FEBRUARY 2013

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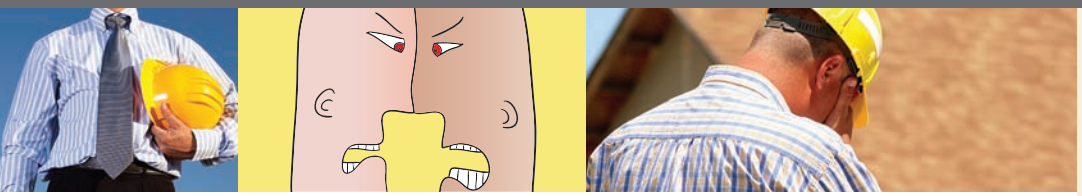

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A Primer on Surety Bonds

By David de Groot

Introduction

Surety bonds are a very common legal mechanism whereby construction project owners can ensure that their general contractors perform and complete their construction contract obligations. Likewise, general contractors can ensure that their subcontractors perform and complete their construction contract obligations. Despite surety bonds being such a valuable legal tool within the construction industry, they are not necessarily well known or well understood. Nor are all the consequences of such bonds fully understood. This article seeks to provide owners, general contractors and subcontractors with some background and other information on surety bonds. In particular, this article

- describes the basic characteristics of a surety bond as opposed to other forms of legal relationships,
- describes the types of surety bonds available, and
- discusses some of the challenges that owners, general contractors and/or subcontractors may experience if and when they rely on the different types of surrety bonds.

The Basic Characteristics of Surety Bonds

According to *Scott and Reynolds on Surety Bonds*, surety bonds have four basic characteristics:

- there is a tripartite relationship involving a principal (the person who acquires the bond), a surety (the person who provides the bond), and an obligee (the person for whom the bonds was acquired);
- the surety's obligation must be collateral to the obligation of the principal (i.e. the surety is only called on if the principal defaults);
- the surety's obligation to the obligee must be the same as, or less than, the obligation of the principal; and
- the surety must be unconnected to the transaction except as surety, having no other interest in the transaction.[1]

Importantly, a surety bond is not a contract of insurance. An insurance contract is a two-party relationship where an insurer agrees to pay money to the other party upon the happening of certain events. A surety bond is a tripartite relationship in which the surety agrees to pay money to an obligee to ensure the performance of the principal's contractual obligation. In other

By acquiring a bid bond, the owner or general contractor acquires immediate payment if the general contractor or subcontractor does not sign a final construction contract.

words, while an insurance contract creates an independent obligation between the insurer and the third-party, a surety bond simply causes a surety to step into the shoes of the principal and perform that party's already pre-existing contractual obligations.

This distinction has two implications. First, the parties' obligations are different. Specifically, an insurer's obligations are its own but arise on the happening of an event. A surety's obligations are those of the principal and arise on the principal's default. Second, and perhaps more importantly:

> [A] loss on a surety bond is ultimately the principal's loss, i.e. the surety looks to the principal for recovery of any loss pursuant to the indemnity agreement, and the surety is entitled at common law, even in the absence of the usual indemnity agreement, to reimbursement from the principal.[2]

Therefore, an insurance contract causes an insurer to pay the counter-party certain funds upon the occurring of an event and the insurer does not seek indemnity from that third party. A surety bond causes a surety to assume the counter-party's obligations and tety will seek to recover those funds from the counter-party. This distinction is important when considering the challenges that can be associated with surety bonds.

Types of Surety Bonds

There are four major types of surety bonds: bid bonds, performance bonds, labour and material bonds and lien bonds. Each of these is discussed briefly in the sections that follow.

A. Bid Bonds

A bid bond is a promise by a surety to an obligee that if the obligee awards a contract to the principal and the principal fails to sign a final construction contract then the surety will pay a stipulated penalty.[3] For example, an owner may require that general contractors include a bid bond with their bids. In such circumstances, the general contractor must contract with the surety on terms that if the owner accepts the general contractors' bid and the general contractor does not sign a final construction contract; the surety is obligated to pay the owner a stipulated penalty. Similar arrangements can be made by a general contractor seeking performance assurances from major subcontractors, such as electrical and mechanical subcontractors.

By acquiring a bid bond, the owner or general contractor acquires immediate payment if the general contractor or subcontractor does not sign a final construction contract. The owner or general contractor does not have to concern itself with proving damages caused by the counter-party's refusal to sign a final construction contract. In turn, the surety has no interest in the project and will pay the owner or general contractor upon the general contractor or subcontractor's failing to sign a final construction contract. The surety will then seek recovery from the contractor or subcontractor's indemnity—which is a more straightforward legal claim. Accordingly, bid bonds encourage general subcontractors or subcontractors to ensure the accuracy of their bids. They also prevent parties from bidding if they are not serious about bidding. These advantages allow owners and general contractors to obtain cost and performance certainty for construction projects.

