CONSTRUCTION BONDS

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At one time the use of sureties in construction contracts was viewed by owners and contractors as a mere formality in the process of negotiating their legal relationship. Those days are gone. In today's economic climate of recession, with its attendant insolvencies, the use of sureties to provide construction bonds has become a very important part of the process.

The major advantage of construction bonds is that they provide the owner, as well as subcontractors and material men, with the alternate remedy of claiming on a bond should the contractor run into difficulties. This remedy is often the most expeditious one when contrasted with other remedies such as claims under the *Builders' Lien Act*.[1] Claims are most often made on construction bonds when the contractor runs into financial difficulties. An additional advantage of claiming on a construction bond, therefore, is that it allows a claim against the party most likely to have "deep pockets," the surety.

This article will commence with a general overview of bonds and will then focus on the four types of construction bonds most commonly used: bid bonds, performance bonds, labour and material payment bonds and lien bonds. The article will also take a brief look at the indemnity agreements which are usually entered into as a part of the bonding process.

The Basics of Bonds

All bonds basically involve a three-party relationship between the "surety," the party which issues the bond, the "principal," the party requesting the issuance of the bond and the "obligee," the party that will benefit from the issuance of the bond. In the

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[1] R.S.A. 1980, c. B-12.

construction industry the surety is usually an insurance company that seeks to profit from issuing the bond, the principal is often the general contractor of the construction project, and the obligee is often the owner of the project.

The most commonly used construction bonds are: a bid bond, which provides some assurance to the owner that the lowest bidder will enter a contract if awarded the contract; the performance bond, which provides assurance to the owner that the work set out in the construction contract will in fact be completed; and the labour and material payment bond, which provides assurance to the owner that the sub-trades and material men working on the construction project will be paid. Another commonly used construction bond is the lien bond, which allows the owner to clear title to the construction project upon the posting of a bond, rather than cash or a letter of credit, to stand as security for the liens.

The respective rights of the surety, general contractor and the owner are governed by the terms of the bond which incorporates by reference the underlying construction contract. A performance bond may also be issued with respect to subcontracts as well as to the main construction contract and, indeed, with respect to any contract where one party seeks a surety for the performance of another.

Although the Document Committee of the Canadian Construction Association suggests the use of “standard” bonds, care must be taken to scrutinize the wording of each bond, as they do in fact vary widely. For example, the terms of a bond issued in favour of the federal or provincial government are significantly different than bonds issued within the private sector.

There are significant differences between bonds and policies of insurance. First, unlike contracts of insurance, bonds are not contracts of the utmost good faith and voidable as a result of the misrepresentation of the principal. That stems from a second difference between the two instruments, which is that a bond, unlike a policy of insurance, is normally a tripartite agreement wherein the obligations under the bond are essentially intended to protect parties other than the principal. Finally, and most significantly, bonds differ from policies of insurance inasmuch as sureties have the right, in the event of loss, to seek recovery of the loss from the defaulting principal. Most often, not only is an indemnity given by the principal, but similar indemnities are provided by related corporations, key individuals and, not infrequently, their husbands or wives. In the result, a fee is essentially charged by the surety for lending its good name to the transaction, on the initial premise that no loss will ultimately accrue to the surety, unlike policies of insurance where premiums are based upon anticipated losses.

An action on a surety bond is an action for damages for breach of a covenant contained in the bond, and thus the obligee is required to mitigate its damages. The bond will be for a stipulated sum of money (the “penal sum”), and the surety cannot, in general, be made liable for any amount in excess of this penal sum. The penal sum is frequently expressed as a specific dollar amount or, alternatively, as a percentage of the contract price.

There is no requirement for the individual benefiting from the bond to exhaust alternate remedies, e.g., a builder’s lien claim, before recourse is made to the bond. Indeed, the owner is not even obliged to sue the principal before making a claim on the bond (although in the usual course of events the principal will be sued as well). Construction bonds are therefore an important remedy to the owner, as the contractor may be insolvent and the claim on the bond may be the most expeditious remedy and often the only real remedy.

At one time recourse to a bond was given a strict construction so that, for example, a failure to give notice in accordance with the terms of the bond could discharge the surety. As a result of the seminal case of *Johns-Manville Canada Inc.* v. *John Carlo Ltd.*[2] (hereinafter referred to as “*Citadel*”), such a strict approach is no longer taken when the bond has been issued by a bonding company for a fee. In this case the Supreme Court

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[2] (sub nom. *Citadel General Assurance Co.*. v. *Johns-Manville Canada Inc.*) (1983), 147 D.L.R. (3d) 593 (S.C.C.).

of Canada made a distinction between "accommodation" sureties and "compensated" sureties. It noted that accommodation sureties enter into bonds with "the expectation of little or no remuneration" and, in view of this lack of recompense, held that it was appropriate for the court to strictly construe the terms of a bond issued by an accommodation surety. The court further noted, however, that "[i]n more recent times, particularly in the construction industry" bonds are issued by surety companies whose "business consists of guaranteeing performance and payment in return for a premium."[3] The court then held that bonds issued by compensated sureties were to receive a more liberal construction, thus closing the door on many previous "technical" defences successfully relied upon by sureties.

