Managing risks in contracts

In a recent presentation to a Link2Build audience, OCA board member Dan Leduc offered some tips and suggestions for contractors and subcontractors on ways to manage risks associated with price escalation and supply chain issues in their construction contracts.

As the price of construction commodities continues to trend upwards, contractors and owners are finding themselves in the difficult position of having to guarantee contract terms in a market where guarantees simply don't exist.

It's not news to say that some commodities are seeing prices rise weekly, and suppliers—where they even can meet orders—won't guarantee prices beyond three or five days at a time. That's a particularly challenging situation for general contractors and subcontractors who are increasingly being asked to reserve their contract prices and terms for periods that stretch to 60 or even 90 days. Something has to give.

Dan Leduc, an OCA board member and a partner with Norton Rose Fulbright LLP, recently delivered a webinar presentation to a Link2Build audience about how to use contracts to manage the risk of price volatility.

Know what you're signing before you sign

Leduc opened his presentation with a simple message to the audience: read a contract before you sign it.

"It's ironic that as contractors, arranging the terms of a project by a contract is in your very nature," he said. "The term 'contract' is even part of the word 'contractor'. Everything you do is done by contract, whether that's leasing equipment, working under a collective bargaining agreement, or buying materials. Yet no one likes reading their contracts and people don't spend nearly enough time doing it."

It goes without saying that a contract, whether it sets out a cost-plus, fixed-price, integrated project delivery or public-private partnership arrangement, sets out the terms of the agreement between parties. It is the part of the contracting process that sets out risk allocation. It's where you agree to perform various tasks and carry various risks, and whoever you're contracting with does the same.

Contracts also inherently include expressed and implied terms. It's critical to understand what terms of the contract arrangement are being expressed clearly in the document, and which are read into the contract by implication. For example, any risks driven by the COVID-19 pandemic, including pricing and supply risks, must be expressed in a contract. They cannot be implied. So, said Leduc, if you don't see anything in the contract about how any risks relating to scheduling, the supply chain or price volatility will be managed, assume they're yours to carry. Don't ever assume critical terms like these are implied.

"In the tender process, you can't always dictate the terms of a contract, but you can go into the contracting process with your eyes wide open," said Leduc. "You have to know the risks you're assuming, and you have to adjust your strategy and your execution plan to ensure you remain profitable."

Leduc also advised contractors to be mindful about how contract risks are allocated by reference. For subcontractors, time spent understanding how risks relating to COVID are being handled in the prime contract between the general contractor and the owner helps to give a better picture of how subs will be affected. In some cases, the prime contract may form part of a subcontract, in which case, it's even more essential to obtain—and read—that prime contract.

"You can't afford not to read your contract documents and make sure you understand what they're saying," said Leduc. "I also tell my clients that every $1 you spend on addressing issues before signing a contract will save you $20 in legal fees after you sign on the dotted line."

Consider negotiations

Contracts can be a result of negotiations. They therefore can be open to amendments to make, in this case, the allocation of risks associated with price volatility fairer to everyone.

Leduc advises that owners consider reducing their contract-award periods. Some are extending out as far as 60 or 90 days, but when steel suppliers, for example, will guarantee their prices for just five days, it's in the owner's best interests to shorten award times. If they persist with their long award periods, contractors will rightly protect themselves against sharp price increases by incorporating huge contingencies.

Another mitigation strategy for contractors is to amend your bid to say you won't hold your price for the required 60 or 90 days, but for a shorter period of, say, 30 days. It's a strategy that contractors certainly use, but Leduc says qualifying a bid in this way may technically render the bid non-compliant. An owner must accept your proposed, amended terms and include them in the construction contract for the change to be brought forward. They can just as easily reject your bid out of hand for including the change.

While qualifying your bid, you might also consider including a price-escalation clause. A simple clause that says something along the lines of 'my price for this commodity is X as of this date, and if that price goes up by Y percent, or if there are issues with supply of this commodity, I can seek recourse through my contract' can help to protect you against price escalations. Leduc advises, however, that strategy involves carefully monitoring commodity prices. He recommends using the Producer Price Index published monthly by the US Bureau of Labor Statistics as a reliable and trustworthy benchmark.

"Again, beware: if your contract doesn't specifically include a price-escalation clause, do not assume it is implied in the contract," he adds. "More often than not, the lack of that clause means you're locking in on a price."