However, bid bonds have certain challenges because the surety steps into the shoes of the principal and may raise defences that the principal could raise. For example, the surety could claim that the amount of the bid bond stipulated penalty is a penalty and not liquidated damages. This can result in litigation over the appropriate amount of the stipulated amount payable.

As well, the surety can raises defences that the principal may have based on the law pertaining to tendering in Canada. Most importantly, the "Contract A" and "Contract B" analogy applied to the law of tendering creates the potential that while the principal may be liable for breach of contract, the surety may not be liable. In this regard, Scott and Reynolds write:

> Whereas the tenderer's informing the owner of a mistake could trigger forfeiture of a cash deposit, it would not necessarily trigger liability under a Bid Bond because the standard wording of a Bid Bond fixes the surety with liability only if the owner's acceptance of the bid has created a binding construction contract, i.e. Mr. Justice Estey's Contract B.[4]

A simple example of this is as follows: the contractor bids on a project and realizes there is a mistake with its bid. The contractor informs the owner who proceeds not to accept the mistaken bid but accepts another bid. If the contractor has a cash deposit that is forfeited upon rescinding the tender, then the contractor will forfeit this cash deposit. But if the contractor has posted a bid bond that pays on the condition that the contractor not sign a construction contract offered by the owner, then there will be no payment. This is so because the owner never offered the contract to the contractor and hence the condition for payment is not met.

Accordingly, care must be taken when properly drafting bid bond terms and conditions.

B. Performance Bonds

A performance bond is a promise by a surety to the obligee that if the principal defaults in the performance of a specific contract then the surety will perform the principals' obligations either by remedying the default, completing the contract, bidding on the cost to complete, or paying money to the obligee to complete the project.[5] For example, an electrical subcontractor may sign a performance bond pursuant to which a surety will complete the electrical subcontractors' work for the general contractor if the electrical subcontractor does not perform on its subcontract. As such, a performance bond is a powerful legal tool to ensure completion of a construction project because the owner may acquire a performance bond for its general contractor and the general contractor may acquire performance bonds for all its major subcontractors, thus ensuring through the construction pyramid that all parties have a surety backing

the performance of their obligations. Where the performance bond is particularly effective, is in the case where the contractor or sub-contractor goes into bankruptcy during the course of the project.

However, despite the significant advantages associated with performance bonds, there are significant defences that a surety can raise to avoid having to pay on this type of surety bond. In particular, the surety can raise the following defences to a demand to pay on a performance bond:[6]

- **the bonded contract is invalid or illegal:** for example, if a contract is for the construction of a property that may be used in the commission of a crime, or if the design drawings for the project are contrary to the building code and cannot be rectified to ensure compliance with the building code, the surety will be under no obligation to complete the project;[7]
- **the principal has not defaulted:** while in many cases the default is clear, in some cases it is not clear that there has been a default. In these cases the surety will assume its principal's position and require the obligee to prove the default before paying on the performance bond;
- **the obligee failed to notify the surety:** before being entitled to call on the surety to perform the construction contract the obligee must give the surety notice of the principal's breaches of its contractual obligations;
- **the obligee is in default:** if the obligee is in default of its obligations under the bonded contract then the surety will not be liable for the principal's default on its contractual obligations. Accordingly, the obligee must be careful to ensure that it is meeting all its contractual obligations. Any default by the obligee will not result simply in a counterclaim for damages but the nullification of the performance bond; and
- **the bonded contract has been varied:** if the bonded contract has been varied in a material manner after the surety bonded the contract, then the surety will not be expected to perform the principal's obligations on the varied contract. Variations in the terms of a bonded contract can include over and underpayments and extensions or abridgments of time for performance.

A performance bond is a valuable tool for owners and general contractors to ensure performance. However, given the number of defences available to the surety, an owner or general contractor must be careful when relying on a performance bond to ensure the performance of subcontractors.

Accordingly, while performance bonds are a powerful tool to ensure performance they also have multiple legal risks associated with them.

C. Labour and Material Bonds

A labour and material bond is a promise by the surety to the obligee to pay the principal's suppliers and subcontractors (claimants) if those parties are not paid by the principal.[8] Accordingly, a labour and material bond is a simple way to ensure that subcontractors and sub-subcontractors have guarantees of payment, thus ensuring their service on a construction project.

Despite these advantages, labour and material bonds can have some unexpected results for owners. In particular, if a surety is required to pay a claimant on a labour and material bond, the surety may require that the claimant assign to the surety any lien rights or other rights that the claimant has against either the obligee or the principal. In this manner, while a labour and material bond ensures payments to subcontractors and sub-subcontractors they can still result in liens being filed against the construction project, and they can also result in actions for unpaid services or materials. Owners thinking that a labour and materials bond avoids lien issues may be in for an unpleasant surprise.