Bid Bonds

In the ordinary course of events, an owner will invite various contractors to bid on the intended construction project and will further require that they submit bid bonds with their tenders. The surety on a typical bid bond binds itself to pay damages to the owner, up to the penal sum of the bond, if the contractor fails to enter into the construction contract and fails to deliver the performance and payment bonds that are usually required by the tender documents. Bid bonds are thus important to owners in that they assure that a bidder will not withdraw its bid within the established tender period, thus discouraging frivolous bids. The requirement of a bid bond also prevents contractors from purposefully submitting a low bid in the hope of being able to up the bid price later, by, for example, arguing that a mistake was made in the initial tender. Bid bonds are also important to the owner in that they protect the owner from losing the benefit of a bargain if the lower bidder is unable or refuses to enter into the contract. In this case the owner will simply claim on the bid bond for the additional amount the owner must pay to enter into a contract with the next lowest bidder.

In the event there is no other bid that is still effective, the owner may have to solicit a new round of bids, and, in such a case, the damages claimed by the owner will

[3] Supra, note 2, at 599.

include the additional expenses of soliciting, e.g., advertising expenses, as well as any damages caused by a delay in completion of the construction project.

There are many reasons why a party tendering a bid would subsequently fail to enter into the construction contract:

> The contractor may be unable to secure required performance and payment bonds because of a shaky financial condition; discover that the bid shaved margins too thin and refuse to go through with the deal; have a subcontractor back out, making the deal unprofitable; become insolvent and file bankruptcy between submitting the bid and receiving notice of its acceptance.[4]

Must the bonding company issue a performance bond if the contractor is awarded the job? Ordinarily, yes. An owner is not entitled to require a contractor to provide any bond at all unless there is a term in the invitation to tender documents to that effect. It is common practice in the construction industry, however, for the tender documents to stipulate that performance and payment bonds are required along with the bid and the bid bond. Thus, it is usually a condition of the tender that the contractor, if awarded the contract, will enter into a construction contract and deliver performance and payment bonds to the owner. In order to ensure that the required bonds are available from the successful bidder a Consent of Surety is often required.

A surety can raise various defences in response to a claim on a bid bond. Such defences include arguments that: the tender was incomplete on its face; the owner changed the terms of the contract from those in the tender documents; the owner failed to conduct itself in good faith; the owner delayed in awarding the contract, to the bidder's detriment; the contract was more properly awarded to another party; or an excusable mistake was made in preparation of the bid. It is the latter defence which has been the subject of much litigation.

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[4] James G. McConnell, "The Role of the Contractor's Surety in Public and Private Construction" (1983) 65 Chicago Bar Record 48 at 49, 50.

R. v. *Ron Engineering & Construction (Eastern) Ltd.*[5] is the leading case on this issue. Although *Ron Engineering* dealt with a tender deposit, and not a bid bond, it has been applied for the principle that where a tenderer advises an owner of a mistake in its tender after tender submission but before the acceptance of its tender, then if the contractor refuses to enter into the construction contract, the owner can claim on the bid bond.[6] The law pertaining to mistake in a tender is still being developed, however, and is beyond the scope of this paper.

Performance Bonds

A performance bond may be issued with respect to any contract where one of the parties seeks a surety for the other's performance and damages are an adequate remedy. Thus, in the construction industry, performance bonds are usually issued when the owner seeks a surety for the contractor's obligations under the main construction contract. Performance bonds are also frequently issued when the general contractor seeks a surety for the performance of subcontractors.

Where there are no difficulties with respect to the construction project the performance bond will remain valid and enforceable until all the stipulations, agreements and provisions contained in the construction contract are performed. Once performance is complete, the bond will become null and void and the surety discharged.

Occasionally, however, difficulties do arise with respect to the construction project and the owner will make a claim on the performance bond. In general, the liability of the surety is capped at the penal sum expressed on the bond. American case law has held, however, that a surety can be liable for compensatory and punitive damages

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[5] [1981] 1 S.C.R. 111.
[6] See also *Calgary (City)* v. *Northern Construction Co.* (1986), 19 C.L.R. 287 (C.A.), affirmed [1988] 2 W.W.R. 193 (S.C.C.).

in excess of the penal sum if the surety engages in sharp practice or shows bad faith in its dealings with the owner, contractor or subcontractors.[7]

The terms of the bond will set out the various alternatives open to the surety once a claim has been made on the bond. After the surety has received notice of an alleged default, the surety will investigate. If the surety determines that there is no defence to the claim on the bond, it will generally be forced to elect one of the following options:

1. *to remedy the default*; by, for example, providing additional financing to the original contractor to complete the job or, if the contractor is solvent, negotiating a conciliation between the contractor and the owner;

2. *to complete the contract*; by, for example, making its own contract with another builder to finish the work at the surety's expense; and

3. *to put a bid for completion to the owner*; by, for example, re-tendering the work and then repaying the owner for any extra costs of the new contract.

The surety will weigh various factors in electing between the above-mentioned options, including the financial condition of the original contractor, the stage of completion of the job when the default occurred and the amount of contract funds still in the owner's control. The surety will generally be reluctant to remedy the default by providing funds to the contractor, as it may expose the surety to an open-ended obligation to fund completion of the construction contract, which is not limited by the bond's stated penal sum. A surety will therefore elect this option primarily in situations where the construction is near completion and the cost of completion is clearly assessable. The surety must also be satisfied that this alternative would be less expensive then terminating the contractor's work on the project and reopening the bidding process.

