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CONSTRUCTION PROJECTS: FROM START TO FINISH

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Sukhbir Manhas

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I. INTRODUCTION

In this paper, we will provide you with techniques in managing risk in contractual relationships for construction projects. The discussion in this paper will first, by necessity, cover general principles governing all contractual relationships. The discussion will then turn to specific issues in relation to contractual relationships for construction projects, from the initial decision as to the form of contractual arrangement to be used for a particular construction project, to the making of the necessary contracts, to administering the contracts once made, and finally to bringing the contracts to an end.

II. GENERAL PRINCIPLES GOVERNING CONTRACTUAL RELATIONSHIPS

A. The Making of the Contract

When making a contract on behalf of a local government, the most important principle to keep in mind is that, in order to limit risk to the local government from the contractual relationship, there must be certainty between the parties as to the terms of the contract. In this regard, it is imperative that the parties finalize the contract prior to the contractor providing any services to the local government.

It is always preferable to evidence the nature of the obligations placed on the parties under the contract in writing. The written contract should stipulate that the written contract constitutes the whole of the contract between the parties and that the representations, discussions, and negotiations between the parties towards the making of the contract that are not evidenced directly in the written contract do not form part of the contract. The written contract should include all of the fundamental terms of the contract (e.g., the description of the service to be provided to the local government under the contract, the price to be paid for the service, the method and timing of payment, the duration of the contract, and the rights of the parties to unilaterally terminate the contract with or without cause). In addition, the written contract should specifically address any specific concerns that the local government has with respect to the contractual relationship.

B. Administering the Contract

The Contract Language

The most fundamental principle to be applied when administering a contract is that the actions of the parties to the contract are governed by, and must be carried out in accordance with, the specific language of the contract being administered. In many circumstances, the specific language of the contract being administered will impose conditions precedent to a party exercising certain rights or privileges under the contract. For example, in a situation where a

local government wishes to exercise its right under the contract to terminate the contract for cause, it is likely that the specific language of the contract authorizing such termination requires that the local government provide notice to the contractor of the same in writing. In such a situation, if the local government fails to comply with the written notice requirement under the contract, it is likely that the Court would hold the local government to strict compliance with the specific language of the contract and find that the owner's termination of the contract was ineffective. As such, it is crucial that local governments be aware of the specific language of the contracts being administered by them in order to ensure that their position vis-a-vis the contractor is not prejudiced by their actions.

The Contract Administrator

Local governments have generally either administered contracts internally through the department responsible for the service being provided or through external consultants retained for the purposes of administering the contract. Regardless of which approach is taken by a local government, it is important that the administration of the contract be coordinated by a single individual who is knowledgeable in relation to the subject matter of the contract. In this regard, it will be possible for the contract administrator to closely monitor the contractor's obligations under the contract and ensure that the contractor is meeting the obligations placed on him by the contract. Otherwise, there is a possibility that specific issues relating to the administration of the contract may be overlooked.

Documents Required Under the Contract

In order to limit liability to local governments from the actions of their contractors, most local government contracts require the contractor to provide the local government with various forms of documentation within a specified time period after the execution of the contract. This documentation generally includes copies of required insurance policies, performance bonds, and labour and materials bonds.

From the perspective of the local government, in order to provide the local government with the greatest security possible, it is important that all required documentation be provided by the contractor to the local government prior to the contractor beginning work under the contract. In this way, if the documentation does not meet the requirements of the contract, the contract administrator can require the contractor to provide the further documentation necessary to satisfy the contract requirements. By doing so, the local government will be in the best position possible to ensure that the safeguards built into the contract relating to the contractor's ability to indemnify the local government for any damage caused by the contractor in the performance of the work under the contract, and to satisfactorily fulfil its obligations under the contract to perform the work, will be given full effect.

With respect to insurance policies, it is important for the local government to have copies of insurance policies required under the contract in case a claim is brought by a third party in relation to the contractor's performance of the contract as one or more of those insurance

policies may provide the local government with coverage in relation to such a claim. Often times, the contract will require that the local government be an additional named insured on these insurance policies, thus affording the local government an additional avenue to pursue on its own in the event of a claim relating to the performance of the contract.

With respect to performance bonds and labour and materials bonds, it is important for the local government to have copies of such bonds required under the contract in case the contractor appears to default on the contract and the local government must decide whether it ought to call on the bond and notify the appropriate bondsman (or surety) of the contractor's default.