On the other hand, labour and material bonds can also have unexpected results for subcontractors and sub-subcontractors who rely on such bonds as a guarantee of payment for their services and materials. Specifically, if the principal has any defences against these claimants, the surety will step into the shoes of the principal and enforce these defences against the claimants. For example, the surety may claim that due to faulty workmanship the principal has a right of set-off against the claimant. Or the surety may rely on a "pay when paid" clause in the principal contract with the claimant to avoid immediate payment.

Accordingly, neither owners nor claimants are entirely protected if various "middle men" in the construction pyramid have labour and material bonds in force.

D. Lien Bonds

A lien bond is a promise by a surety that if a an owner or general contractor does not pay a lien for which judgment has been rendered against the owner or general contractor, then the surety will pay into court the value of lien judgment.[9] Accordingly, lien bonds allow owners or general contractors to discharge liens from a property while avoiding cash flow interruptions by paying cash into court or decreased credit options by relying on a line of credit.

Importantly a lien bond is posted as security to allow the lien to be discharged and as such stands in the place of the lien. Even if judgment is obtained against the owner or general contractor but the claimant is not successful in proving the validity of the lien, then the lien claimant will not have recourse against the lien bond. Rather, the lien claimant will need to pursue the owner or general contractor for payment of the judgment.

As well, liens often do not include security for interest, and may only provide limited protection for legal costs. Accordingly, if a lien claimant settles a lien claim it is important that the parties to the settlement ear-mark the amounts for the principal debt, interest and legal costs. Of course, such allocations will need to be reasonable.

Finally, lien bonds often suffer all the complications associated with liens in general because the lien bond is standing in the place of the lien. In this manner, those seeking to rely on lien bonds should also seek advice on general matters pertaining to liens.

Conclusion

While surety bonds can give rise to challenges, they remain a good option for owners and general contractors to ensure that construction projects are completed without undue delay. They also provide subcontractors and sub-subcontractors with payment assurances for construction projects. There are significant benefits to surety bonds as all avoid delays, which often lead to increased construction costs and other forms of financial loss. Accordingly, while surety bonds may cause parties to have ongoing disputes related to the project after a project is completed, they enable parties to avoid unwanted delays while the project is ongoing. As such they are a good mechanism to ensure construction performance.

Footnotes

[1] Kenneth W. Scott, Q.C. and R. Bruce Reynolds, Scott and Reynolds on Surety Bonds, volume 1, looseleaf (Toronto: Thomson Reuters, 1993) [updated to 2012] at 2-1.
[2] Ibid. at 2-9.
[3] Ibid. at 9-1.
[4] Ibid. 9-13.
[5] Ibid. 10-1 and 10-7.
[6] See Ibid. 10-14 to 10-26.8.
[7] See for example One Hundred Simco Street Ltd. v. Frank Burger Contractors Ltd. [1968] 1 O.R. 452 (C.A.).
[8] Scott and Reynolds, at 11-1.
[9] Ibid, 12-1.

Construction Management Standard Contract:

By Kevin Burron

Introduction

In late 2010, the Canadian Construction Documents Committee (CCDC) released two new standard documents: CCDC 5A and CCDC 5B. These two documents take the place of the earlier CCA 5 Construction Management Contract published by the Canadian Construction Association. The new CCDC 5A form, similar to the original CCA 5 form, is intended for use in the traditional construction management arrangement, where the construction manager acts as the owner's agent in dealing with trade contractors. The new CCDC 5B form is written for use in the "construction manager at risk" arrangement, where the construction manager undertakes the actual construction and enters into contracts directly with trade contractors. In this regard, the CCDC 5B is a welcome addition, as the CCA 5 was unsuitable for this type of project delivery method and it was easy to end up with a contract that did not properly protect the parties' respective interests. The new CCDC 5A and 5B forms help solve this problem.

The Significance of the Two Contracts

When entering a construction management contract, it is critical that the parties consider the nature of the relationship they intend to create and use the appropriate form of contract for that relationship. The obligations of the owner and construction manager under the agency construction management and the construction manager at risk models are significantly different. It is important that the construction management contract addresses these differences in order to protect the interests of both parties.

In the typical agency construction management scenario, the construction manager represents the owner throughout the project, from pre-design through to construction and commissioning. The construction manager acts as the owner's agent, and typically enters into contracts with trade contractors on behalf of the owner. This means that the owner is effectively acting as the general contractor, with the construction manager's help. The construction manager does not assume the risk of cost overruns or delays on the project, as these risks are allocated between the owner and the various trade contractors. If properly understood and implemented, one of the benefits of this arrangement is that it should allow the construction manager to act in the owner's best interest without its own interests interfering.