If the contractor is solvent and the dispute is over a specific act of default, the surety may elect to remedy the default by taking steps to resolve the conflict between the contractor and owner.

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[7] *Continental Realty* v. *Andrew J. Crenolin Co.*, 380 F. Supp. 246 (S.D.W. Va. 1974); *Miracle Mile Shopping Centre* v. *National Union Indemnity*, 299 F. 2d 780 (1962).

A surety will also rarely elect the second option of completing the contract. Sureties are not in the business of construction, and thus this option requires the surety to operate outside of its area of expertise. If the surety elects this option, it will likely subcontract the completion work to another contractor. This will have the effect of making the surety a buffer between the owner and contractor. Electing to complete the contract may also expose the surety to an open-ended funding obligation in excess of the penal sum. This option will therefore also generally be elected only in circumstances where the work is near completion and costs are clearly assessable.

The third alternative, of re-tendering the contract, is the option most often elected by sureties. This option is attractive to the surety because the cost of completion, the increased cost of the new contract, is known by the surety. Thus, the surety will not be exposed to an open-ended funding obligation and will have its exposure capped at the penal sum of the bond.

Once there has been a declaration of default so as to trigger the bond, the surety stands in the place of the principal and has the right of subrogation, including a right to the remaining contract funds. The type of events that will generally give rise to a claim against the bond includes: the insolvency of the contractor, substantial delays in the progress of the work, an abandonment of the work, the filing of lien claims by the subcontractors and material men, and other evidence of financial difficulties, e.g., a failure to remit withholding taxes or workers' compensation levies to the government.

A performance bond may be assigned by the obligee, provided that there is nothing in the terms of the bond to prevent an assignment and such an assignment will confer all the benefits of the bond to the assignee.[8]

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[8] *Five-Fifty Beatty Street Ltd.* v. *Markwood Construction Ltd.* (November 26, 1986), Taylor J. (B.C.S.C.) [unreported].

A performance bond takes on the characteristics of a payment bond when one of the conditions to be performed is payment for labour and materials. It has been noted that:[9]

> Although the term "payment bond" is properly applicable only to a bond under which the money guaranteed thereby becomes due to the obligee, the term is sometimes used loosely to refer to what is essentially a performance bond, but where one of the contractor's obligations under the contract is the prompt payment of suppliers and sub-contractors, who are parties neither to the building contract nor to the bond.

Notwithstanding the fusion of these obligations, it is industry practice to require a separate payment bond as well as a performance bond.

It is clear that there must be a default in order to trigger the bond.

Not all defaults, however, will be of sufficient seriousness as to give rise to a claim on the bond. If the owner intends on treating a default as sufficient to trigger the bond, the owner must give notice of this intention pursuant to a declaration of default. This is made clear in a passage of Conrad J. in *Marigold Holdings Ltd.* v. *Norem Construction Ltd.*[10] ("*Marigold*"), wherein she stated: "I might add that I think it was a precondition to the surety's obligation that there be a declaration of default to the surety as the surety's obligations do not arise until this occurs." Indeed, it is arguable that, absent such a declaration of default, a surety which involves itself in the project may be exposed to the argument that it is liable for tortious interference with contractual rights.

There are various steps that an obligee can take to protect its position while deriving the full benefit of the bond. The obligee must be careful to take these steps, for failure to do so may give rise to a defence by the surety to the claim on the bond.

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[9] Immanuel Goldsmith, *Goldsmith on Canadian Building Contracts* (Toronto: Carswell, 1989) at 155, 156.
[10] (1988), 60 Alta. L.R. (2d) 289 (Q.B.).

As a necessary first step, the obligee should read the bond carefully, and strictly comply with its terms, such as the provisions setting out the requirements to give notice of default to stipulated parties within a stipulated time period. Although strict compliance with these technical details may not discharge the surety in view of *Citadel*, provided that the surety is not prejudiced, attention by the obligee to these details is a sound preventive measure to forestall litigation of the issue.

One of the defences frequently raised by sureties (which will be discussed in detail later), is that the obligee has acted without the knowledge and consent of the surety in such a way as to prejudice the surety. On this basis a surety will claim a discharge of the bond. It is therefore important for the obligee to act in close cooperation with the surety after the principal has been declared in default by, for example, not paying out monies without the consent of the surety. In the case of *Mulgrave (Town)* v. *Simcoe & Erie General Insurance Co.*,[11] an overpayment by the owner without the consent of the surety was held to discharge the surety.

The obligee should also take care not to prejudice any rights the surety might have pursuant to its indemnification agreements with the principal and others.

Defences Available to Sureties

Material Alteration of the Construction Contract

A material alteration of the construction contract which is bonded, without the knowledge and consent of the surety, will discharge the surety. The root authority for this principle is *Doe* v. *Canadian Surety Co.*[12] As a performance bond binds the construction contract, the surety assumes the risk that the contractor will not perform that specific contract. If there is a material alteration to the risk which the surety has not

[11] (1977), 73 D.L.R. (3d) 272 (N.S. C.A.); see also *Macklin School District No. 2420* v. *Saskatchewan Guarantee Fidelity Co.*, [1919] 2 W.W.R. 396 (Sask. K.B.).
[12] [1937] S.C.R. 1; See also *Truro (Town)* v. *McCulloch* (1973), 38 D.L.R. (3d) 1 (S.C.C.), and *Five-Fifty Beatty Street Ltd. Partnership* v. *Markwood Construction Ltd.* (1987), 26 C.L.R. 193 (B.C.S.C.) [affirmed (1989), 33 C.L.R. 231 (B.C.C.A.)].

consented to, such an alteration will release the surety from any obligation under the bond. An alteration to the contract that is unsubstantial or necessarily beneficial to the surety, however, will not discharge the surety. Conrad J. stated in *Marigold*:[13]

> Material variation is generally thought of as being one that varies the risk so that a prudent person would take it into consideration in deciding whether to enter the transaction.

