CLARK WILSON LLP
BC's Law Firm for Business

Construction Bonding

by

Hannelie Stockenstrom
Clark Wilson LLP
tel. 604.643.3145
hgs@cwilson.com

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CONSTRUCTION BONDS

1. INTRODUCTION

It has become the practice in the construction industry, at least on large construction projects, to require contractors to post (i) Bid Bonds, (ii) Performance Bonds and (iii) Labour and Material Payment Bonds before the beginning of construction, and (iv) Construction Lien Bonds in the event that construction liens are registered against the title of the owner's land during the work.

This paper has been prepared to provide the parties to construction contracts with information on some of the various types of bonds that are available in the industry and to explain how each work. The paper will also describe what owners and contractors must do to protect their rights under the various types of bonds.

This paper is not intended as legal or professional advice. Readers should seek specific legal advice on particular legal issues with which they are concerned.

2. SURETYSHIP GENERALLY

A bond is a contract between certain parties which creates a legal relationship known as "suretyship".

A bond can be defined as a written agreement wherein the first party (Surety) guarantees that the second party (Principal) will fulfil his obligations to the third party (Obligee). In bonding situations the Principal has a contract to perform for the Obligee. A bond serves to ensure that the Surety will "make good the default which the [P]rincipal was or should be liable to pay or make good…"[1]. In exchange for guaranteeing the Principal's performance, the Surety charges the Principal a premium.

It is important to recognize from the outset that a bond is not an insurance policy. An insurance policy is a two party agreement, between an insurer and an insured. In an insurance contract, the insurer agrees to pay the loss upon the happening of a defined contingency. Accordingly, the obligation of the insurer is only triggered by an insurable event, which is typically an accidental event, an error or an omission. The insurance premiums are based on actuarial calculation of losses since losses are expected.

A bond on the other hand is a three party agreement, between a Principal, a Surety and an Obligee. It is a contract of guarantee, not a contract of insurance. One of the Surety's guiding principles is that no loss should occur from issuing a bond. This means that the Surety does not expect the Principal to suffer any loss which would ultimately result in the calling of the bond. Accordingly, premiums for bonds are "fee based" through calculations which take into account the cost of extending credit and administering the contract.

Note that well before a bond is ever issued, the Surety will have investigated fully the character, capacity and credit worthiness of the Principal to determine that Principal's financial strength and will usually also require a variety of indemnities from the Principal by way of a separate indemnity agreement as a condition to issuing a bond. The Surety will also obtain indemnity agreements from everyone who has an equity interest in the Principal, such as the owners and their spouses, (known collectively as the "Indemnitors") before it even issues the bond. These indemnity agreements serve to grant the Surety the right to full indemnity for all losses and expenses suffered that relate to that specific bond being written, including solicitor and clients costs.

Another distinguishing feature between a bond and an insurance contract, is that the loss on a surety bond is ultimately the Principal's loss. This is so, because pursuant to the separate indemnity agreements, the Surety will look to the Principal and any other Indemnitors for recovery of any loss. The Surety is entitled at common law, even if there is no written indemnity agreement, to be indemnified by the Principal.[2]

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[1] *Whalen v. Union Indemnity Co.* (1932), 41 O.W.N. 208 (H.C.) at 208
[2] Kenneth Scott, Q.C. and R. Bruce Reynolds, *Scott and Reynolds on Surety Bonds* (Toronto: Carswell, 1994) at p. 2-9

If a claim is made by an Obligee on a bond, the Surety will investigate to make sure that the Obligee has performed all its obligations. The Surety does this because it does not want to jeopardize its rights of recovery against the Indemnitors. Additionally, before the Surety responds, the Surety will seek the assistance of the Indemnitors to consider the claim from the Principal's perspective. Such a step is needed to be certain that the Principal is in fact liable to the Obligee.

The parties to the bond:

A Principal is the party whose obligations are guaranteed by the bond and the party who requests the Surety to issue the bond. As an example, if the bond is provided to an owner, the Principal is the contractor with whom the owner has contracted, or if the bond is provided to a general contractor by a subcontractor, the subcontractor is the Principal;

An Obligee is the party who receives the benefit of the guarantee or obligation provided by the bond and who requests or requires the Principal to provide the bond. As an example, if the bond is provided by the general contractor, the owner is the Obligee. Likewise, if the bond is provided by the subcontractor, the general contractor is the Obligee;

A Surety is the party who has agreed to guarantee the obligations of the Principal. This would normally be a bonding company.

An action against the Surety on a surety bond is an action for damages for breach of the promise contained in the bond[3]. The basis of the Surety's liability is found in the bond into which it has entered[4]. Although the Surety has to indemnify the Obligee for any loss suffered as a result of the contractor's faulty performance, the Surety's liability is limited to the actual damages sustained by the Obligee. In addition, the face amount of the bond will fix the maximum liability of the Surety, despite the Obligee's actual damage.