In the construction manager at risk model, as the name implies, the construction manager assumes some of the risk of the project delivery. In this model, the construction manager initially acts as a consultant or advisor during the planning and design stages of the project. However, at that point the construction manager's role changes, with the construction manager typically assuming the role of general contractor. In this role, unlike the agency construction management model, it is the construction manager, not the owner, who takes on the budget and scheduling risks. It is important to understand that upon effectively becoming the general contractor, the construction manager is protecting its own best interests, and is no longer acting in the owner's best interest or on the owner's behalf.

Advantages of the construction manager at risk model include potential efficiencies that can result from the general contractor's (construction manager's) input into the planning and design process, the ability for the owner to approve subcontracts, and the potential for fast-tracking or phased construction if the construction manager can start construction on portions of the project before the design for the entire project is complete. Proper language in the construction management contract is essential to deal with the construction manager's shifting role. Before CCDC 5B, no such language existed in a standard form construction management contract.

Highlights of the New Contracts

Some of the significant differences between these new forms and the old CCA 5 form are discussed below.

CCDC 5A: Construction Management Contract – for Services

This is an agency construction management contract, and although similar to the CCA 5 contract there are some significant differences, the key ones outlined below:

1. **Scheduling**
   Under CCA 5, the construction manager agreed to "strive to achieve substantial performance of the project" by a stipulated date. Under CCDC 5A, the construction manager agrees to "continue in accordance with any schedule provided in Article A-3". If a schedule is provided, this requirement may shift some of the risk of project delays to the construction manager, which was not the case under CCA 5.

2. **Own Forces Work**
   CCA 5 permitted the construction manager, with the owner's permission, to perform

Updated to Cover Manager At Risk

work with its own forces on a cost-plus basis. No equivalent provision exists in CCDC 5A, and own forces work must be agreed to beforehand and included in Schedule B1 – Additional Services and Compensation. Alternatively, a separate trade contract with the construction manager could be used for own forces work.

3. **List of Services**
   Schedule A1 in CCDC 5A sets out a list of Services which is somewhat different than CCA 5, and enables the parties to identify who will be performing each listed service and, for those performed by the construction manager, the method of payment for each.

4. **Reimbursable Expenses**
   The list of reimbursable expenses set out in Schedule A2 is different than the list in CCA 5, and notably omits salaries, wages and benefits for the construction manager's personnel, which construction managers should ensure are either included in their fee or specifically added to Schedule A2.

5. **Construction Budget**
   Under CCA 5, the construction manager was obligated to prepare a construction budget at the pre-construction phase and then "revise and refine" the budget and incorporate changes as the project progressed. Under CCDC 5A, the construction manager must prepare multiple levels of cost estimates (Class D to A) at different stages of the project. The requirements for each class of cost estimate are defined in the agreement.

CCDC 5B: Construction Management Contract – for Services and Construction

This form of contract was designed for use in the construction manager at risk scenario. Although similar to CCDC 5A in many respects, some significant differences include:

1. **"Services" and "Work"**
   In addition to Services which are similar to CCDC 5A, CCDC 5B also includes Work to be performed by the construction manager. Work is a defined term that includes the actual construction of the project by the construction manager. This reflects the construction manager's shifting role.

2. **Compensation**
   Alternatives for the construction manager's compensation for Services are the same as those in CCDC 5A. However, CCDC 5B includes three pricing "options", whereby the price for the Services and Work can be changed to a guaranteed maximum price (GMP), a GMP plus percentage cost savings, or a stipulated price. These are not true options in the contractual sense because they require the agreement of both parties to be exercised. But if the parties agree, the options can be exercised at any time. If the stipulated price option is exercised, the contract essentially converts into a CCDC 2 contract.