It has also been stated that:

> The test of materiality . . . is whether the alterations place the surety in a position different from what it promised to guarantee.[14]

Case law suggests that the requirement that the alteration be "material" can impose a substantial hurdle. For example, the 1987 British Columbia Supreme Court in *Fifty-Five Beatty Street Ltd. Partnership* v. *Markwood Construction Ltd.*[15] refused to discharge the surety notwithstanding several major changes to the construction contract. This case is somewhat unusual in that the general contractor declared the default of the owner, which caused the owner to make demand upon the performance bond. In the course of construction the owner had experienced various difficulties which caused it to substitute a new financial institution to finance the construction loan, change architects, and issue a significant number of change orders to the work, which resulted in an increase in the contract price by more than 23%. The owner was late in making payments under the general contract and the general contractor gave notice of default to the owner. The owner made a claim against the performance bond, and the surety "took the position that the performance bond had been invalidated by the owner's failure to perform its obligations under the general contract and by reason of the fact that the owner's conduct had materially impaired, varied or undermined the risk accepted by the surety thereby

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[13] Supra, note 10, at 325.
[14] David Paul, "The Law of Construction Bonds in Arkansas; A Review" (1986), 9 University of Arkansas Little Rock Law Journal 323 at 336.
[15] Supra, note 12.

vitiating its obligations under the performance bond."[16] The owner therefore commenced an action against the surety and general contractor and the issue determined in the trial judgment was whether the owner was entitled to recover against the surety under the performance bond.

Legg J. noted that *Citadel* required him to apply a more liberal construction of the bond as the bonding company was a compensated surety. He then noted that the bond itself did not require the owner to notify the surety with respect to changes in financing, the contract price or completion delays and, after reviewing in detail the alleged material changes, held that there was no material variation in the contract that permitted the surety to avoid its obligations under the performance bond.[17] This judgment was upheld on appeal.

An improper payment of monies can also give rise to a defence of material variation of the contract. This is illustrated in the case of *Mulgrave (Town)* v. *Simcoe & Erie General Insurance Co.*[18] This case involved a contract for the construction of a water system at a fixed price. The contractor, Digdon, was given two time extensions to complete the work. There were also deficiencies noted in the work to be performed. Notwithstanding these deficiencies, however, the owner paid out monies under the contract such that the contractor was paid in full. The town then declared the contractor in default under the contract and claimed against the performance bond. The surety resisted this claim on the basis that it had been prejudiced by the payment of monies as the payment "removed most of the incentives for the subcontractors and the suppliers to complete the work" at the request of the surety. The court noted that these monies were no longer available to the surety to apply towards the cost of completion. The trial judge held that these payments constituted substantial alterations to which the surety had not consented, and thus the surety was discharged. The decision was upheld on appeal.[19]

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[16] Supra, note 12 at 194.
[17] Supra, note 12, at 217.
[18] (1977), 73 D.L.R. (3d) 272 (N.S. C.A.).
[19] See also *Nickel Investments Ltd.* v. *Great American Insurance Co.* (1974), 46 D.L.R. (3d) 212 (Ont. H.C.)

Another example of a situation where the courts have held that the surety is discharged because of a material alteration of the contract is when the completion date of the construction contract has been extended without the surety's consent. This is illustrated in the recent case of *St. John's Metropolitan Area Board* v. *William J. Vokey & Sons Ltd.*[20] In this case the work contracted for was not completed within the time set out in the construction contract and, without the consent of the surety, the time for completion was extended for two and one-half years. The court held that the surety's obligation was to be treated as having ended "after the lapse of a reasonable period of time" and that the 2 ½ year extension "was beyond that which could be considered reasonable."

Marshall J.A. stated:[21]

> It is axiomatic to the liability of a surety that he or she can only be held accountable in respect of the obligation guaranteed. Where the parties to a guaranteed contract subsequently agree to variations in their contract which go to its root, the original agreement is discharged and replaced by the new one emanating out of the material variations. In such instances the surety, in the absence of his or her assent to the new arrangements, does not continue to be liable.

And further:[22]

> Where, as in the present case, the impugned alteration is an extension of time, the circumstances of the case must be addressed to determine whether the prolongation amounted to a mere indulgence incidental to the guaranteed contract, or a substantial variation going to the root of the contract.[23]

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[20] (1991), 44 C.L.R. 243 (Nfld. C.A.), affirming (1988), 30 C.L.R. (Nfld. T.D.).
[21] Ibid, at 246.
[22] Supra, note 20, at 246.
[23] See also: *Macklin School District No. 2420* v. *Saskatchewan Guarantee & Fidelity Co.*, [1919] 2 W.W.R. 396 (Sask. K.B.); *Thomas Fuller Construction Co. (1958)* v. *Continental Insurance Co.* (1973), 36 D.L.R. (3d) 336 (Ont. H.C.); *Truro (Town)* v.*McCulloch* (1973), 38 D.L.R. (3d) 1 (S.C.C.) and *Ferrara* v. *The National Surety Co.*, [1917] 1 W.W.R. 719 (S.C.C.).

