

# Here's the Drill: The Court in *Sjostrom Sheet Metal Ltd. v. Geo A. Kelson Company Limited* Confirms That a Cost-Plus Contract is Not Equivalent to a Blank Cheque

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Cost-plus arrangements are a common form of construction contract between project owners and contractors in Canada. These agreements create unique benefits and risks which should be carefully considered before entering into them. As discussed below, the degree of diligence required by contractors under a cost-plus contract with respect to providing proof of entitlement to costs claimed may be subject to a contextual analysis of a court in the event of a dispute. With that said, contractors can protect their interests by diligently recording costs incurred and properly communicating with the owner in the event of cost overruns.

## 1. What is a Cost-Plus Contract?

Under a cost-plus contract, the contractor will be reimbursed for project construction costs plus an agreed upon mark-up. The construction costs (or "direct costs" or "Cost of the Work") will typically include, for example, the costs associated with materials, labour, tools, temporary equipment and the costs associated with subcontractors. The contractor's mark-up is typically intended to cover its overhead and profit and is often charged as a fixed fee or percentage of the construction costs.

## 2. Potential Benefits and Risks of a Cost-Plus Agreement.

Cost plus contracts may have unique risks and benefits for both contractors and owners. For example:

- **Contractor Perspective: Profit is guaranteed in a way unlike lumpsum contracts.** Cost-plus contract agreements may lower the risk for contractors of lost profits due to unexpected costs or cost overruns, especially where uncertainty exists regarding site conditions, designs or materials to be supplied at the time the parties enter into the agreement.
- **Owner Perspective: Expedited Contract Implementation, Insight into Construction Costs and Early Contractor Engagement.** From the owner's perspective, a cost-plus contract may allow for an expedited contract negotiation or implementation process, allowing for a contractor to begin work before the scope of work must be finalized. They also typically provide increased transparency in that the owner can see and review the true construction costs as the project is completed. In construction management contracts (which are a common type of cost-plus contract), the owner may also benefit from the involvement and input of the contractor with specialized industry experience during the earlier stages of the project.
- **Owner Perspective: Contractors may not be financially incentivized to keep project costs down.** Owners may be

concerned that contractors are financially incentivised to not keep construction costs down (particularly if the contractor's fee is structured as a percentage of construction costs). However, there can be various contractual mechanisms that can be implemented to address some of this risk.

### 3. **Despite Potential Concern, the Court in *Sjostrom Sheet Metal Ltd. v. Geo A. Kelson Company Limited* ("*Sjostrom*")<sup>[1]</sup> Confirms That a Cost-Plus Contract is Not Equivalent to a Blank Cheque to the Contractor.**

*Courts suggest that* contractors must exercise a "degree of diligence" in carrying out the work under a cost-plus contract to prevent significantly higher costs than estimated without prior approval.<sup>[2]</sup> While potentially subject to change, estimates often provide a baseline for parties or courts in assessing the reasonableness of the final price of a project, taking into account factors such as:

- the relative sophistication and knowledge of the parties;
- the circumstances under which the estimate was given;
- the knowledge and expertise of the party providing the estimate;
- whether it was relied upon by the party requesting it;
- whether the contractor assumed any of the risk that the estimate might be exceeded;
- whether the contractor provided the owner with information regarding rates for labour;
- equipment rental and materials; or
- whether the owner encouraged the contractor to proceed with the construction knowing that the estimate would be exceeded.<sup>[3]</sup>

It may therefore be prudent for contractors to promptly notify owners when they experience cost overruns as compared to the operating budget or estimate.

### 4. ***Sjostrom* Suggests that there is a High Evidentiary Burden on Contractors Seeking to Recover on a Cost-Plus Basis.**

While the court in *Sjostrom* did not prescribe the exact manner in which contractors must maintain their accounts, the court suggests that contractors must be able to sufficiently show proof of their charges.<sup>[4]</sup>

While the onus rests on an owner who disputes an amount claimed by a contractor to show that the amounts claimed or the accounts provided are incorrect or unreliable, contractors should be aware that if doubt is cast upon the accounts, or they lack the requisite documentary evidence to substantiate their claims for payment, the onus shifts back to them to satisfy the court that their accounts are accurate and properly support the amounts claimed.<sup>[5]</sup>

Therefore, during a project a contractor should maintain proper accounts and provide evidence of costs claimed. While records maintained are not required to reflect a particular form (unless the contract dictates otherwise), if sufficient detail is not provided there is a possibility that a contractor's request for reimbursement will be denied.

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[1] [2023 ONSC 4959 \(CanLII\)](#) ("Sjostrom").

[2] *Sjostrom* at para 41 citing *Infinity Construction Inc. v Skyline Executive Acquisitions Inc.* 2020 ONSC 77.

[3] *Sjostrom* at para 41.

[4] *Ibid.*

[5] *Ibid.*

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