Force majeure is one of the terms the industry threw around a great deal in the spring of 2020 when the COVID-19 pandemic caught everyone off guard. In some cases, it helped contractors recoup some of the additional costs they incurred on projects due to the need for more personal protective equipment, lost productivity, supply chain hiccups, and so on. Leduc's advice for 2021: don't assume force majeure is still in play.

"COVID is not an unforeseen event any longer," he explained. "We know now what it's doing to labour, to prices, to productivity. Force majeure, when it's in place, helps mitigate the effects of unforeseen events."

Likewise, he cautions against carrying forward any clauses that qualify a bid based on lost productivity. The productivity issues created by COVID a year ago are largely behind us, and are fading even further out of view as more of the population is vaccinated.

Once you sign, you commit

Post contract award, there's not a great deal a lawyer can do to help a contractor who's accepted risk they cannot manage.

In situations where a contractor asks for, and is refused, an increase in costs, the threat of leveraged default may come into play. In that case, the contractor holds an off-the-record, or 'without prejudice', discussion with the owner to advise that it is unable to pay for materials to complete the project and cautions that its competitors would likely be in the same situation.

The contractor warns of a potential default on the contract, arguing that if it were to do so, the owner would have to pay costs to not only buy the remaining materials itself, but also pay the cost to sue the contractor for default, and waste time. Those costs, the contractor argues, would be the same or greater than the cost to retain the contract and pay the price escalation it initially requested.

The aim of the tactic is to open a discussion with the owner to reach an agreement on how to manage the cost escalation, but it's not without risk. Threatening default is a strategy of last resort.

Pay attention to the fine print

Leduc's last piece of advice is to exercise caution. Spend that time reading a proposed contract and its fine print, and seek legal advice if something isn't clear or seems risky.

"Contractors usually spend lot of time on the numbers they submit at the tender stage of a contract—a lot more time than they usually spend on reading the terms and conditions of the contract, which is where the risk-allocation happens," said Leduc. "My advice: pay attention to the fine print. It's as important—or more so—than working out your selling price."

Material prices, demand increase Q1 construction costs

The increase of 5.6 percent in the cost of residential construction is the largest on record, and is largely due to rising demand and material shortages. Non-residential building construction prices, meanwhile, rose by 1.5 percent.

Rising material prices and relentless demand for housing have combined to increase construction costs across the board.

Statistics Canada's latest look at building construction prices, for the first quarter of 2021, shows an increase of 5.6 percent for residential construction—the largest increase since the data series began in 2017. Non-residential building construction prices, meanwhile, rose by 1.5 percent, led mostly by higher construction costs for factories and warehouses.

Construction costs rose for every building type in the first quarter, ranging from a 1.2 percent-increase for office buildings, to a 6.9-percent gain for townhouses, and a gain of 6.8 percent for single-detached houses.

The higher construction costs were mostly driven by a shortage of construction materials. In March, the prices of softwood lumber rose by nearly 12 percent while the price of plywood rose by more than 20 percent.

At nearly 119 percent, softwood lumber prices rose at their fastest year-over-year pace on record in March, partially because of low stocks following the temporary shutdown of sawmills during the first wave of the COVID-19 pandemic.

The surge in residential construction costs was also spurred by historically low interest rates and a desire for more living space during the pandemic. Investment in residential construction continued to rise, mostly driven by the growth of single-family home construction. Residential construction investments have been reached consecutive record levels since September 2020, and stood at a new high of $12.3 billion in February.

In Toronto, for example, residential construction costs were up 7.2 percent overall, led by a 9.0 percent price increase to build single-detached houses.

Non-residential building construction costs rose at the fastest pace for factories (+2.1 percent) and warehouses (+1.8 percent) in the first quarter. Warehouse space is at a premium in the wake of retail e-commerce sales increasing 92.0 percent year over year in February, following a 116.8 percent surge in January.

Non-residential building costs were up in every city covered by the survey, with prices rising at the fastest pace in Ottawa (+2.4 percent) and Montréal (+2.0 percent), mostly because of warehouses and factories.

Residential building construction costs rose at a record year-over-year pace of 11.7 percent in the first quarter, mostly because of limited supply and increased demand for building materials. Costs rose at the fastest pace in Calgary (+16.8 percent), Toronto (+15.0 percent) and Ottawa (+14.6 percent) in the first quarter.

Non-residential building construction costs rose 2.1 percent year over year, led by Ottawa (+4.9 percent) and Montréal (+4.4 percent).