The "No Default" Defence

Before the surety is obliged to honour a claim under the performance bond, it must, in fact, be clear that there has been a default of the principal. In the usual situation such a default will be clear because the principal has financial difficulties and is unable to complete the contract. The situation is not so clear, however, when the principal is solvent but experiencing other difficulties. In this situation the surety may well decide to take the principal's position and challenge the obligee to prove that a default had in fact occurred.

The Defence of Failure to Notify

It is incumbent upon the obligee to notify the surety of the principal's default, as the surety is entitled to elect as between several options, i.e., remedying the default, completing the contract, or allowing the obligee to open bidding for a contractor to complete the work. While the obligee wishing to claim upon the bond must therefore give notice of the default to the surety, it is not required of the obligee that every breach which may occur during the course of a project be brought to the attention of the surety. This was made clear by Houlden J. in *Thomas Fuller Construction Co. (1958)* v. *Continental Insurance Co.*,[24] wherein he stated:

> On a careful reading of the bond, it is my opinion that the bond negatives any obligation on the part of the obligee to notify the defendant of defaults by [the principal] unless the default was of so serious a nature that the obligee deemed it proper to make a declaration of default and to call upon the bonding company to perform its obligations under the bond. At this stage, the plaintiff was required to give notice of default to the bonding company, but not otherwise.

In *Marigold*[25] the issue of whether the bonding company was released from its obligation under a performance bond for failure to receive timely notice, or any notice at all, was put

[24] Supra, note 23, at 351.
[25] Supra, note 10.

squarely in issue. Norem Construction Ltd. contracted to build a 66-suite apartment building for a limited partnership which included Marigold Holdings Ltd. The building leaked, and Marigold brought an action for damages for breach of contract and negligent performance by the contractor and the architect. The contractor and the architect were found by Conrad J. to be jointly and severally liable for the damage. The performance bond issued by Sovereign General Insurance Company incorporated the construction contract between Marigold and Norem, the principal under the bond. The default claimed to trigger the bond was Norem's failure to deliver a waterproof building. Notice of default was not given to the surety until the action was commenced and "[t]he reason for not giving notice was the [Marigold] never though of it."[26] The surety argued that the conduct of Marigold discharged the bond on several bases including the fact that "it did not receive notice of a serious default to [the surety's] prejudice,"[27] there was a material variation of the principal contract without the surety's knowledge or consent, and that an overpayment was made after knowledge of the default.

Conrad J. applied *Thomas Fuller Construction Co. (1958)* v. *Continental Insurance Co.*[28] as authority that notice of default must be given to trigger the bond. Conrad J. then stated that *Thomas Fuller* "stands for the further proposition that it is for the obligee to determine when a default serious enough to terminate the contract, and call on the bond, has occurred."[29] She noted that, following the declaration of default, ". . . the surety has rights. He has an election as to how he wishes to proceed . . ." and stated:[30]

> I agree that the bond does not provide notice as a pre-condition in the sense that a lack of notice could provide a technical defence to the surety. However, in its simplest form I am satisfied the bond provides that while the obligee has the right to determine when default has occurred, if he is going to look to the surety on a default he had better let him know . . .

[26] Supra, note 10, at 321.
[27] Ibid.
[28] Supra, note 23.
[29] Supra, note 10, at 323.
[30] Ibid.

Conrad J. then found that the surety had been prejudiced by this lack of notice and held that the surety was discharged.[31]

The Defence of Misrepresentation

Although a bond is to be distinguished from an insurance contract, there is nevertheless an obligation on the obligee to reveal material facts to the surety. If it can be said that the surety issued the bond on the basis of misrepresentation(s) the surety may be discharged.

This is made clear in the Supreme Court of Canada case of *Doe* v. *Canadian Surety Co.*[32] In *Doe* the contractor had made several substantial errors in preparing his bid, and these errors were known to the obligee. The obligee did not tell the surety company about the errors made by the contractor and a performance bond was subsequently issued.

David J., writing the majority judgment, applied *Rowlett on Principal and Surety*[33] for the principle that:[34]

> "A creditor must reveal to the surety every fact which under the circumstances the surety would expect not to exist; for the omission to mention that such a fact does exist is an implied misrepresentation that it does not."

He further stated that:[35]

> . . . it is a question of fact whether in the circumstances you ought to disclose and whether the non-disclosure amounts to misrepresentation – that is, with intent to mislead. The question we have to ask ourselves, as a

[31] Marigold sought to have the discharge of Sovereign appealed, but the Alberta Court of Appeal in (1989), 67 Alta. L.R. (2d) 256 held that Marigold's application was out of time.
[32] Supra, note 12, at 24-25.
[33] 3d ed. (London: Sweet & Maxwell, 1936) at 161.
[34] Supra, note 12, at 24-25.
[35] Ibid.

> question of fact, is: would persons in the position of the plaintiffs acting in good faith and with common sense, have thought the surety would enter into a qualified bond . . . if the surety had known of the contractor's substantial mistakes in calculating his costs . . . If the surety had known all this, would it have given such a bond as it did?

The Defence of Expiry of a Limitation Period

Great care must be taken in examining the bond to see if it imposes a limitation period within which any action against the surety must be commenced. A typical bond will provide for a one-year limitation period.