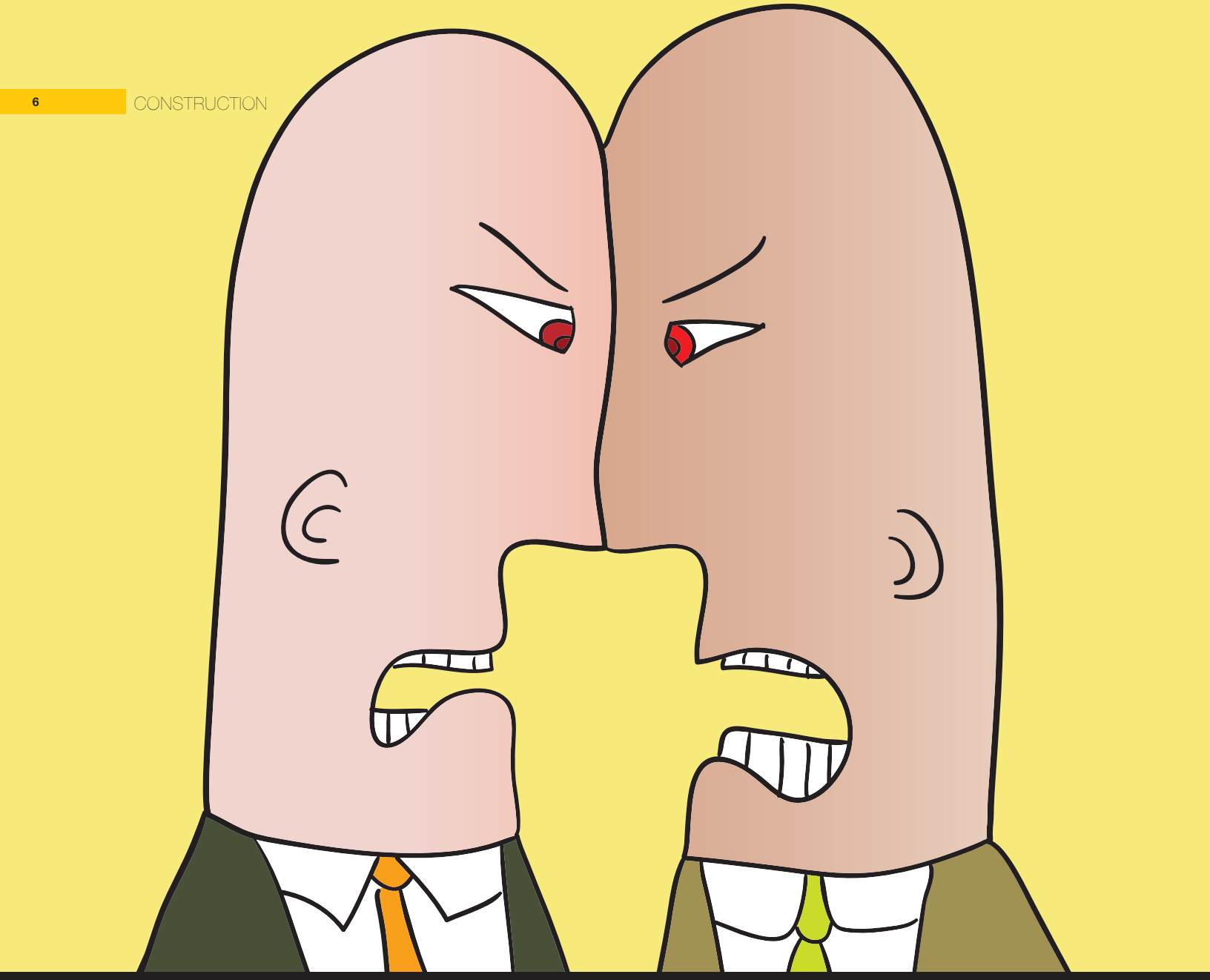
3. **Scheduling**
   GC 3.5 requires that the construction manager prepare a construction schedule prior to the first application for payment, sufficient to demonstrate that the Work will be done within the Contract Time. The parties should ensure that the Contract Time is appropriately defined in Clause 1.3 of Article A-1 of the contract. Under GC 6.5, the construction manager must apply by written notice if seeking an extension of the Contract Time, and provide an explanation for any delay.

4. **No Agency**
   CCDC 5B expressly states that the construction manager is not the owner's agent. Therefore the CCDC 17 standard form of trade contract is not appropriate for use with the CCDC 5B contract.

5. **Owner's approval of subcontracts**
   Even though it is the construction manager, not the owner, who enters into subcontracts directly with subcontractors, the construction manager must submit bids received for each part of the Work and obtain the owner's approval of subcontractors before entering into subcontracts.

Concluding Thoughts

CCDC 5A and 5B provide an update to the existing standard form construction management contract and provide a standard for the construction manager at risk type of contract. Owners and construction managers need to understand which form of contract applies to their circumstances, as well as their respective obligations under whichever contract is used. If properly used, the new CCDC standard construction management contracts provide a fair and effective legal framework for construction management projects for all parties.



Battle of the Forms: YOUR TERMS OR MINE?

by Robert J. Carleton

What Is A Battle Of The Forms?

A typical scenario leading to a battle of the forms arises where parties purport to enter into a contract through the exchange of their standard form documents, neither party knowing the exact contents of the other party's forms and the forms often including terms which are inconsistent with each other. The parties may have operated on this basis repeatedly, largely unaware of the inconsistency in their standard forms, until a problem arises. When a dispute does arise, the court hearing the case will have to decide which terms apply. In such situations the assumption that parties are aware of the terms of the contracts they enter into is called into question.