It should be noted that, in some cases, documentation required to be provided by the contractor to the local government under the contract may require renewals prior to the contractor completing the work under the contract. For example, in the case of insurance policies, where the contract will require more than one year to be completed, it will be necessary for the contractor to provide the local government with renewals of all required insurance policies prior to their expiry. In this regard, it is important that the contract administrator ensure that either the contractor has provided the local government with the necessary renewals, or the local government has exercised any rights that it has under the contract to renew the insurance policies itself and deduct the cost of the same from the contract price.

Terminating the Contract

The greatest exposure to liability for local governments in contractual relationships arises in situations where the local government seeks to terminate a contract prior to the contract expiring on its own terms. In the event that the local government wrongfully or improperly terminates the contract, the local government may be liable to the contractor for the profits lost by the contractor from the early termination of the contract.

All local government contracts should include provisions authorizing the local government to unilaterally terminate the contract with or without cause.

Local governments should be extremely cautious in exercising the right to terminate the contract. In the case of termination of the contract for cause, the local government must be clear that sufficient cause exists to justify termination of the contract immediately. Where there is some question as to whether there is sufficient cause to terminate the contract, the local government should exercise its right to terminate the contract without cause on the basis of the notice period specified in the contract.

In any event, regardless of whether the termination of the contract is for cause or not, the local government must exercise the right to terminate in accordance with the procedure, if any, specified in the contract.

III. SPECIFIC ISSUES IN RELATION TO CONTRACTUAL RELATIONSHIPS FOR CONSTRUCTION PROJECTS

A. The Decision as to the Form of Contractual Relationship

Traditionally, there have been two forms of contractual relationship used by local governments in relation to construction projects; the first, known as being where the local government enters into a single contract with a contractor for all services in respect of the construction of the project and the second being where the local government enters into a contract with a construction manager for all services relating to the management of the construction project and enters into direct contracts with numerous trade contractors to carry out discrete aspects of the construction of the project. The former is known as a "General Contractor" form of contractual relationship and the latter is known as a "Construction Management" form of contractual relationship. More recently, local governments have been considering a third form of contractual relationship in relation to construction projects, being a hybrid of the latter form of contractual relationship known as "Construction Management At Risk".

The General Contractor form of contractual relationship transfers the greatest degree of risk in respect of the costs of constructing the project from the local government to a third party, in this case the general contractor. In this form of contractual relationship, the general contractor is responsible for completing the construction project for the contract price, subject to amendment for approved extras, regardless of the costs actually incurred by the contractor to complete the work. In addition, if a subcontractor defaults in respect of the completion of its work in respect of the contractor, the contractor is responsible for ensuring that the subcontractor's work is completed at no additional cost to the local government. Moreover, if that subcontractor's default results in delays to other subcontractors completing their work, the contractor is responsible for ensuring that the other subcontractors' work is completed at no additional cost to the local government. In addition, if the general contractor defaults on its contract, the local government only has one party that it must deal with in order to ensure the completion of the project. As a result of this significant transfer of risk, the up-front disclosed costs of such a contractual relationship are generally higher than the up-front disclosed costs of a Construction Management or Construction Management At Risk.

Generally speaking, the Construction Management form of contractual relationship retains risk in respect of the costs of constructing the project with the local government. The role of the construction manager is to coordinate the construction of the project (including the preparation of tender and contract documents, the handling of the tender processes for the trade contracts, and the completion of tender documents), and the supervision of the construction of the project with the various trade contractors. As for the contract with the construction manager, it must be remembered that the construction manager's fee is based on the amount of time expected to complete the project and, to the extent that the time to complete the project exceeds that estimate, the construction manager will charge additional monthly amounts for that additional time. In addition, standard form construction manager

contracts require local governments to reimburse the construction manager for, amongst other things, the construction manager's actual costs of providing the construction management services. In this regard, the construction manager's contract fee represents the construction manager's expected profit on the contract; the construction manager being reimbursed for its actual costs of providing the services as a "reimbursable expense". As for the contracts with the trade contractors, it must be remembered that each trade contractor is only responsible for the work included within its contract and that the coordination between the trade contractors is the responsibility of the local government through the construction manager. Often times, the contract with the construction manager and the contracts for the trade contractors do not adequately address the coordination responsibilities of each party, and the construction manager fills the gaps and charges the local government for doing so. Moreover, there is usually work that is required to be done that is not within the scope of any of the trade contracts. The construction manager usually carries out this work and charges the local government for the same. All of these are "hidden" costs that can rapidly increase the up-front disclosed costs of a Construction Management form of contractual relationship. In addition to these hidden costs, the local government has risk in respect of each of the contracts with the trade contractors that the trade contractor will default in respect of its contract. In such circumstances, the local government is responsible for the costs associated with remedying the default of that trade contractor, and with the additional costs incurred by other trade contractors as a result of the default of that trade contractor. These costs can rapidly escalate. In addition, the local government will have to maintain a builders lien holdback in respect of each trade contract and deal with any liens filed against the local government's property on which the project has been constructed. Local governments should add to the up-front disclosed costs of a Construction Management form of contractual relationship an estimate of the costs associated with the risks outlined above.