It may be difficult to ascertain the commencement date for the running of the limitation period. Again, a typical bond will provide that the one-year limitation period will run from the date on which final payment under the contract falls due.

The difficulty in ascertaining the commencement of the limitation period is illustrated by *Nickel Investments Ltd.* v. *Great American Insurance Co.*[36] In that case the bond provided that the one-year limitation period would commence running "from [the] date on which final payment under the Contract falls due." The parties agreed to a date marking the substantial completion of the building project and it was argued that the one-year limitation period should run from this date. The issue thus became whether the date of final payment under the contract was the date of substantial completion, or some time after this date when the final payment was made. The issue was resolved by Lieff J. as follows:[37]

> In the instant circumstances . . . I proceed on the basis that the date from which the agreed one-year limitation contained in the bond starts to run is that date upon which one could say either that the building was "fully completed" or there has been "completion of the entire work".

The defence of expiry of the limitation date was therefore unsuccessful.

[36] (1974), 46 D.L.R. (3d) 212 (Ont. H.C.).
[37] Supra, note 36, at 218.

It should be noted that bonds carry two limitations. The first relates to providing notice and is subject to relief from forfeiture. The second requires suit within one year. The latter limitation is *not* subject to relief for forfeiture.[38]

Defences Available to Principals

All of the above defences available to the surety are available to the principal as the surety stands in the place of the principal in defending claims on the bond. The principal can likely be expected to be very aggressive in advancing the defence that there was no default to trigger the bond. The principal can also be expected to assert that the problem(s) with the construction project were not caused by an act or omission of the contractor, but rather by the acts or omissions of the owner or perhaps of the architect and engineers on the project. For example, the principal might claim a non-payment of the owner as "[w]rongful failure of payment invariably justifies a contractor to suspend performance without being held in default."[39]

The principal may also claim that "[c]ertain events, such as an act of God or a flawed design, may render further performance impossible and entitle a contractor to a pro rata share of the contract price for work performed prior to [this] event."[40]

Another defence that might be claimed by the principal is that the owner has consented to what otherwise would be an act of default and thus, having once waived the act of default, should be estopped from asserting it subsequently. "An owner may give up the right to terminate by granting time extensions, by permitting a contractor to work beyond insolvency, by continuing to make progress payments beyond the time for completion, or by permitting the contractor to proceed with the work despite known effects."[41]

[38] *Elance Steel Fabricating Co.* v. *Falk Brothers Industries Ltd.*, [1989] 2 S.C.R. 778.
[39] Robert A. Rubin and Lisa A. Banick, "Contractor Default – Practical Advice to Owners" (1988) 28 C.L.R. 61 at 64.
[40] Ibid.
[41] Ibid.

The principal might also point to the owner's failure to follow the termination procedure set out in the construction contract and argue that, in order to invoke the right of termination of the contract, the owner must carefully comply with the notice provisions and other procedures. This argument would be unlikely to succeed, however, in view of *Citadel*.

Labour and Material Payment Bonds

Although most construction contracts contain an obligation of the general contractor to pay its subcontractors and material men, and thus this covenant is imported into the performance bond, a separate payment bond is also usually requested in construction projects. Having said this, however, it should be noted that there are "combination" payment and performance bonds which may be given the more generic title of a "contract bond" or "contractor's bond."[42]

A payment bond provides that the surety must pay the labour and material suppliers on the project if the principal has not made these payments. The basic functions of the payment bond are to allow the project to remain lien free so that construction will not be delayed because of subcontractor and material men liens and to provide added security to ensure completion of the project.

Care must be taken in scrutinizing a payment bond in order to assess who the beneficiaries are under the bond. A typical bond states that it is limited to "those who supply labour or materials to the prime contractor or to a first tier subcontractor."[43] In other words, most payment bonds allow claims only by those in direct contract with the principal. However, most government projects carry a requirement that the payment bond extend to *all* suppliers of labour and materials, whether or not they are in direct contract with the principal.

[42] J. Dennis O'Leary, "How, Where and When to Perfect Payment Bond Claims on Federal Construction Projects" (1986) 3 Complete Lawyer 53.
[43] Supra, note 4, at 52.

As a general rule a “third party beneficiary,” such as the subcontractors and material men protected under a payment bond, would not be entitled to sue the surety to enforce payment on the bond because of the rule that says strangers to a contract cannot enforce it. This legal impediment is sidestepped, however, by having the payment bonds constitute the obligee as a “trustee” of the monies for the benefit of the subcontractors and material men.

As is generally the case with other construction bonds, payment bonds are stipulated to be of a certain penal sum, generally equivalent to the penal sum of the performance bond, and the surety cannot be made liable beyond this limit. A standard form payment bond will generally also provide that notice must be given within a certain time, (typically 90 days after the last work or delivery), and that an action to enforce the bond must be commenced within a stipulated limitation period[44] (typically one year).