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[3] see *Thomas Fuller Construction Co. (1958) v. Centennial Group of Companies Ltd.*, [1987] N.S.J. No. 302 (Co. Ct.), affirmed [1987] N.S.J. No. 627 (N.S.S.C. App. Div.)
[4] *Citadel General Assurance Co. v. Johns-Manville Canada Inc.*, [1983] 1 S.C.R. 513

Recovery of the further damages suffered by the Obligee can only be claimed from the Principal. Since the owner is entitled to recover his actual damages from the Surety, there is an obligation on the owner to mitigate his damages[5]. However, the Obligee is not required to exhaust all other sources of recovery before claiming on the bond[6]. It should also be noted that a default by the Obligee of its obligations under the bonded contract may constitute a defence to liability for the Surety[7].

A bond refers to a specific construction contract. The Obligee cannot increase the risk for the Surety without the Surety's consent. Therefore, if there is a material change to the contract without the Surety's consent, the Surety will be released from its obligations under the bond, unless the change is unsubstantial, contemplated in the bond itself or benefits the Surety[8].

To be effective and enforceable, a Bond must be signed by the Surety and the Principal, and must be delivered to the Obligee[9]. In a 1996 Ontario case, *Paul D'Aoust Construction Ltd. v. Markel Insurance Co. of Canada*[10] the bonding company had issued a surety bond to a window contractor who was required under its contract to furnish a bond to the owner. The bond was to guarantee completion of the contract as well as the contractor's performance during the ensuing maintenance period. The contractor intentionally did not deliver the signed bond to the owner. The owner advanced payment to the contractor in the mistaken belief that the bond was in his possession. The bonding company, who delivered the bond to the contractor, also assumed that the bond was in the owner's possession. The contractor defaulted and the owner made a claim against the bond. The court decided that the bond had to be signed by the contractor and

[5] *Scott and Reynolds on Surety Bonds, supra* at p. 2-38.1
[6] *Citadel General, supra*
[7] *Five-Fifty Beatty Street Ltd. Partnership v. Markwood Construction Ltd.*, [1987] B.C.J. No. 1221 (S.C.), affirmed [1989] B.C.J. No. 434 (C.A.) but note that per *Citadel General, supra* a "compensated surety" contract is more liberally construed in favour of the claimants and minor variations will not allow a surety to escape liability.
[8] per *Holme v. Brunskill* (1878), 3 Q.B.D. 495 and *Doe et. al. v. Canadian Surety Company*, [1937] S.C.R. 1 and see *Preload Co. of Canada (Trustee of) v. Regina (City)*, [1959] S.C.R. 801, *Five-Fifty Beatty, supra* and *Marigold Holdings Ltd. v. Norem Construction Ltd.*, [1988] A.J. No. 612 (Alta. Q.B.)
[9] per *Larbonne v. Shore*, [1928] 2 W.W.R. 8 (B.C.C.A.) and *Aldgate Enterprises Ltd. v. Pacific Filtration Ltd.* (1990), 44 C.C.L.I. 14 (B.C.S.C.)
[10] (1996), 31 C.L.R. (2d) 180 (Gen. Div.), (1999), affirmed 45 C.L.R. (2d) 65 (C.A.), affirmed [2001] 3 S.C.R. 744 (SCC)

delivered to the owner in order to have force and effect.[11] The lesson learned from this ruling is that the Obligee should demand and have the executed bond in its possession before it ever advances any monies to the Principal.

3. BOND INTERPRETATION

Since a bond is merely a contract, it is to be interpreted by way of ordinary contract interpretation, namely according to that bond's own terms.[12] Additionally, the words in a bond are generally given their plain and ordinary meaning[13]. If the wording in the bond is clear enough it may serve to limit or exclude a Surety's liability[14].

It must be noted that there is a distinction in the law regarding the types of Sureties. "Accommodation sureties" are Sureties who freely guarantee the obligations of another party. In such cases, the Courts have held that there should be a strict interpretation of the bond in favour of the Surety. On the other hand, "compensated sureties" are Sureties such as bonding companies, who receive a fee, payment or some other form of remuneration or compensation in exchange for providing their guarantees. In such cases, the Courts have held that the standard is more relaxed than the strict approach governing "accommodation sureties".

> "It is clear that, while Canadian authority to date has tended to favour a more liberal approach to the consideration of the rights of claimants under bonds of this nature, it has not gone as far as the American courts in distinguishing the compensated from the accommodation surety. 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

[11] also see *Magna Contracting & Management Inc. v. Newfoundland* (2002), 10 C.L.R. (3d) 183 (Nfld. T.D.) where the Court held that the bid bond was unenforceable based on the fact that it lacked the signature of the Principal.
[12] *Lac La Ronge Indian Band v. Dallas Contracting Ltd.*, 2004 SKCA 109 at para. 78
[13] *Thomas Fuller Construction Co. (1958) v. Chateau Insurance Co.*, [1988] O.J. No. 2491 (Ont. H.C.) affirmed [1991] O.J. No. 1161 (Ont. C.A.)
[14] *Lac La Ronge, supra, Thomas Fuller v. Chateau, supra* and *Burns & Dutton Concrete & Construction Co. Ltd. v. Yule et. al.* (1968), 1 D.L.R. (3d) 699 (B.C.S.C.) affirmed (1969), 8 D.L.R. (3d) 683 (B.C.C.A.)