The Construction Management At Risk form of contractual relationship transfers some risk from the local government to the construction manager in that the construction manager guarantees cost overruns to the extent of the construction manager's fees under its contract. However, in exchange for this guarantee, the construction manager generally demands a greater construction management fee and requires that it have greater control in respect of the selection and control of trade contractors. This form of contractual relationship essentially carries with it the same risks associated with the Construction Management form of contractual relationship, with those risks offset to the extent of the construction manager's fees. Again, local governments should add to the up-front disclosed costs of a Construction Management form of contractual relationship an estimate of the costs associated with those risks, less the amount of the construction manager's fees.

B. The Making of the Contracts

When entering into contracts for the construction of local government projects, local governments should be cautious in utilizing standard from construction contracts, such as the CCDC Stipulated Price Contracts, as such contracts have been developed over the years by the

construction industry and have largely been drafted in a manner to protect the general contractor, the construction manager, or the trade contractor as the case may be to the detriment of the local government. In this regard, local governments should insist that the general conditions to the standard form contract be amended to properly allocate risk as between the local government and the other party, and that supplementary general conditions be added to the standard form contract for that purpose. For example, amendments should be made to standard form general contractor and trade contractor contracts that clearly identify the rights of the local government as they relate to the keeping and use of deficiency holdbacks on the one hand, and the keeping and use of builders lien holdbacks on the other hand, and the rights of the local government to call on performance security in circumstances of default, which circumstances are more clearly identified in the contract. Moreover, amendments should be made to standard form construction manager contracts to clarify the overall price to be paid to the construction manager.

C. Administering the Contracts

Obligations of the Owner's Consultant or Construction Manager

Quite frequently, when we are requested to advise a local government in respect of issues relating to a tender process, we are told that the local government's consultant (usually an architect or engineer) or construction manager has recommended that the local government get advice from us as to how to proceed. When we enquire of the client as to the respective roles of the local government and its consultant or construction manager, we discover that the local government has contracted with the consultant or construction manager to administer the tender process and to make recommendations to the local government as to the award of the contract in question. By that contract, the local government has usually effectively transferred risk in respect of the tender process to the consultant or construction manager. By seeking advice from us as to an issue that has arisen in a tender process, the local government may be putting itself in the position of that risk being returned to it.

When requested by a consultant or construction manager to refer a matter to a third party, a local government should always first determine whether the matter is within the scope of the contract between the local government and the consultant or construction manager. Local governments pay significant fees and charges to their consultants and construction managers and should demand that the consultants and construction managers carry out all of their responsibilities under their contracts.

Extras and Change Orders

Generally speaking, all construction contracts entered into by local governments contain provisions that provide the local government with the ability to make additions, deletions, or other revisions to the work to be performed by the contractor under the contract. It is important to note that such provisions generally provide that no addition, deletion, or other revision to the work is authorized unless a "change order" has been issued by the local

government, and that the contractor shall not perform any addition, deletion, or other revision to the work without first receiving a "change order" from the local government authorizing the same.

While the specific language of the provisions of construction contracts that permit local governments to make additions, deletions, or other revisions to the work to be performed under the contract by the contractor suggests that it is the local government that initiates the issuance of "change orders", this is not the case in practice. To the contrary, it is usually the contractor that approaches the local government and requests the issuance of a "change order" to authorize an addition, deletion, or other revision to the work that the contractor deems to be necessary. In fact, in most of these situations, the contractor is retroactively requesting that the local government authorize an addition to the work that has already been performed by the contractor. In this manner, the contractor is seeking payment in relation to the same as an "extra" notwithstanding the fact that the addition was not pre-authorized by the local government.

Moreover, in some situations, contractors have requested "change orders" from local governments for work that the contractors have performed which already falls within the scope of the contract between the contractor and the local government. In this manner, the contractor is essentially seeking double recovery in relation to that work.