The *Builders’ Lien Act*[45] provides statutory rights to unpaid subcontractors and material men which can be exercised upon filing a lien claim against title to the construction project. The existence of payment bonds provides an alternate, and often better, method of recourse for the subcontractors and material men. Case law has made it clear that a claimant’s potential remedies under the lien legislation need not be exhausted before the claimant makes claim on the payment bond.[46] In many cases, a claim on a payment bond will be much more expeditious than a claim asserting statutory lien rights. More importantly, it has been noted that a claim on a payment bond may “represent the best remedy available for a subcontractor/material man because liability is not dependent on the existence of a lien fund” and, with a compensated surety, there is the additional protection against the loss or reduction of the claimed amount as a result of the contractor filing for bankruptcy.[47] An action to enforce the bond can, however, be joined with a

[44] Kenneth W. Scott, Q.C., “Bonding and Insurance” (1985), 18 C.L.R. 207.
[45] Supra, note 1.
[46] Supra, note 2, at 603.
[47] Barry Kogut, “The Short Limitation Periods Governing Construction Contract Claims” (1983) 55 N.Y. St. B.J. 20.

claim asserting statutory lien rights.[48] Once the surety has made payment pursuant to a payment bond the surety is subrogated to the claimant's rights.[49] Typically, the surety will demand an assignment of lien rights from the claimant should such rights exist.

In theory, the claimant should be entitled to successfully claim under a payment bond even when the surety has denied liability under the performance bond as the surety has separate obligations under the two bonds.[50] In *Truro (Town)* v. *McCulloch*[51] it was made clear that, given that the obligations of the surety under a performance bond and a payment bond are separate obligations, the surety could be discharged from its obligation under the performance bond by, for example, a material alteration in the contract, and yet still be required to honour its obligations under the payment bond.

There are various pitfalls that a claimant should be aware of with respect to payment bonds. Although, in view of *Citadel*, a trivial irregularity with no prejudice to the surety will no longer be a sufficient ground to discharge the surety, a payment bond should nonetheless be carefully scrutinized by the claimant and an effort made to comply with all notice and other provisions in order to avoid litigation of the issue. The payment bond should also be carefully scrutinized to see who is to be benefited under the bond, as if a potential claimant is too remote it will be denied the right to claim. Does the bond restrict potential claimants to those who have a direct contractual relationship with the general contractor, or is the benefit more extensive?

Relief from Forfeiture

As previously noted, prior to *Citadel*, bonds were strictly construed, and the failure to meet all of the bond's requirements, such as the giving of notice in the manner stipulated by the bond, had to be strictly complied with or the surety would be held to be

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[48] *Dominion Dewatering Ltd.* v. *Guaranty Co. of North America* (April 29, 1987), Fedak L.J.S.C. (Ont. S.C.) [unreported].
[49] *E C & M Electric Ltd.* v .*Medicine Hat General & Auxiliary Hospital & Nursing Home (District No. 69)* (1987), 50 Alta. L.R. (2d) 48 (Q.B.).
[50] Supra, note 39, at 67.
[51] Supra, note 12.

discharged. *Citadel* changed this principle of strict construction to one of a liberal construction of bonds where the surety is a "compensated" surety. *Citadel* distinguished between "accommodation" sureties and "compensated" sureties, as follows:[52]

> It will be observed that all [of the previous cases] involved sureties of the type which have been described as accommodation sureties. This expression is taken to mean sureties who have entered into their contract of surety in the expectation of little or no remuneration and for the purpose of accommodating others or of assisting others in the accomplishment of their plans. In respect of them, the law has been astute to protect them by strictly construing their obligations and limiting them to the precise terms of the contract of surety. Any material variation in the terms of the guaranteed indebtedness and any extension of time or postponement of the debtor's obligation, or any discharge or relinquishment of any security for the debt without the consent of the surety will discharge him. In other words, courts have adopted the *strictissimi juris* construction of the surety contract.
>
> In more recent times, particularly in the construction industry, the need for financial guarantees to ensure prompt payment for materials and labour supplied has seen the entry into this field of professional surety companies, often called bonding companies, which are frequently also engaged in the insurance business. Their business consists of guaranteeing performance and payment in return for a premium. They are known as compensated sureties. It was argued that they should not be treated by the courts with the same solicitude reserved heretofore for accommodation sureties.

And further:[53]

> It is my view, however, that the rules which have been applied to accommodation sureties are in many ways unrealistic and inapplicable to cases where professional sureties, in the course of their ordinary business, undertake surety contracts for profit and thereby approach very closely the role of the insurer. The basis of the surety's liability must, of course, be found in the bond into which it has entered, but in the case of the compensated surety it cannot be every variation in the guaranteed contract, however minor, or every failure of a claimant to meet the conditions imposed by the bond, however trivial, which will enable the surety to escape liability. Where, as here, the object of the notice provisions in the

[52] Supra, note 2, at 599.
[53] Supra, note 2, at 601.

> bond has been fully achieved within the time-limits imposed and where there has been no prejudice whatever to the appellant, the whole purpose for the obtaining of the bond would be defeated if the appellant were to be discharged.

Thus, a failure to strictly comply with the notice provisions in the bond considered in *Citadel* did not discharge the surety unless the surety could show that it had suffered prejudice.

