing bank. Essentially, letters of credit allow local governments to "get paid now, and argue later".

Another form of security is the surety bond. Generally, a bond is a three-party agreement, where the first party (the "surety") guarantees that the second party (the "principal"; for example, a developer) will fulfil its obligations to a third party (the "obligee"; here, the local government). In exchange for guaranteeing the principal's performance of its obligations, the surety charges the principal a premium and requires indemnification from the principal if the

principal defaults. As a result of the indemnity by the principal, any loss on a bond is ultimately the principal's loss (provided that the surety is able to recover). The local government who requests the bond, has the benefit of the obligation of the principal, and, if that fails, the guarantee of the obligation from the surety. The bond creates a three-way agreement between the parties and incorporates the terms of the underlying contract.

Unlike letters of credit, bonds do not stand on their own; they are based on the terms of the agreement between the three parties, which includes reference to the underlying agreement between the surety and principal that requires the security. In contrast to an issuer's role under a letter of credit, a surety company faced with a default claim by a local government must consider the validity of the claim prior to paying out. In our experience, sureties generally adopt the position of the principals under the bond in denying any claim of breach of the underlying agreement. To do otherwise puts the surety at risk of losing its right to be indemnified by the principal; sureties therefore have a great incentive to protect their own financial interest upon receiving a claim. As a result, the "get paid now, and argue later" principle doesn't apply here, as a local government will have to successfully make its case to the surety to receive payment. In this way, bonds can turn into an extension of a contractual dispute between a local government and the contractor.

With this brief background to these two types of security, we turn to the question of how are they affected by COVID-19? The answer lies in the underlying agreement. As mentioned at the beginning of this section, the obligations to provide security stem from agreements between local governments and contractors, with the purpose of the security being to provide assurance that the work or service contracted for will ultimately be completed.

If a contractor is unable to fulfil its obligations under the contract due to COVID-19, the contractor may be able to seek relief under a force majeure clause or the doctrine of frustration of contract. Alternatively, the contractor may turn to creditor protection under either the Federal *Companies' Creditors Arrangement Act* or *Bankruptcy and Insolvency Act.*

While a contractor is seeking to rely on a force majeure clause or the doctrine of frustration of contract, the local government could be left without the benefit of the work or service it contracted for. If the contract included a requirement for security, the form of security provided would be crucial to the local government's ability to obtain replacement work or service. If the security held by the local government is a letter of credit, there would be no obligation on the local government to refute the claim of the application of the force majeure clause or the doctrine of frustration. The local government could simply draw down on the letter of credit and obtain the replacement work or service in a timely manner. Of course, if it ultimately turns out that the contractor was protected by the force majeure clause or the doctrine of frustration of contract, the local government will be the party held to have been in

breach, by drawing down on the security improperly. Thus, local governments should seek legal advice before drawing down on such security. If the security held by the local government is a surety bond, it is unlikely that the surety company will agree to a pay out on the bond in circumstances where the contractor asserts protection under a force majeure clause or the doctrine of frustration of contract.

Where the contractor has turned to creditor protection under either the Federal *Companies' Creditors Arrangement Act* or *Bankruptcy and Insolvency Act*, such protection often involves either a court order or receivership order that includes a prohibition on parties to contracts with the contractor, which would include local governments, from taking any enforcement steps against the contractor in relation to their contractual rights. Such prohibitions are commonly referred to as "stays of proceedings". In fact, a court order under the *Companies' Creditors Arrangement Act* can impose a positive obligation on a party to a contract with the contractor to continue to fulfil its contractual obligations to the contractor despite the contractor's ongoing failure to meet its contractual obligations to the party. Under both these statutes, the goal of the legislation is to maintain the status quo as it relates to the assets of the contractor who has sought creditor protection.

As a letter of credit is a contractual arrangement between the issuing financial institution and the local government, the stay of proceedings under a court order or receivership order often does not prevent a local government from drawing down on a letter of credit. The theory behind this being that, while the local government has drawn down on the letter of credit, and by doing so has negatively impacted the interests of the financial institution, the interests of the contractor remain unaffected as the stay of proceedings prevents the financial institution from taking any enforcement steps against the contractor. Of course, whether a local government can draw down on a letter of credit in the face of a stay of proceedings will depend on the terms of the letter of credit and the terms of the court order/receivership order.

The situation is more complicated with a surety bond. As mentioned above, a surety bond is a three-way agreement between the surety, the contractor, and the local government. As such, depending on the wording of the surety bond and the court order/receivership order, the stay of proceedings may prevent the local government from making a claim on the bond while the order is in place.

One simple manner in which a local government can make its resort to a letter of credit or surety bond more effective is to include in its agreements provisions which expressly establish circumstances amounting to default by a contractor. For example, many construction contracts include sections that expressly provide that it is a default under the contract if the contractor makes an assignment in bankruptcy. By doing so, the issue of whether there is a default is put beyond doubt, and the local government is in a much safer position to take remedial action under the contract, including through resort to contractual security.