When dealing with requests for "change orders" from contractors, local governments must be critical in evaluating the request. First, the local government ought to consider whether the subject matter of the "change order" sought by the contractor falls within the scope of the work required to be performed by the contractor under the contract in its current form. Second, if the subject matter of the "change order" does not fall within the scope of the work required to be performed by the contractor under the contract in its current form, the local government must consider whether the subject matter of the "change order" is reasonably necessary for the proper completion of the project.

Generally speaking, where a "change order" is to be authorized under a contract, such authorization is required to be in writing and takes effect immediately thereafter.

Payment Under the Contract

Construction contracts entered into by local governments generally contain detailed provisions which provide for both progress payments to be made by the local government to the contractor as the work under the contract is being performed, and final payment to be made upon completion of the construction project. In this regard, it is likely that these provisions establish a procedure for the handling by the local government of requests from the contractor for payment.

Generally speaking, requests from the contractor for payment under the contract are considered by an individual who has been nominated as the "payment certifier" under the

contract by both the contractor and the local government. In most cases, this individual is the contract administrator.

When the payment certifier receives a request from the contractor for a progress payment under the contract, the payment certifier must, within a time period established under the contract, determine the value of the work performed by the contractor under the contract in relation to the progress payment, and issue a certificate for payment in that amount to the local government. In most cases, the local government will then be obliged to make payment to the contractor in the amount of the certificate for payment. However, it is likely that, as a precondition to such payment, the local government has the ability under the contract to require the contractor to provide the local government with a sworn declaration that all amounts owing to third parties relating to the work for which the progress payment is sought have been paid.

Likewise, when the payment certifier receives a request from the contractor for final payment under the contract, the payment certifier must, within a time period established under the contract, determine whether the work under the contract is complete and, if it is, issue a certificate for final payment. In most cases, upon issuance of a certificate for final payment, the local government will be obliged to make payment to the contractor in the amount of the certificate for final payment, subject to receiving a sworn declaration from the contractor similar to the one discussed above.

It is clear from the above that local governments should always endeavour to have their consultant act as payment certifier on construction contracts. Despite the fact that the standard form contracts specify the contractor's consultant as the payment certifier, local governments should never accept the same. It is far too dangerous a game to play to authorize the contractor's consultant to certify payments to his own client.

Builders Lien Holdbacks

With the *Builders Lien Act*, S.B.C. 1997, c. 45, the administration of construction contracts, at least in relation to builders lien holdbacks, became somewhat more complex.

Pursuant to section 4(1) of the Act, the amount of the holdback is to be equal to 10% of the greater of the value of the work or material as they are actually provided under the contract (value being calculated on the basis of the contract price or, if there is no specific price, on the basis of the actual value of the work or material), or the amount of any payment made on account of the contract price.

In the case of progress payments made under the contract, it is clear that section 4(1) of the Act requires local governments to retain holdbacks in relation to each progress payment made by the local government in relation to the contract or on account of the contract price.

Pursuant to section 8 of the Act, the holdback period is set as follows:

> 8 (1) If a certificate of completion is issued with respect to a contract or subcontract, the holdback period in relation to
>
> (a) the contract or subcontract, and
>
> (b) any subcontract under the contract or subcontract
>
> expires at the end of 55 days after the certificate of completion is issued.
>
> (2) The holdback period for a contract or subcontract that is not governed by subsection (1) expires at the end of 55 days after
>
> (a) the head contract is completed, abandoned or terminated, if the owner engaged a head contractor, or
>
> (b) the improvement is completed or abandoned, if paragraph (a) does not apply.

The holdback period set out in section 8(1) of the Act turns on the actions of the payment certifier nominated under the Act involving the issuance of certificates of completion under the Act. Generally speaking, the payment certifier nominated under the Act is the same individual who has been nominated as "payment certifier" under the contract for the purposes of issuing certificates for payment (i.e., the contract administrator).

Section 7 of the Act provides the payment certifier with guidelines for the issuance of certificates of completion under the Act. The more significant of these guidelines are:

1. Section 7(3) which provides that, on the request of a contractor or subcontractor, the payment certifier must, within ten days, determine whether the contract or subcontract has been completed and, if the payment certifier determines that it has been completed, the payment certifier must issue a certificate of completion;

2. Section 7(4) which provides that, if a certificate of completion is issued, the payment certifier must, within seven days, deliver a copy of the certificate to the owner, the head contractor, and the person at whose request the certificate was issued, deliver a notice of certification of completion to all persons who

submitted a request for particulars under subsection (2) in relation to the contract or subcontract, and post, in a prominent place on the improvement, a notice of certification of completion;

3. Section 7(8) which provides that a payment certifier who receives a request for certification of completion under subsection (3) and who fails or refuses, without reasonable excuse and within the time specified in that subsection, to issue a certificate of completion respecting the contract or subcontract is liable to anyone who suffers loss or damage as a result; and,

4. Section 7(9) which provides that a payment certifier who fails or refuses to comply with the requirements of subsection (4) in respect of a certificate of completion issued by the payment certifier or as a result of the declaration of the Court is liable to anyone who suffers loss or damage as a result.