Since the *Citadel* decision, another tack has been taken to ensure that the surety is not discharged by the failure to meet the express notice provisions under the bond. In this approach the bond is characterized as a policy of insurance, and the court is asked to exercise its equitable jurisdiction under the *Insurance Act* to relieve the claimant from forfeiture of the bond, notwithstanding imperfect compliance with the bond's provisions.[54]

When relief from forfeiture was claimed in the early cases following *Citadel*, the court frequently discharged the surety on the basis that failure to comply with notice provisions was not "imperfect compliance" but rather "non-compliance," and thus relief from forfeiture was not available.[55] Another line of cases did, however, grant relief from forfeiture notwithstanding a failure to strictly comply with notice requirements.[56]

The issue was finally resolved by the Supreme Court of Canada in *Elance Steel Fabrication Co.* v. *Falk Brothers Industries Ltd.*[57] In this case McLachlin J., writing for

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[54] The *Insurance Act*, R.S.A. 1980, c. I-5, as amended, provides in s. 211:

> When there has been imperfect compliance with a condition or term of the contract as to proof of loss to be given by the claimant and a consequent forfeiture or avoidance of the insurance, in whole or in part, and the Court considers it inequitable that the insurance be forfeited or avoided on that ground, the Court may relieve against the forfeiture or avoidance on any terms it considers just.

[55] See *Dawson Construction Ltd.* v. *Victoria Insurance Co. of Canada* (1986), 21 C.L.R. 16 (B.C.S.C.).
[56] See *Dashchuk Lumber Ltd.* v. *Proman Projects Ltd.*, [1987] 6 W.W.R. 673 (Sask. C.A.); *300201 Alberta Ltd.* v. *Western Surety Co.* (1989), 65 Alta. L.R. (2d) 286 (C.A.).
[57] Supra, note 38.

the court, stated that the issue was whether the section of *The Saskatchewan Insurance Act* granting relief from forfeiture "permits the Court to grant relief from forfeiture where the claimant failed to give notice of his claim to the insurer within the time prescribed by a labour and material payment bond." Elance Steel gave notice of its claim 28 days after the expiry of the 120-day period for notice set out in the bond. An issue was raised as to whether failure to give notice within the time prescribed by the bond constituted "imperfect compliance," and thus could be relieved from forfeiture pursuant to the statutory provisions, or whether it was "non-compliance," and thus beyond the purview of the statutory provision. The court noted that the statutory provision was "a remedial section and as such should be given an appropriately broad interpretation."[58] The court held that a failure to give notice of a claim within the time period prescribed constituted imperfect compliance rather than non-compliance and thus relief from forfeiture could be granted.

Lien Bonds

Difficulties arise in a construction project when liens are filed against the title to the project, as the owner will generally not pay the contractor the next progress payment due until the title is cleared. The main purpose of a lien bond is as security to allow a clearing of the title rather than posting cash or a letter of credit with the court.

The *Builders' Lien Act*[59] empowers the court to order that a title be cleared of liens registered against it if security is given that the claimant(s) may have recourse to. When liens are filed against title the contractor will apply to the court to post a lien bond as security for the lien claimants. The lien bond will be made payable to the accountant of the court and will have a stipulated penal sum.

[58] Ibid, at 782.
[59] Supra, note 1, at s. 35(1) [am. S.A. 1985, c. 14, s. 20]

After the general issue of entitlement to a lien(s) has been litigated, if the principal fails to pay the valid liens, the surety will be required to pay monies into court for satisfaction of these claims, up to the penal sum of the bond.

Northern Air Construction Ltd. v. *York (Borough) Public Library Board*[60] is authority that lien bonds deposited with the court in order to have a title cleared of liens are available to satisfy the liens vacated, notwithstanding that the owner has paid holdback monies into court.

In the event that the general contractor is insolvent and does not defend the lien claims, the court may allow the surety to intervene in the court proceedings to challenge the validity of the lien claims.[61]

Indemnity Agreements

In the ordinary course of events the surety will require indemnity agreements from the principal, the related companies, the key individuals standing behind the company and, possibly, their spouses, before the surety will issue a bond. Although it is the practice to require indemnity agreements, the surety is entitled at common law to be reimbursed by the principal, even in the absence of an indemnity agreement.

The indemnity agreement is generally broadly drafted to give the surety the right to a full indemnity for all of its losses with respect to the bond, including expenses incurred, solicitor/client costs, and any interest thereon.

The defences available to indemnitors are those generally found in contract law, and the indemnification agreement may well be challenged on the basis of misrepresentation as to the principal's assets, for example. It could also be challenged on the basis that there was no consideration if the indemnity agreement is executed after the

[60] (1985), 50 O.R. (2d) 201 (Div. Ct.).
[61] Harvey J. Kirsh, *The Construction Lien Act, Issues and Perspectives* (Toronto: Carswell, 1989).

bond has been given. An indemnitor will also likely aggressively assert that there was no default under the surety bond.

The case of *Elite Insurance Co.* v *.J.C. Kerkhoff & Sons Contracting Ltd.*[62] is illustrative of the defences that can be advanced by an indemnitor, although in this case the indemnitor was ultimately unsuccessful.

Conclusion

The use of construction bonds will likely become of increasing importance in the construction industry, especially in these recessionary times. For the owners of a construction project the requirement that the general contractor provide bid, performance and payment bonds is an effective way of pre-screening those who tender, as contractors who are experiencing financial difficulties will be unable to provide these bonds. Construction bonds also provide the owner with a relatively expeditious remedy against the surety, which is an important consideration when the contractor is insolvent.

The law is developing to hold sureties liable in an increasing number of situations. The *Citadel* decision has changed the former principle of strict construction so that compensated sureties will now be subject to a more liberal construction of the bond and thus to more successful claims on the bond.

[62] (1984), 5 C.L.R. 254 (B.C.S.C.)