> 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 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. The failures complained of in this case in no way affect the relationship between the parties and in no way change the true basis of the bond contract. The appellant is simply faced with the duty of carrying out the bargain it made. I would not give effect to this ground of appeal.[15]"

Where there is ambiguity in the bond, the rule of contra proferentem will apply[16]. Application of this rule provides that any ambiguous terms must be construed against the party that drafted the bond. In most cases this will be the Surety.

All parties should be aware that where a bond either incorporates by reference or is conditioned upon the performance of a specific agreement (as set out in that bond) then that agreement with all its conditions becomes a part of the bond itself and the two must be read together and construed as a whole.[17]

Remember that bonds by their very nature rarely stand on their own. There is always some underlying agreement that corresponds to the bond. Accordingly, the protection that a bond provides is a mixture of the bond, the underlying agreement and the applicable law. Disputes involving bonds often result from poor tendering practices (bid bonds) or poor contract documents (final bonds). Parties should take care in preparing both tendering and contract documents and should always seek appropriate legal advice whenever there is doubt.

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[15] *Citadel General, supra* – McIntyre J. at p. 524. See also *Bank of Montreal v. Collum*, 2004 BCCA 358 leave to appeal refused [2004] S.C.C.A. No. 412.
[16] *Thomas Fuller Construction Co. (1958) Ltd. v. Continental Insurance Co.* (1970), 36 D.L.R. (3d) 336 (Ont. H.C.) and *Whitby Landmark Development Inc. v. Mollenhauer Construction Ltd.*, [2003] O.J. No. 4000 (Ont. C.A.)
[17] *British American Oil Co. Ltd. v. Ferguson et. al.*, [1951] 2 D.L.R. 37 (Alta. S.C. App. Div.) and see *Employers Liability Assurance Corp. v. Canada*, [1969] 2 Ex. C.R. 246 where it was held that both bonds (performance and L&M) and the contract were to be construed together. See also *Campbell Comeau Engineering Ltd. v. Alta Surety Co.*, [1996] N.S.J. No. 372.

4. CONSTRUCTION SURETY BONDS DEFINED

A. Bid Bonds

Bid Bonds guarantee that, if a contractor is awarded a construction contract in response to a tender, and the contractor refuses to enter into the construction contract in accordance with the terms of the tender, the Surety will pay the difference between the successful tender and the next lowest tender up to the penalty limit of the Bid Bond.

B. Performance Bonds

Performance Bonds guarantee that the contractor will perform all of its obligations under the construction contract. If the contractor fails to perform all of its obligations under the construction contract, the Surety's obligation arises, provided that the Obligee has performed its obligations under the contract.

C. Labour and Material Payment Bonds

Labour and Material Payment Bonds provide for the payment of subcontractors and material suppliers should the Principal on the bond not make payments as required.

D. Construction Lien Bonds

Construction Lien Bonds guarantee (normally to the Court) that, provided the lien claimants for whom the bond is posted successfully prove their claims of builders liens against the lands of the owner, payment will be made to the lien claimants, subject to the provisions of the *Builders Lien Act*.

5. BID BONDS

A. Definition

Standard tender documents almost always require a contractor to submit a Bid Bond. The purpose of a Bid Bond is to ensure that the contractor submits its own bid in good faith. The Bid Bond requirement also serves to discourage prospective bidders from submitting frivolous bids.

The Bid Bond ensures that upon the acceptance of a tender, the contractor will do two things:

(a) enter into a formal contract with the owner; and

(b) give security for the performance of the contract as is required by the terms of the tender.

If the contractor meets these commitments, the Surety's obligations under the Bid Bond are at an end. If the contractor fails to meet any of the obligations under the Bid Bond, the contractor is in default and the owner can call upon the Surety to compensate the owner for any loss.

It is generally a condition of the Bid Bond that the tender must be accepted within some specified period (generally 30 or 60 days) from the closing date of the tender. If this is not done, the contractor (as the Principal), the owner (as the Obligee) and the Surety must execute an agreement to any extension, or the Bid Bond will simply expire and become unenforceable.

If the contractor defaults under the Bid Bond, the Surety must (subject to any defences it may have) compensate the owner according to the terms of the Bid Bond. The Surety will then expect to recover payment from the contractor, pursuant to the indemnities that the contractor provided to the Surety.

Note that the Surety's Bid Bond obligations are triggered by the enforceability of the contractor's bid. This means that if the contractor's tender is not enforceable (for example through non compliance or patent error both different from the issue discussed below – "mistake") then the Bid Bond is also not enforceable based on the fact that there is no obligation on the non compliant contractor to enter into a Construction Contract ("Contract B" per *Ron Engineering*[18]) with the owner.