Under section 7(3) of the Act, the level of "completion" required for a contract or subcontract by the payment certifier in order to issue a certificate of completion is that the contract or subcontract is capable of completion or correction at a cost of not more than 3% of the first $500,000 of the contract price, 2% of the next $500,000 of the contract price, and 1% of the balance of the contract price.

The holdback period set out in section 8(2) of the Act turns on the completion, abandonment, or termination of the head contract, or the completion or abandonment of the improvement.

While the level of "completion" required under section 8(2)(a) of the Act corresponds with that required by the payment certifier for the issuance of a certificate of completion, the level of "completion" required under section 8(2)(b) for an improvement is that the improvement, or a substantial part of it, is ready for use, or is being used, for the purpose intended.

"Abandonment" under section 8(2) requires the passage of a period of 30 days during which no work has been done in connection with the contract or improvement, unless the cause of the cessation of work was and continues to be a strike, lockout, sickness, weather conditions, holidays, court order, shortage of material, or other similar cause.

With builders lien holdbacks, it is important to recognize that local governments do not have the authority to retain the holdback once the holdback period has expired. In this regard, it is important that the contract administrator be closely aware of the progress of the construction project in order to ensure that he is aware when the holdback period is triggered under either section 8(1) or 8(2). Moreover, it should be noted that, if the payment certifier under the Act issues a certificate of completion in respect of the contract improperly (e.g., prior to actual completion of the contract in accordance with the test set out in the Act) it appears that such a certificate of completion will nonetheless trigger the holdback period. As such, any failure on the part of the payment certifier to comply with the notice and posting requirements under section 7 may result in the payment certifier being held personally liable for any losses or

damages suffered by third parties as a result of the improper issuance of the certificate of completion.

Failure on the part of a local government to comply with the Act, and in particular those provisions outlined above, could result in significant liability to both the local government and the payment certifier.

Default Under the Contract

Where their contractors are in default under a construction contract, local governments, in addition to having common law causes of action against the contractors for damages in breach of contract, generally have a number of additional remedies available to them under the contract.

In cases where the contractor's default does not go to the root of the contract, the local government is generally authorized under the contract to give the contractor notice of default (which is generally required to be in writing), requiring the contractor to correct the default within the time period set out in the contract. In such circumstances, the contract will likely set out the steps necessary to be taken by the contractor in order to comply with the local government requirement to correct the default. In this regard, it is likely that the contractor will be deemed to have complied with the requirement if it has commenced the correction of the default within the specified time period, provided the local government with an acceptable schedule for the corrective work, and corrects the default in accordance with that schedule.

Where the contractor fails or refuses to correct, or commence the correction of, the default within the time period specified by the local government, the contract will likely provide the local government with two options for remedying the contractor's failure or refusal to correct the default. First, the local government will likely be authorized under the contract to correct the default itself and deduct the cost of the corrective work from any payment then or thereafter due to the contractor. In this manner, the local government recognizes that the contract continues in existence and can continue to exercise its remedies under the contract. Second, the local government will likely be authorized under the contract to terminate the contractor's right to continue with the work in whole or in part, or terminate the contract completely. In this manner, the local government brings the contract to an end and must avail itself of its remedies at common law if it suffers damages as a result of the contractor's default under the contract.

In cases where the contractor's default goes to the root of the contract, the local government is generally authorized under the contract to terminate the contract upon giving the contractor written notice of the same. In such circumstances, it is very important that the local government be confident that the contractor's default is of such a nature as to warrant the immediate termination of the contract. Otherwise, it is likely that the contractor will bring legal proceedings against the local government for breach of contract.

IV. CONCLUSION

In conclusion, the fundamental principles to bear in mind in order to limit liability arising from contractual relationships are that there must be certainty in the obligations placed on the parties under the contract and that the local government must act in accordance with its rights under the contract (including following procedures for exercising those rights set out in the contract). In the end, if a local government approaches contractual relationships with common sense tempered by a little caution, the local government will be safe from significant liability down the contractual road.

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