Three common mistakes in construction contracts

By Elliot A. Smith

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The construction contract is the main tool that defines a relationship between an owner and its general contractor or construction manager. 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.

1. Uncertain whether contract is fixed price or cost plus

Fixed-price contracts provide the owner with a high degree of cost certainty from the outset of their project. 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. Surprisingly, we often see construction arrangements where it is unclear whether the basis is fixed price or cost plus. This often occurs where the owner "approves" the price provided by a contractor, without it being clear whether the approved number is a budgetary estimate or a fixed price.

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.

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.

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.

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.

About the Author

Elliot A. Smith is a partner in Osler, Hoskin & Harcourt LLP's Construction and Infrastructure Group. In addition to being a lawyer, Elliot is also a professional engineer. He has more than a decade of experience advising clients on all aspects of major infrastructure projects, including project development, procurement, contract negotiation, and administration issues. Elliot's practice has a strong emphasis on the development of power plants, both renewable and conventional, as well as the negotiation of power and capacity purchase agreements. He also regularly advises clients on other areas of construction law, such as construction contracts, equipment supply agreements, operating and maintenance agreements, and long-term utility supply agreements.

Negotiating a construction contract for a project in Canada poses unique challenges for anyone involved in the project, including lawyers, owners, contractors, architects, and engineers. Elliot's new book, **The Canadian Construction Contracts Guidebook**, is a comprehensive guide to support both lawyers and anyone else in the construction industry who negotiates construction contracts. This easy-to-use guide addresses construction contract issues from the perspective of how best to establish the contractual arrangement, as opposed to addressing contract administration issues after the fact. The book covers all the major sections of a typical construction contract, including performance of the work; payment structures and payment for the work; completing the work and warranties; liability; defaults, termination, and dispute resolution; and much more.