[18] *R. v. Ron Engineering & Construction (Eastern) Ltd.*, [1981] 1 S.C.R. 111 where the Court set out a two contract model for the tendering process using Contract A and Contract B

B. Mistake in Tender

Where there is a mistake in a contractor's bid and the contractor refuses to enter into a contract with the owner, the owner will look to the Surety under the Bid Bond for any compensation that the owner believes is it due and owed.

If the contractor makes an error in its tender which is obvious on its face, the owner cannot "snap up" that tender and then claim on the Bid Bond. In such a situation, no contract is formed because both the owner and the contractor were aware of the existence of the obvious mistake.[19]

When the mistake is not apparent on the face of the tender and can only be shown by additional information, the tender is valid and cannot be withdrawn after the close of tender. If the contractor chooses not to proceed with the work and enter into a construction contract with the owner, the owner is entitled to the proceeds of the Bid Bond[20]. This was held to be the case in *Ron Engineering* where the contractor submitted his tender along with a tender deposit of $150,000. The tender documents included a term that if a tender was withdrawn, or if the Commission did not receive the executed agreement within a certain time, the Commission could retain the tender deposit. The contractor, on the opening of the tenders, learned that it had made a mistake in its tender, by neglecting to add the cost of labour to the total tender amount. The contractor advised the owner of the mistake, but the owner refused to allow the contractor to withdraw the tender. The contractor refused to enter into a construction contract. The owner, relying on the tender deposit term in the tender documents, decided to retain the deposit and proceeded to accept another tender. The contractor commenced an action to recover the tender deposit. As the mistake was one of calculation, and not evident on the face of the tender, the court agreed that the tender was not capable of being withdrawn and the bid deposit was forfeited.

It is important to remember that many tender documents do allow a tenderer to withdraw its tender at any time up until the time that tenders close. If the tender documents do allow for

[19] *McMaster University v. Wilchar Construction*, [1971] 3 O.R. 801 (H.C.)
[20] see *Quantum Homes Ltd. v. Guarantee Co. of North America*, [1990] O.J. No. 1315 (Ont. H.C.) and *Toronto Transit Commission v. Gottardo Construction Ltd.*, [2005] O.J. No. 3689.

withdrawal, a tenderer who becomes aware of a mistake, whether evident on the face of the tender or not, could withdraw its tender without penalty up until the close of tenders.

C. Making a Claim

An owner who wishes to make a claim must notify the Surety in writing. Tendering documents sometimes require that the owner prepare a formal contract in accordance with the precise terms of the tendering documents and present it to the contractor for acceptance. If so, this must be done before the owner can claim under the Bid Bond. If the tendering documents do not have this requirement, the owner need not present a formal contract before it can claim under the Bid Bond.

D. Limitation Periods

Standard Bid Bonds provide that an owner must preserve its claim by commencing an action within 6 months of the date of the Bid Bond. Virtually all Bid Bonds establish a limitation period within which an owner must commence any action on the bond. In the unlikely event that the Bid Bond does not establish a limitation period, the limitation period to commence an action is that established by statute or common law in each of the various provincial jurisdictions.

E. Calculating the Penalty

The Standard Form Bid Bond provides that the liability of the Surety is limited to the lesser of:

(a) the difference between the amount of the contractor's bid and the bid which the owner ultimately accepts from another party; and

(b) the penalty stated on the face of the Bid Bond.

The Surety cannot be liable for an amount greater than the penalty stated on the face of the Bid Bond. Where the owner's damages exceed the penalty specified in the Bid Bond, the owner will be forced to bring an action against the defaulting contractor for the difference.

An owner must take all possible steps to mitigate the damages that the owner has suffered, or the owner's claim under the Bid Bond may be reduced accordingly.

6. PERFORMANCE BONDS

A. Definition

A Performance Bond has been defined as follows:

> "Generally, a Performance Bond constitutes a promise from the surety to the obligee that if the Principal defaults in the performance of a specific contract, so long as the obligee has performed its obligations under the contract, then the surety, usually subject to certain conditions, will be obliged to either remedy the default, complete the contract, or put bids for completion to the obligee.[21]"

Accordingly, a Performance Bond is a guarantee that the contractor will truly and faithfully perform all of its obligations under the construction contract. The bond's function is to place the Surety in the position of guaranteeing, to the Obligee, the Principal's performance of a specific Construction Contract, subject to certain conditions set out on the face of the Bond. A Surety will only be liable on the bond if all the express conditions in the bond are met.

Note that although the wording of the bond may vary in any particular case, invariably the condition of a Performance Bond is that the Principal will properly perform and fulfil all of its obligations under the Construction Contract.

B. Making a Claim

Performance Bonds generally provide that the contractor will *"promptly and faithfully perform the contract"*. If the contractor breaches the contract or fails to complete it, and the owner has performed all its obligations under the contract, the Surety, if called upon by the owner, must either remedy the default or in some other way perform the contract.

[21] *Scott and Reynolds on Surety Bonds, supra* at p. 10-1

Note that it is a condition of the Surety's obligation that the Obligee (read in most cases as "owner") must have performed its obligations under the contract. The Obligee's failure to fulfill its obligations may excuse the Surety from responding[22].

