Five common mistakes in construction contracts

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In this Update

- Identify common mistakes in construction contracts
- Determine the risks and consequences of such mistakes
- Provide contractual and other working solutions to avoid them

Elliot Smith, a partner in Osler's Construction and Infrastructure Group, is a professional engineer and has over a decade of experience negotiating construction contracts. He recently wrote a comprehensive book, "The Canadian Construction Contracts Guidebook," to support anyone involved in a construction project who needs to negotiate a construction contract, including lawyers, owners, contractors and consultants.

The construction contract is the main tool that defines a relationship between an owner and its general contractor or construction manager. Any construction contract requires careful thought, negotiation and drafting, because in addition to defining the relationship between the parties, it provides certainty to the project, allocates risk and provides mechanisms to mitigate risks. From a relatively simple home renovation to a large infrastructure project, parties usually enter into some form of written construction contract, yet, we all too often see the following common mistakes in these contracts.

Mistake 1: Uncertain whether contract is fixed price or cost plus

Fixed-price contracts are one of the most common types of construction contracts as they provide the owner with a high degree of cost certainty from the outset of their project. As the name suggests, the owner and contractor agree that the contractor will perform a scope of work at a fixed price, with limited circumstances in which the contractor is entitled to a change. As surprising as it may seem, we often see construction arrangements where it is unclear whether the basis is fixed-price or cost plus.

Often, when a contractor is engaged at the design stage to help with scoping and estimating, towards the end of the design the contractor will submit its final cost estimate for the project. These estimates are typically based on a sum of subcontractor pricing, contingency, any self-performed work or general conditions work, and a percentage mark-up for overhead and profit. Quite often, the owner will simply "approve" the estimate by signing back the estimate or issuing a purchase order. When that happens, the basic commercial term of whether the agreement is fixed price is unstated and is often unclear from the context. Is the price a "budgetary estimate" or a fixed price? Who gets to keep the contingency if it goes unused, and who will fund the cost of any overruns? Even if asked, the parties themselves may be unsure what they have just agreed to.

This type of uncertainty can lead to a significant dispute if the project costs significantly more (or less) to execute than the agreed amount. While the parties may have been unclear at the outset as to what they were agreeing to, once it's clear whether the project is running over – or under – the agreed amount, the owner and contractor will tend to naturally fall into believing the agreement is fixed or reimbursable – depending on which way the difference in price runs.

This issue can be easily avoided if the parties enter into an appropriate contract rather than the owner signing back the estimate submitted by the contractor or issuing a purchase order, since even the shortest form construction contract would typically be clear on this point. If for some reason that's not practical or possible in the circumstances, then whatever documentation is being used to record the arrangement between the owner and the contractor should at a minimum specify whether the price is fixed or an estimate.

Mistake 2: Incorrect application of the law

Parties often get one of three things wrong in relation to the *Construction Act* in Ontario and similar lien legislation in other provinces: they either mistakenly think they can completely contract out the legislation; they attempt to deviate from how the legislation applies to their project (such as by changing holdback percentages or lien periods); or they attempt to conform to the terms of the applicable legislation but get it wrong. This most frequently arises when either the parties decide to use a standard form contract from another jurisdiction (such as a U.S. jurisdiction that permits lien waivers, which are generally not enforceable in Canadian jurisdictions), or when the parties decide that it would be commercially preferable to avoid application of the applicable lien legislation.

This issue is expected to become much more prevalent in Ontario as prompt payment and mandatory adjudication come into force under the new *Construction Act* on October 1, 2019. These sections of the Act impose much more prescriptive requirements on all parties to a construction project, and generally cannot be avoided.

Incorrect treatment of lien legislation – regardless of the reason – imposes real risks on the parties as third parties, such as subcontractors and suppliers, will certainly not be bound by an attempt to vary the application of lien legislation, and even the parties to the agreement themselves may change their position if unforeseen circumstances arise on the project. A court will not generally enforce a contractual provision that is contrary to lien legislation. For example, an owner and a contractor might agree contractually for the contractor to waive its right to lien in exchange for no holdback, but if things go badly on the project and the contractor feels it is owed money, there is little the owner can do to stop it from filing a lien. In this example, since the owner has not been holding back, it does not have the funds to bond off the lien. Even in circumstances where the owner and contractor stick to their bargain despite the fact that it's not enforceable, a subcontractor could still lien and the owner again is caught without the necessary holdback funds.