IV. SOCIAL PROCUREMENT

Historically, local governments have been very significant consumers of both goods and services and, as such, have often been able to obtain those goods and services on more favourable terms than the average consumer. Local governments have partially achieved this through the use of public procurement process such as requests for proposals and tenders, taking advantage of the greater competitive market. A large part of local government's success in obtaining value for dollar through public procurement processes has been the fact that suppliers of goods and services view working with local government as being significantly advantageous to them. As a general rule, local governments are valuable customers. They require goods and services on a consistent and ongoing basis. When the economy is good, local governments are by necessity active in responding to development and other demands; when the economy is struggling, local governments take an active role in supporting its recovery. In addition, local governments pay their bills on time.

Because of the fact that local governments are desirable customers, they are able, to a large degree, to dictate the terms on which they contract with suppliers of goods and services.

In this paper, we discuss how local governments have leveraged their position as desirable customers to further social policies through what has come to be known as "social procurement". For a complete discussion of the law relating to local government procurement, please see our paper titled "The A to Z of Local Government Procurement" (https://www.younganderson.ca/assets/seminar_papers/2016/The-A-to-Z-of-Local-Government-Procurement.pdf).

Social procurement is the use of one's purchasing power to support and enhance social policy objectives. Generally speaking, social impact elements that may be considered in procurement include supplier diversity, workforce diversity, and workforce development. Supporting and enhancing supplier diversity refers to providing opportunities for diverse suppliers, such as companies owned and operated by Indigenous peoples. Supporting and enhancing workforce diversity refers to providing opportunities for suppliers with a diverse workforce, including people with disabilities and other traditionally underrepresented groups. Lastly, supporting and enhancing workforce development means providing opportunities for suppliers who encourage development of the workforce, including through apprenticeship, skills training, and other developmental support to employees.

The intention behind social procurement is that it creates an incentive for suppliers to support and enhance social policy objectives in two ways. First, by directly rewarding suppliers for their actions that meet criteria set out in the procurement process that add social value. Second, by indirectly encouraging suppliers to enhance their social value to allow them to more successfully compete for future procurement opportunities that may include social value criteria.

While the intention behind social procurement is commendable, successfully implementing social procurement policies can be challenging from a legal perspective.

First, when drafting procurement documents that seek to enhance social policy objectives, the drafter must have a clear understanding of how those objectives can best be achieved. Often, when reviewing procurement documents that include specific criteria intended to enhance social issues, the criteria don't necessarily have the desired effect. For example, a criterion in a tender that provides for points based on the number of apprentices employed by a bidder, serves the purpose of rewarding a non-local bidder that has over 100 employees, with five apprentices, disproportionately to a local bidder that has only 10 employees, with one apprentice. In this example, the point system established by the criterion in the tender for evaluating the social benefit of each bidder disproportionately benefits larger companies over smaller companies.

Second, when drafting procurement documents that seek to enhance social policy objectives, the drafter must strive to avoid criteria that are overly subjective in nature. When a bidder/proponent submits a bid/proposal in response to a procurement process that involves social procurement initiatives, the bidder/proponent should be able to determine from the procurement documents the criteria that will be applied to the evaluation of their bid/proposal. Failure to disclose an evaluation criterion, or how it will be applied, could result in a legal challenge to the local government's procurement decision. Moreover, where the application of a social procurement criterion is overly subjective or arbitrary, the local government's procurement decision may be subject to judicial review on the basis that the decision was unreasonable, either substantively or on the basis of the process by which the decision was made.

Lastly, when drafting procurement documents that seek to enhance social policy objectives, local governments should be aware of the Trade, Investment and Labour Mobility Agreement (TILMA) and the New West Partnership Trade Agreement (NWPTA). Both of these trade agreements require that the parties "will provide open and non-discriminatory access to procurements".

While British Columbia local governments are not signatories to the TILMA and NWPTA, and the Province has not enacted any legislation directly obliging local governments to comply with them, these agreements can have some impact on local governments. First, local governments may indirectly be bound by these trade agreements where they are receiving Federal or Provincial grant monies to partially fund the acquisition of goods or services. Both the Federal and Provincial governments have included requirements in grant agreements that local governments receiving grant funds comply with these trade agreements. Second, the NWPTA includes a dispute resolution process whereby a party can submit a complaint in relation to a local government's procurement process, alleging that the process does not comply with the NWPTA. If the complaint is determined to be valid, the local government would be subject to a

penalty award of up to $50,000.00 and an additional cost award of up to $50,000.00. Thus, the local government's maximum liability exposure for a procurement process that violates the NWPTA is $100,000.00, with the complainant being able to enforce payment of that liability as if it were a judgment in the British Columbia Supreme Court.

When drafting procurement documents that seek to enhance social policy objectives, the drafter must ensure that the documents do not create an unfair or discriminatory procurement process.

Given the legal uncertainties associated with social procurement, we recommend that local governments attribute no more than 10% of the total points in a procurement process to social policy objectives. In addition, we recommend that local governments, in evaluating bids/proposals incorporating social policy criteria, keep detailed records of all evaluation scoring, including social impact criteria, and be prepared to provide explanations for its rationale should its decision be challenged.

V. CONCLUSION

What the COVID-19 pandemic has taught us is that, when preparing contract documents, local governments need to be proactive and expressly address the implications for contractual rights and obligations from unforeseen circumstances. While local governments will never be able to predict the future, it is always a valuable exercise to review contractual provisions relating to "force majeure" and security requirements to ensure that known issues are adequately addressed.

As for social procurement initiatives, local governments should consider the issues highlighted in this paper when drafting procurement documents to ensure that their processes will withhold scrutiny.

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