The standard bond wording provides as follows: *"Whenever the Principal shall be, and declared by the Obligee to be, in default under the Contract, the Obligee having performed the Obligee's obligations thereunder …"* As such, for an Obligee to claim under a performance bond (i) the Principal must be in default under the contract and (ii) there must have been a proper declaration of default by the Obligee. The case law provides that "default" refers to only those defaults that are of such a serious nature that the Obligee deems it proper to make a declaration of default and to call upon the Surety to perform its obligations under the bond[23]. However, an Obligee would be well advised to notify the Surety whenever significant problems with respect to the contract arise.

It is very important that an Obligee follows the right steps to properly advance a claim under a bond. The Obligee should carefully review the wording of the bond under which the claim is made and comply with the requirements set out in the bond itself.

If the Obligee wishes to make a claim, the Obligee's first obligation is to promptly notify the Surety in writing of the default. This notice must be clear, direct and unequivocal since the Surety's obligation to respond promptly does not arise until a formal demand has been received from the Obligee[24].

Also, the notification of default should be timely, so that the Surety has the opportunity to investigate the alleged default and then choose one of the remedy options available to it. Failure by the Obligee to provide prompt notification may be viewed as prejudicial to the Surety and indeed may result in the Surety being released from its obligations[25]. Likewise, the Obligee

[22] *Five-Fifty Beatty, supra*
[23] *Thomas Fuller v. Continental, supra*
[24] *Fraser Gate Apartments Ltd. v. Western Surety Co.*, [1995] B.C.J. No. 1458 (S.C.), varied upon appeal [1998] B.C.J. No. 1367 (C.A.) and see *Lac La Ronge, supra* at para 42
[25] *New Look Restoration Ltd. v. Osgoode Developments Ltd.*, [1992] O.J. No. 1647 (Ont. G.D.) and *T.S. Manufacturing Co., a division of 381572 Ontario Ltd. v. Juniper Lumber Co.*, [2000] N.B.J. No. 239 (N.B. Q.B.)

cannot, without notice to the Surety, proceed with or attempt to remedy the contract itself or hire a third party to do so and then assume that at some future time it will be entitled to collect against the Surety payment for any losses it suffered in the process[26].

Upon receipt of notice from the Obligee, the Surety is entitled to a reasonable period of time to perform a proper analysis of the situation. What is "reasonable" depends on the facts of each case.

> "In my opinion the question of whether or not a surety has acted "promptly", must depend upon the particular facts of the case, the context of that case. The surety must act as soon, and with such dispatch, as is reasonably possible. Promptly does not mean immediately, as it does in many policies of insurance, although the circumstances of a given case may require almost immediate and continuous response. Generally the surety will be entitled to a reasonable period of time to properly investigate the contractual and factual circumstances of the claim, with particular regard to the question of whether the principal is in default under the contract, and whether the obligee has performed its obligations under the contract. That such an investigation, and reasonable time within which to do it, is required must be evident from the very nature of the bond.[27]"

The Obligee should at all times attempt to fully communicate and cooperate with the Surety. This will allow the Obligee to rebut any claim where the Surety attempts to deny liability on the ground that the Obligee acted without the knowledge or the consent of the Surety. This does not necessarily mean that an Obligee should stand around waiting for the Surety's decision to proceed. In some cases, repairs are needed immediately. In such situations, the Surety and the Obligee may decide to enter into an agreement on a course of action for completing the necessary work without prejudicing the Surety's right to deny liability under the Performance Bond.

In investigating the default, there are a number of duties that the Surety must consider. The most important of these is that the Surety has a duty to both the Obligee and the Principal, as well as

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[26] *Whitby Landmark, supra*
[27] *Fraser Gate, supra* – Hood J. (B.C.S.C.) at para. 81

the Indemnitors, to fully investigate the default. In investigating the default it is important that the Surety communicates with the Principal to assess its position with respect to the default before undertaking any work and incurring any expense. If the Surety completes the work where there was no default by the Principal, it will have breached its duty to the Principal and to the Indemnitors and it will have relieved them from liability to pay the costs of the completion to the Surety.

C. Performance

Under a Performance Bond it is the right of the Obligee to insist that the Surety perform the contract on behalf of the Principal.

What does this mean?

(a) The owner must ensure that it gives the Surety the full opportunity to perform the contract;

(b) The owner cannot proceed with performing the contract of a defaulting contractor and assume that the owner will be entitled to be indemnified by the Surety for the losses it suffers in the process;

(c) The Surety has a right to insist on being permitted to perform the contract to satisfy the obligations that the Surety has entered into pursuant to the Performance Bond.

Once the Surety has received notice of default, investigated and ultimately determined that there is default and no defence available to the Surety, it must then choose one of the following options available to itself under the bond:

1. remedy the default;

2. complete the contract; or

3. obtain a bid or bids for submission to the obligee for completion of the contract.