How Do Courts Deal With A Battle Of The Forms?

Who will succeed in a "battle of the forms" is difficult to predict because the facts of each case tend to determine the outcome. Since the "battles" are so fact specific, even slight changes in the facts can alter the analysis—and subsequently the outcome—considerably. However, case law has produced some general guidelines.

Courts will first examine the parties' conduct in order to assess what each party believed about the terms and conditions of the contract. This may include an examination of the parties' previous dealings for evidence that one party knew and accepted the other's terms and conditions.

The courts will then look to when the contract was formed, keeping in mind the two most basic principles of contract law—offer and acceptance. "Battle of the forms" cases often hold that the contract's terms are those the parties had agreed on at the time the offer was accepted. The problem is that determining precisely when the offer was accepted and the contract finalized is not always easy.

Alternative Types Of Analysis

Traditional Offer & Acceptance – The landmark case on "battle of the forms" was decided by what is often called the traditional offer and acceptance analysis. In Butler Machine Tool Col Ltd. v. Ex-Cell-O Corporation ("Butler Machine")[1] the Court stated that it would consider all of the relevant documents and the conduct of the parties to determine if, although there are differences, the parties have reached agreement on all material points. The Court of Appeal stated that in most cases where there is a "battle of forms", there is a contract as soon as the last of the forms is sent and received without objection. However, the difficulty is to decide which form, or which part of which form, is a term or condition of the contract. The main issue in dispute in this case was a price variation clause which the seller insisted formed part of the contract. The seller's initial offer stipulated the price variation clause under a heading that stated such prevision was to prevail over any terms and conditions in the buyer's order. The Court of Appeal determined that the initial offer made by the seller on the seller's terms and conditions was rejected and that the response made by the buyer—which did not contain a price variation clause—was a counter offer, accepted by the seller who signed and returned an acknowledgement on request of the buyer. The acknowledgement was accompanied by a letter drafted by the seller stating the acknowledgement was in accordance with the seller's original quotation, however, the Court of Appeal clarified that this referred to the price and identity of the machine, but did not bring into the contract the small print conditions on the back of the quotation—where the price variation clause was located.

Although decided by relying on traditional principles of offer and acceptance, the Court of Appeal's judgment in this seminal case has created a lexicon that has been both accepted and rejected with equal enthusiasm and has led to the development of several "rules" or "doctrines" that the court may employ to determine "battle of the forms" issues that come before it.

The Last Shot – In some cases the battle will be won by the one who fires the last shot. This is the party who puts forward the last terms and conditions - if these terms and conditions are not objected to by the other party, that other party may be taken to have agreed to them. For example, two parties enter into an agreement, party A drafts and signs a form setting out pricing terms which is delivered to party B, who in turn signs the form but also adds additional terms (even handwritten terms) before sending the form back to party A. If party A continues to move forward with the transaction, party A will likely not be allowed to later claim that it simply ignored the additional terms added by party B.[2]

The Blow in First – In some cases the battle is won by the party who gets the blow in first. This would be the case where, although there is a material difference, for example, as to price, the buyer accepting the seller's offer on the buyer's different terms and conditions will not be allowed to take advantage of the difference unless he draws it specifically to the attention of the seller. For example, party A provides a price quotation with its terms and conditions on the reverse side of the form and party B responds to the quotation with a purchase order containing its own terms and conditions along with a request that party A return a signed "acknowledgment". Party A does not sign the acknowledgement, but still completes the transaction. If a dispute arises, party B's terms and conditions may not form part of the contract. There are several reasons for this which include: (i) the conduct of the parties demonstrate that neither had considered any terms other than those on the face of documents; (ii) party B did not specifically draw the attention of party A to the additional or differing terms and conditions; and (iii) party B did not complain when party A failed to return the requested acknowledgment.[3]

Shots Fired on Both Sides – In some cases there is no clear winner, rather terms and conditions presented by both sides will form the final contract. This would be the case where there is a concluded contract—a meeting of the minds between the parties—but forms which have been exchanged vary on their terms and conditions. In such a case similarities between the varying forms must be construed to work together and conflicting terms must be replaced using a reasonable implication as to what the parties had intended. For example, party B sends a quotation out to party A. Party A later sends to party B a purchase order containing party A's standard terms and conditions, in addition the form states that acceptance will constitute a legal contract and requests prompt written acknowledgment. Party B sends the acknowledgment with its own standard terms and conditions on the back that tie back to terms and conditions provided by party B on its earlier quotation. In such circumstances a court might find that the terms and conditions attached to party B's acknowledgment which had been referenced in the earlier quotation form part of the contract even though the terms arrived after the "crystallization" of the terms of the contract.[4] This may be even easier for the court to infer if there have been extensive prior commercial dealings between the parties.