This issue can be prevented by using an appropriate Canadian form of contract which correctly contemplates all the applicable legislative requirements, and not seeking to deviate from any requirements of lien legislation without clear confirmation that that is permissible under the relevant act. Legal counsel should always be consulted before using a form prepared for use in one jurisdiction in a different jurisdiction.

Mistake 3: Excessive upfront payment by owners

In response to contractors' requests, owners often agree to make substantial down payments in order to both mitigate the contractor's risk of non-payment by owner and reduce the working capital requirement for the project (and thus reduce the cost to the owner). This poses a two-fold risk for the owner: first, the owner takes on the contractor's credit risk by advancing money ahead of receiving goods and services, and second, in case of any breach of contract or unsatisfactory performance by the contractor, the owner will not have any funds to set off against and may have to chase the contractor to recover any funds owed.

Owners can mitigate this risk by reducing the amount of any down payment to the extent possible. In many cases it may be in the owner's best interest to absorb the working capital cost in exchange for a lower (or no) down payment, given the reduced credit risk to the owner. If the project requires long-lead materials requiring deposits to commence manufacturing, the owner can choose to pay suppliers directly for the materials, regardless of whether they make the purchase themselves or through their contractor. In this case, the owner takes on the supplier's credit risk, but at least that risk is diversified across a number of suppliers instead of being concentrated with a single general contractor.

In circumstances where the owner is making a down payment, they should consider procuring security in the form of a letter of credit, a parent company guarantee, or bonding from the contractor to mitigate the risk. Where upfront payments are made, it should be clear how they will be applied – whether to the first milestones, the final milestones, or throughout the project. From an owner's perspective, the sooner the upfront payment is applied against a milestone the less risk there is associated with that down payment.

Mistake 4: Unclear consequences for delay

Projects often face delays for a number of reasons, and yet, construction contracts often either do not provide express remedies for delay such as liquidated damages, or they contain inconsistent provisions setting out the consequences of delay. For example, in some cases there will be liquidated damages, which the parties agree is a "genuine pre-estimate of the harm suffered by owner resulting from the delay," but the clause will go on to provide that if the owner doesn't actually suffer any harm, no liquidated damages are payable (a "no-harm-no-foul" type provision). While both of these are workable approaches on their own, when combined it changes the nature of the liquidated damages from a pre-estimate of damages to a cap on possible damages.

When negotiating a contract, the parties should always specifically turn their mind to what should happen if the contractor is late in delivering the project. Are they liable for liquidated damages, and if so, are they a sole and exclusive remedy? Are there any caps or limits on the liquidated damages? Are they still the owner's "sole and exclusive" remedy for delay, even if the cap is reached? Where there are liquidated damages and a cap that is expressed as a percentage of the contract price, owners should divide the cap by the daily rate (or other time period) to determine how many days it would take to reach the cap, and understand what that might mean in the context of the particular project.

Liquidated damages are often disliked by contractors and thought of as an "owner-friendly" term, but in fact they cut both ways. In some circumstances, without a pre-agreed liquidated damage amount and caps, the contractor would actually be exposed to *greater* damages for breach of contract for failing to achieve substantial performance by the guaranteed date, relative to what they might have agreed to as a liquidated damage.

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Mistake 5: Incomplete warranty provisions

A warranty is a contractual obligation to remedy defects in work which becomes apparent after handover of the project to the owner. Typically, warranty clauses stipulate the duration of warranty, but sometimes they are written in short form without specifying other key elements of the warranty terms, such as whether the contractor has the obligation to remove and replace the defective part, responsibilities for return shipping, and whether there is a further extended warranty on the warranty repair work. In some cases, a warranty might be listed as a “12-month warranty,” but without specifying when the time period begins to run. Sometimes that might be obvious, but in other circumstances it may be unclear if it runs from installation or start of use. For example, appliances may be purchased for a household renovation project six months before the project is done and turned over to the owner. If the appliance only has a 12-month warranty from delivery, the owner might effectively only have six months of protection.

The parties to a construction contract should always consider the warranty clause carefully, and understand what they expect to happen in the event of defects, and whether the clause aligns with those expectations.

Conclusion

These are just a sampling of many of the most common types of errors that can arise in a construction contract. In some cases, a contract with these problems can be used on many projects without issue, since it’s often not until serious problems arise on a project that the parties will turn to their written agreements, and it’s then that these types of issues can lead to protracted and expensive litigation, which could have been avoided had the contract been clear in the first place.

Osler’s Construction Group has extensive experience in contract drafting. Our lawyers will be happy to provide you with any assistance in contract negotiations, drafting and review.