Performance Bonds generally provide that the Surety has the right to choose which arrangement it wants to ultimately complete the contract, and hence the owner may not take any unilateral actions without consulting the Surety. As previously stated, if the owner does take unilateral actions without consulting the Surety, the owner risks releasing the Surety from its obligations. Note that the Surety has a duty to the Principal and the Indemnitors not to assume any liability to the Obligee if the Principal has a legitimate defence.

On the other hand, where the Surety is liable to the Obligee, the Surety must balance its obligations to remedy the default with its duty to the Principal and the Indemnitors to complete the work in the most cost effective way. The Surety must therefore ensure that it exercises reasonable diligence in selecting a replacement contractor, that it does no more work under the contract than necessary, and ensures that costs incurred in performing the work are reasonable and proper in the circumstances.

(a) Remedying the Default

Under this option the Surety will attempt to reconcile the dispute between the Obligee and the Principal. "Remedying the default" is described as follows:

> "This option is available when the principal is solvent and some dispute has arisen during the course of the performance of the contract as a result of which the obligee has declared the principal to be in default. The surety sometimes can play a conciliatory role and bring the parties together so that the default will be remedied and the principal will carry on with the contract.[28]"

If the default occurs as a result of a shortage of working capital on the part the Principal, the Surety may attempt to remedy the situation by providing financing to allow the Principal to complete the contract.

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[28] *Scott and Reynolds on Surety Bonds, supra* at pp. 10-7 to 10-8

(b) Completing the Contract

While there is nothing to prevent it from completing the contract itself, this option is rarely used by the Surety. Since the Surety does not usually have construction personnel on staff, one variation of this option is for the Surety to subcontract the work back to the Principal or to create a new company which employs the key personnel of the Principal.

(c) Putting a bid for completion to the Obligee

This is the most frequently employed option and involves obtaining bids from other contractors for completion of the contract. The unsuccessful bidders who originally bid the job are often approached by the Surety to give a price for completion of the contract.

While these are the three main options available to the Surety once default occurs, it must be stressed that this assumes that the Surety has no defence available. Defences available to the Surety such as failure to notify the Surety of default, material variation of the contract and failure to deliver the bond to the Obligee will be discussed below.

D. Limitation Periods

A Performance Bond generally provides that an action under the bond must be commenced within 2 years from the date on which final payment under the contract falls due.

It is important to note that the relevant date is the date on which final payment "falls due", not the date that the last payment was made. The safest practice for an Obligee would be to make claim on a Performance Bond immediately upon default by the Principal.

Both owners and contractors should review the terms of their specific bond. Some of the bonding companies have begun to change the terms of their bonds to provide that the Surety will not be liable for any of the Principal's obligations under the bonded contract for events occurring or discovered more than two years after the date of "substantial completion".

If the Performance Bond does not provide for a limitation period then the limitation period to commence an action is that established by statute or common law in each of the various provincial jurisdictions.

Note that where it is determined that the Principal has not ceased work on the project, then time will not run and the Surety could face indefinite liability. The court considered the limitation period of one year from the completion of the work in the case of *Lunenburg For Special Care Corp. v. Duckworth*[29] and held that the time limit had never commenced as the contractor due to its own default had never finished its work under the Construction Contract.

The question of when the limitation period commences was also considered in *Maidstone (Township) v. Loosemore Excavating Inc.*[30]. In that case Simcoe & Erie was the bonding company which had issued a Performance Bond to the Township. Loosemore Excavating Inc. was the drainage contractor which had performed the work. Under the terms of the contract the last payment fell due 45 days after acceptance of the work by the owner. Although the Township's engineer never certified final acceptance of the work, final payment was made to the contractor. The bonding company was not aware that final acceptance of the work was never certified. The bonding company's records indicated that the work was paid for in full and the bonding company assumed that the work was certified. However, the condition of the bond that the last payment fell due only after final acceptance of the work was not met. As a result, the two-year time limit under the bond was not triggered and the bond remained active for several years after final payment was received by the contractor. The court rejected the bonding company's arguments that the time limit for a claim under the bond had expired.

Note that this argument will not extend to Labour and Material Payment Bonds. Under a Labour and Material Payment Bond the time begins to run from the date when the contractor ceased work on the contract.

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[29] [1973] N.S.J. No. 134 (N.S. T.D.)
[30] [1996] O.J. No. 2765 (Ont. G.D.), reversed in part [1998] O.J. No. 5046 (Ont. C.A.)

E. Scope of the Performance Bond

The general principle is that the purpose of a Performance Bond is to guarantee that the work set out in the Construction Contract will be performed to completion. The bond itself is not meant to act like an insurance policy. Hence compensation for certain losses, such as consequential damages, has typically not been considered to fall within the scope of the bond. What then for damages set out in the construction contract itself, such as a penalty for the contractor who fails to complete on time (ie. liquidated damages) or an anticipated rebate for cost savings?