The High Level Agreement – Parties can sometimes prevent the battle by having negotiated a "high level" agreement.[5] If negotiations occur between senior representatives from both parties who agree on certain terms, it is unlikely that the parties intended to change the transaction by using standard terms and conditions expressed by the administrative staff involved in carrying out the transaction.

How To Avoid A Battle Of The Forms?

Implementing a set procedure when entering into sales contract involving standard forms can help prevent a "battle of the forms" from developing. Parties are wise to ensure that the other parties to the transaction receive notice of its terms and conditions as early in the transaction as possible and to ensure one's own terms and conditions are included with the offer or acceptance.

Other precautions include placing a signature line and a statement acknowledging consent to the form's terms and conditions on the standard form. In addition a request the acknowledgment be signed and the insistence on the receipt of the signed acknowledgement before acting upon the contract will go a long way to prevent disputes.

Unfortunately, the various approaches that have developed to deal with "battle of the forms" issues have contributed to some uncertainty in the law in this area. Parties who deal with standard form transactions should ensure that a well detailed procedure is in place and that it is consistently followed in order to best protect one's position.

Footnotes

[1] [1979] 1 All E.R. 965, 1 W.L.R. 401.

[2] See for example: *Cariboo-Chilcotin Helicopters Ltd. v. Ashlaur Trading Inc.* 2006 BCCA 50, 14 B.L.R. (4th) 1.

[3] See for example: *Tywood Industries Ltd. v. St. Anne-Nackawic Pulp & Paper Co.* (1979), 100 D.L.R. (3d) 374 (Ont. H.C.).

[4] See for example: *General Refractories Co. of Canada v. Venturedyne Ltd.* (2002) 110 A.C.W.S. (3d) 1157, 2002 CarswellOnt 36 (S.C.J.) *[General Refractories]*.

[5] See for example: *Hershey Canada Inc. v. Solae, LLC* [2007] O.J. No. 3215, 159 A.C.W.S. (3d) 819, 2007 CarswellOnt 6370 (Ont. S.C.J.) and *General Refractories*.

"Extra" Liability:

Managing the Risk of Extras in Construction Contracts

By Melanie Teeteart and Alison Koper, Student-at-Law

The Problem

"Extra work" is work that falls outside the original scope of the contract. Disagreements over extra work invariably arise on most construction projects—particularly large and complex ones.

Many construction contracts provide for changes to the original scope of work through "change order" or "extra work" clauses. In reality, given the demanding and complicated schedules on large multi-faceted construction projects, procedures for obtaining executed change orders are not always followed. Time constraints may require a contractor to move forward with extra work without formal documentation in place.

Furthermore, the individual with authority to execute a change order on behalf of the owners may interpret the nature of the work requested differently than the contractor. Namely, the owner's agent may insist that the work requested is within the original scope of the contract, whereas the contractor may be of the view that it is outside the original scope of the contract.

As such, disagreements inevitably arise between the contractor and owner: Is extra compensation warranted for the work or not?

The Risk

Contractors and owners face risks when they fail to properly follow contractual extra work procedures. Contractors may find themselves out of pocket significant sums of money by relying on oral assurances from project managers or other on-site supervisors to the effect that they will be compensated for the extra work. Owners may find that the project cost skyrockets over the contract price if they are required to pay for these undocumented extras.

Complicating this area of law even further is the Supreme Court of Canada's decision in *Peter Kiewit Sons Co. v Eakins Construction Ltd.*[1] *("Peter Kiewit")*—oft cited and much criticized— which places a heavy burden on a contractor faced with disagreement over extras during the project.

Performing Work Under Protest

In *Peter Kiewit*, a subcontractor was told to perform work it considered an extra to the contract. The project engineer disagreed that the work was extra work and no promise of additional payment was made. The subcontractor completed the work but immediately and continuously protested. The subcontractor sued for damages and lost. The Supreme Court held:

> One party says that it is being told to do more than the contract calls for. The engineer insists that the work is according to contract and no more, and that what is asserted to be extra work is not extra work and will not be paid for. The main contractor tells the sub-contractor that it will have to follow the orders of the engineer and makes no promise of additional remuneration. In these circumstances the sub-contractor continues with the work. It must be working under the contract. How can this contract be abrogated and another substituted in its place? Such a procedure must depend upon consent, express or implied, and such consent is entirely lacking in this case. Whatever Eakins recovers in this case is under the terms of the original sub-contract and the provisions of the main contract relating to extras… the remedy of the Eakins company was to refuse further performance except on its own interpretation of the contract and, if this performance was rejected, to elect to treat the contract as repudiated and to sue

for damages. **In the absence of a clause in the contract enabling it to leave the matter in abeyance for later determination, it cannot go on with performance of the contract according to the other party's interpretation and then impose a liability on a different contract. Having elected to perform in these circumstances, its recovery for this performance must be in accordance with the terms of the contract. (emphasis added)**

In these circumstances, a contractor's options—when faced with an owner or an owner's agent who disagrees that the work is extra work and no provision in the contract allows for later determination of such a dispute—are limited and arguably unfair: (1) proceed with the contract and forego the right to additional compensation, or (2) refuse to do the work, treat the contract as repudiated and sue for damages—which has the added disadvantage of exposing the contractor to a potential claim from the owner for damages.

