Too much lawyering

LEGEND HAS IT that a philosophically inclined man once fell out the window of his 10th floor office, and reflecting upon his changing situation, as he passed the third floor, he remarked, "Oh well, so far so good." This tale becomes relevant as you read on.

One effect of *Ron Engineering* case law has been to cause municipal purchasers and their lawyers to revise their standard contract forms to avoid liability in tender related disputes and to attempt to shift various risks from the city to its suppliers. A lawyer drafting a contract must identify the risks associated with that contract. In the absence of contrary instructions from the purchaser/client, the lawyer will automatically assign any identified risk to the party for whom the lawyer is not acting. Since lawyers usually rely on precedents drafted by other lawyers, the tendency over time is for contracts to become progressively more one-sided. Almost always, the revised terms depart significantly from prevailing market conditions.

The danger is this: in a market economy the terms of a contract will be reflected in the price, which will reflect the costs and financing needs of the supplier, such as cost of production, service and delivery, overhead, profit and assumed risk.

Prevailing market prices for goods and services reflect the normal allocation of risk between supplier and customer; the normal customer's service needs; and delivery expectations. Obviously, when delivery is to a remote location, then the price must necessarily increase, reflecting the higher costs incurred by a supplier. Similarly, any adjustment of risk departing from the prevailing risk allocation practice also results in a corresponding increase in price.

So long as the price adjustment reflects the probability adjusted cost implications of the occurrence of a particular risk, such variation neither improves nor worsens the city's position. The city's overall cost remains the same because the price increase is balanced by the reduction in the anticipated cost of meeting the risk, due to its assignment to the supplier. In other words, like the man falling from the window, the city may say, "so far, so good."

Sometimes a city may push the envelope too far and the risk allocation may generate a disproportionate cost increase relative to the benefit afforded. In this article, we survey some terms appearing in recent municipal contracts across Ontario and try to explain why these terms generally work against the city's own interest.

Various forms of bid security impose a cost disproportionate to the cost of the risk avoided. Municipalities used to request a bid bond as security against the risk that the winning supplier in a tender would refuse to enter into a contract. Bonds are not free. Their cost to the successful bidder will be passed onto the city. Moreover, since all suppliers must provide such a bond, even the losing bidders incur a cost, which will be incorporated in the loser's general overhead and is then passed along to other customers. Also, the cost of a bond reflects, but is not limited to, the risk of supplier default. In issuing a bond, both the supplier and the bonding company incur transaction costs. Accordingly, the cost of the bond exceeds the risk mitigated through the provision of the bond. The city can no longer conclude that "so far" things are "so good."

Some municipalities found it too difficult to enforce bid bonds as a security and so sought alternate forms of security. A few now require bidders to deliver a certified cheque for a stipulated amount (e.g., $250,000) as security against the risk of supplier default. Certified cheques adversely impact the supplier's cash flow and may also increase its aggregate borrowing requirement. Any

resulting increase in cost will be passed on to the municipal customer. The cheque requirement may make it too expensive for suppliers to compete for that work. Reduced competition usually usually results in a higher final price.

Whenever the cost of meeting contract terms exceeds the benefit derived by shifting risk to the supplier, "dead weight" is added to a customer's final price. Many different terms do so. For instance, municipalities often stipulate a given level of warranty coverage as one of the terms of a tender. However, where goods are being supplied, the supplier is usually a retailer or wholesaler, not the manufacturer. If the stipulated warranty coverage exceeds the manufacturer's warranty, then the supplier must assume a higher level of risk in dealing with the city than it does in dealing with its other customers. Usually, a supplier is no better positioned than the city is to assess the risk of additional warranty coverage so, the likely consequence is a further "dead weight" cost added to the city's price.

Contract terms that ask the supplier to assess the magnitude and probability of risk invariably result in a disproportionate increase in price. Such terms are frequently encountered in the construction context. For instance, a city may engage an environmental consultant to test the condition of a property, but then stipulates that the contractor bears the risk of any unidentified environmental condition. Of course the contractor must hedge its price to reflect the additional risk assumed. Usually the city knows more about the property than the contractor possibly can, thus the contractor's price adjustment almost certainly errs on the high side.

The following list (not exhaustive) offers a brief description of contract stipulations that tend to result in a disproportionate increase in the cost of obtaining a supply of goods or services:

- Requiring a contractor to assume the risk of unknown structural faults when carrying out the renovation of a building: The contractor will likely assume that the city suspects the existence of serious problems and will increase the price quoted by a significant amount.
- Requiring insurance against risks that are remote: The risk associated with an insurance contract is reflected in the premium. However, there is usually a minimum premium for coverage of a given kind. If that minimum premium exceeds the anticipated value of the risk, then there is a dead weight cost.
- Limiting a contractor's opportunity to assess risk associated with a prospective contract: One could legitimately restrict the number of site visits, the taking of photographs and the carrying out of tests, but each limitation increases the amount of uncertainty associated with a contract, which will then be reflected in the final price.
- Arbitrary rights to disqualify bids or to admit bids that are apparently not qualified: In a negotiated, private sector contract, normally the customer will deal with two or three possible suppliers, eventually narrowing the choice down through such discussions.
- Unilateral options to cancel: In essence, a contract is a binding promise. However, governments often seek to reserve unilateral rights to cancel a purchase contract, in order to allow themselves flexibility to implement policy changes. Also, governments often reserve a right to buy from other suppliers, and to vary the size of an order. Unless a supplier is confident of a firm commitment by the government, it may treat the contract as little more than an expression of interest. As a result, the supplier will hedge its price to avoid the risk of an adverse fluctuation in the spot market price. In practice, cities rarely take advantage of a unilateral right to terminate and should ask themselves whether it is worth paying a premium to buy a right rarely used.
- Unrealistic completion dates and liquidated damages: Major projects cannot be carried out overnight – they may be weather sensitive or require extensive approvals. If the contractor must commit to an unrealistic completion date and provide for the payment of liquidated damages if that date is not met, the contractor will likely factor the extra time that might be required into the contract price. As a result, the city ends up paying itself for the late delivery.
- Bid qualifications are set too high: If the experience required to qualify to bid excludes all local suppliers, then the municipality will be forced to deal with remote suppliers, which will likely cause an increase in cost and may also lead to a lower level of service.

Terms determine price so, when lawyers exercise too much control in municipal contracting the price usually goes up.

To avoid unnecessary costs, municipalities need look critically at the allocation of risk under their standard terms of contract. If the cost of obtaining protection or a right exceeds the benefit that it affords, then why buy it? Many municipal purchasing managers will argue that once their legal advisor suggests that a given provision be included, it is difficult for them to justify not including it. While this argument is defensible, it indicates a misunderstanding of the lawyer's role.

Lawyers identify legal risks and advise on how to avoid them. They are not expected to make business decisions. Lawyers drafting a contract should be responsible to find out whether or not the terms they are proposing reflect current industry-wide practice. If the proposed terms vary from prevailing practice, the lawyer should provide a cost-benefit assessment of the suggested change. If the lawyer cannot do so – even working in conjunction with the municipality's risk management staff – then the lawyer's advice needs to be discounted to reflect its uncertain price implications. Obviously it is advisable for all aspects of the contracting process to be fully documented in the file.

Steve Bauld, former purchasing manager at the City of Hamilton, is now VP of the Ontario General Contractors Association.

Kevin McGuinness is a lawyer with Ontario's Attorney General.

Together they have collaborated on several books about procurement and leadership, and were regular contributors to *Summit* magazine's column "In our opinion."