The authorities on this issue have held that an Obligee will be entitled to recover any and all reasonably foreseeable damages suffered as a result of the Principal's default up to the monetary limit set out in the bond unless such costs are expressly excluded by the terms of that bond. Accordingly, each case will be treated based on the specific wording of the bond in question and additionally in some cases the underlying construction contract[31]. For example, in *Whitby Landmark Development Inc. v. Mollenhauer Construction Limited*[32], it was argued that the bond was only intended to cover the costs of completing the physical construction work under the contract but did not extend to the collateral obligation of the contractor, namely the obligation to share the cost savings it achieved with the owner as was required pursuant to the terms of the construction contract. The Court held that the construction contract had been incorporated into the terms of the bond and that ultimately the broad language of the bond[33] served to include the cost savings owed by the contractor to the owner. However, the Court also found that in this case the owner had failed to make a timely declaration of default to the Surety and consequently had forfeited its claim under the bond.

A subsequent decision in the *Lac La Ronge*[34] case contrasts with the ruling in the *Whitby Landmark* decision. Again the Court's decision was based on interpreting the specific terms of

[31] Where the bond incorporates by way of reference the construction contract, the terms of the construction contract also form part of the bond.. Also see *Thomas Fuller v. Continental, supra* where it was held that in interpreting a bond, the intention of the parties as to the obligations of the surety is found in the language of the bond.
[32] see note 16 for citation
[33] *Whitby Landmark supra,* at para 22 and 25 – the Court specifically mentioned the "cost of completion" language and the "balance of the Contract price" definition set out in the bond terms
[34] see note 13 for citation

the bond in question. In *Lac La Ronge*, the trial judge had held that the Surety was liable under the bond to pay the owner liquidated damages, a remedy set out against the contractor for failure to complete under the construction contract. The Court of Appeal reversed the decision and held that the construction contract only entitled the owner to deduct liquidated damages from payments to the contractor "which became due and payable". Once the contractor defaulted on the construction contract, such payments no longer became due and payable hence liquidated damages could not then be properly deducted. As such, no liquidated damages were owed under the bond. The Court distinguished its decision from the *Whitby Landmark* decision as follows:

> "In Whitby, the Court interpreted "balance of the contract price" as being reduced by any amount that is owing by the contractor to the owner at the time of default. In this case [Lac La Ronge], the trial judge deducted amounts which became owing after the default.[35]"

F. Denial of Claim and the Surety's Defences to Bonds

Since a bond is merely a contract between parties general contract principles apply in cases such as mistake as to the terms of the bond and rectification of mistake. In addition to such general principles, a Surety can also raise a number of defences to a claim against a bond. In deciding to accept any such defences, the Courts have tended to focus on the question of whether the Surety has been prejudiced by the actions of the Principal or the Obligee during the time period covered by the bond.

Standard Performance Bonds contain the following language *"Whenever the Principal shall be, and declared by the Obligee to be, in default under the Contract, the Obligee having performed the Obligee's obligations thereunder [under the contract], the Surety may …"* As such, for an Obligee to claim under a Performance Bond, the Principal must be declared to be and must actually be in default under the contract, Additionally, if the Obligee wishes to make a claim, its first obligation is to notify the Surety.

[35] *Lac La Ronge, supra* – Jackson, J.A. at para. 67

As stated earlier, it is a condition of the Surety's obligation to guarantee that the Obligee must have performed its own obligations. This is expressly stated in the bonding terms themselves by virtue of the words *"the Obligee having performed the Obligee's obligations thereunder"*. If an Obligee does not fulfil its obligations under the construction contract, it may forfeit its right to make a claim under the Performance Bond. Accordingly, a cautious Obligee should keep the Surety informed of any potential problems regarding performance of the contract.

An Obligee's right to claim under a Performance Bond may also be jeopardized based on the following defences available to a Surety:

a. The bonded contract is unenforceable

If the bonded contract is deemed invalid[36], impossible to perform or illegal[37] then the Surety will not be liable.

b. No default by the Principal

In order for the Obligee to claim under a performance bond they must show that the Principal was in default under the contract. As previously explained "default" refers to only those defaults that are of such a serious nature that the Obligee deems it proper to make a declaration of default and to call upon the Surety to perform its obligations under the bond[38]. Where it can be shown that the breach complained of by the Obligee is merely minor in nature, then this condition will not be satisfied.

c. The bond is not executed properly or is never delivered to the Obligee

As previously discussed, a bond must be signed by both the Principal and the Surety and must be delivered to the Obligee in order to be effective and enforceable. Failure to comply with these

[36] *Kesmat Investment Inc. v. Canadian Indemnity Co.*, [1985] N.S.J. No. 109 (N.S.S.C. App. Div.)
[37] *One Hundred Simcoe Street Ltd. v. Frank Burger Contractors Ltd. et. al.*, [1967] 1 O.R. 195 (Ont. H.C.), varied on appeal [1968] 1 O.R. 452 (Ont. C.A.), affirmed (1969), 2 D.L.R. (3d) 735 (S.C.C.)
[38] *Thomas Fuller v. Continental, supra*

requirements will result in the bond having no force and effect as demonstrated by the ruling in *Paul D'Aoust Construction*[39].