Peter Kiewit has never been overturned. It is sometimes followed and often creatively distinguished on the facts. As such, contractors should exercise caution when they are faced with circumstances where:

- a project engineer (or another agent of the owner) has the authority to decide what work is required by the contract,
- the project engineer changes project plans but decides that the work is within the scope of the original contract and directs that it be completed without additional remuneration,
- the contractor is aware of the changes but completes the work under protest, and
- the contract does not contain a term that reserves disputes over extra work for later determination.

However, Peter Kiewit will not apply to circumstances in which the owner or his agents provide express or implied approval of extra work. In such cases, the contractor is not performing under protest.

Express and Implied Approval for Extras: The Test

The test for determining liability for extras requires a contractor to establish the following four elements:

1. Does the work performed fall outside the scope of work originally contemplated in the contract? If so, the work was in fact an extra. There is a grey area where the answer may not be so obvious e.g. the supply of materials of a better quality than the minimum quality necessary to fulfill the contract without authorization from the owner (express or implied) is not an extra. The contractor generally bears the burden of proving that the work performed was in fact extra work.
2. Did the owner (or an owner's agent) authorize the extra work by giving express or implied instructions? A contractor who completes extra work without such express or implied authorization is not entitled to remuneration.
3. Was the owner informed or necessarily aware that the extras would increase the cost?
4. If there was a provision in the construction contract requiring changes to be in writing, was that provision waived by the conduct or acquiescence of the owner? Such a provision is inserted for the protection of the owner and can be waived by the owner.[2]

If the contractor can establish these elements, the owner will be responsible for the cost of the extras.

No Change Order: What now?

What happens when the contract requires a written change order for extras but none is obtained? The contractor's failure to obtain a change order does not prevent the recovery of costs associated with extra work. Courts can and do find in certain circumstances that an owner has waived the express requirement for a change order.

If the contractor provides clear evidence showing that the parties did not intend to be bound by the terms of the written agreement—and in particular the change order provision—then the owner may have to compensate the contractor for the work even though no change order was obtained.

How does a contractor know when the evidence is clear enough? Courts have generally found that clear evidence exists when one or more of the following elements are present:

- knowledge on the part of the owner that the performance of the extras would increase the cost,
- verbal instructions from the owner or a duly authorized agent directing the contractor to complete the extra work (or authorization of extras implied in instructions to, for example, comply with government standards),
- assurances from the owner that the work has been approved,
- implied consent evidenced by the owner encouraging the work or failing to object to the work,
- the owner benefiting in some way from the extras (e.g. improving the safety and integrity of the project),
- an arrangement adopted by the parties for dealing with extras that is different from that provided for in the written contract. For example, if the requirement for change orders was regularly ignored during construction, courts will often find the parties waived the change order provision by their conduct.

In such cases, the court will find that the parties adopted an arrangement outside the original scope of the contract to deal with extras. Nevertheless, a contractor should be wary of performing extras and then requesting authorization from the owner after the fact.

A contractor should also avoid completing extras following vague promises by the owner, such as instructions to "Do what is necessary and reimbursement will be provided" or "Don't worry; I'll see you're all right". On their own, such assurances will likely not be enough to prove that a change order was not required.

Concluding Thoughts

If a change order cannot be obtained, a contractor is advised to keep thorough records evidencing all of the circumstances surrounding the completion of extras, including how they were authorized and by whom. This will support the contractor's argument that an arrangement to deal with extras outside the original scope of the contract was adopted by the parties.

If contractors find themselves in a position where they are performing work under protest, they are advised to exercise caution. They will likely be brought within the ambit of the *Peter Kiewit* case unless their contract contains a term that reserves disputes over extra work for later determination

Footnotes

[1] 1960 CarswellBC 143 (WL Can) (SCC).

[2] *Kei-Ron Holdings Ltd. v Coquihalla Motor Inn Ltd.,* 1996 CarswellBC 1251 (WL Can) (BC SC). This test has been cited with approval by the courts in Alberta. *See: Banister Pipeline Construction Co. v TransCanada Pipelines Ltd.,* 2003 CarswellAlta 1144 (WL Can) (Alta QB).

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