d. Failure to Notify

The Obligee must notify the Surety of the Principal's default and give the Surety an opportunity to follow one of the options available to it under the bond. If the Obligee fails to notify the Surety, the Surety may be discharged. The Obligee need not give notice of every default, but if the Obligee wishes to declare the default and call upon the bond, it must notify the Surety. This declaration of the Principal's default by the Obligee must be timely. If the declaration in not timely, and the Surety has been prejudiced by a late notice of default, the Surety may have a defence. An Obligee would be well advised to ensure that the declaration of default is specific and is delivered in writing to the Principal with a copy to the Surety.

e. Material change to the contract

The Surety bonds a specific contract and takes the risk that the Principal will not perform that specific contract. Accordingly, the Obligee cannot increase the risk for the Surety without that Surety's consent. Therefore, if there is a material change to the contract without the consent of the Surety, the Surety will be released, unless the change is unsubstantial or benefits the Surety.

What constitutes a "material change" depends on the interpretation of the contract. Most construction contracts assume that there will be changes to the scope of work, and accordingly include a "Changes in the Work" clause. These changes may or may not be material. A "material change" has been said to occur where the scope of work has been increased to such an extent that it changes the nature of the contract. A material change may also be where the Obligee has agreed to waive any delay or adjust the construction schedule.

For a Surety to avoid liability, the changes in the contract must be material, must prejudice the Surety and must be without the consent of the Surety[40].

[39] *Paul D'Aoust Construction, supra*

f. Improper payment of contract funds

Payments made contrary to the payment schedule in the contract may also serve to discharge the Surety[41]. This may happen where the Obligee advances funds to the Principal in order to ease the Principal's cash flow problems and such advances are out of proportion to the work that has been completed. Courts have held that in such circumstances, the Obligee has prejudiced the Surety because the amount of funds available to the Surety, should it subsequently undertake to complete the construction contract, has been otherwise reduced.

It should be noted that where an Obligee advances payment to the Principal, acting in good faith and relying on an erroneous architect's or engineer's certificate, it is doubtful that the Surety would be released from its obligations[42]. In such a case however, the Surety is still entitled to a right of subrogation against the negligent third party.

g. Extension of completion date

A variation of the completion date may also constitute a material change of the contract which may release the Surety. In such cases, the Court will look to see if the extension served to prejudice the Surety. Accordingly, Obligees should be very careful that they do not do anything which could be interpreted as consenting to an extension of the completion date and thus provide the Surety with a defence to payment under the bond.

7. LABOUR AND MATERIAL PAYMENT BONDS

A. Definition

A Labour and Material Payment Bond ("L&M Bond") has been defined as follows:

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[40] see note 8

[41] see *Credit Heights Ltd. v. United States Fidelity and Guaranty Co.* (1987), 26 C.L.R. 228 (Ont. H.C.), *Town of Mulgrave v. Simcoe and Erie General Insurance Company* (1977), 73 D.L.R. (3d) 272 (N.S.C.A.) and *Thomas Fuller v. Continental, supra*

[42] *Riverview Heights Estates Ltd. v. Palurema Contractors Ltd.*, [1981] O.J. No. 368 (Ont. H.C.) and see *Thomas Fuller v. Continental, supra* at p. 361 where it was held that in order to discharge the Surety the Obligee would have to knowingly overpay the Principal.

> "Generally, a Labour and Material Payment Bond constitutes a promise by the surety to the obligee under the bond that if the principal fails to pay suppliers of services and/or materials to the principal with respect to a specific contract or project then, subject to certain conditions being satisfied, the surety will pay the claims of those claimants pursuant to the bond[43]."

In situations where the bond is provided to the owner, the Principal under the L&M Bond will usually be the general contractor with the owner as Obligee. Where the bond is provided by a subcontractor to a general contractor, the Principal will be the subcontractor with the general contractor as Obligee.

An L&M Bond is a guarantee that the Surety will pay, under certain conditions, the accounts of those subcontractors and material suppliers on the project if the Principal is unable or fails to do so. However, as with other surety bonds, the Surety is only liable for the limit on the bond.

L&M Bonds are generally required in the public sector, however they are starting to be used widely in the private sector. The exact application of an L&M Bond should be taken into account as the form of the bond will depend on the specific requirements of the owner and the project in question. As with Performance Bonds, the wording of these bonds particularize certain types of liability. Accordingly, the wording may vary from bond to bond. Remember, it is always important to obtain a copy of the bond and carefully read its provisions to determine the liability of the Surety in the specific circumstances. This is additionally so for subcontractors and material supplies. Copies of the L&M Bond should be obtained prior to providing any services or materials in order to ensure that there is adequate security in the event of possible future non-payment.

As stated earlier, the wording of the bond is important. For example, it is a general principal of contract law that only parties to a contract may enforce that contract. In this regard, an L&M Bond differs from other bonds as the potential claimants under the bond, the subtrades and/or material suppliers, are not parties. In order to get around this "third party beneficiary rule", the specific wording of the L&M Bond serves to makes the owner (who is the Obligee) the Trustee

[43] *Scott and Reynolds on Surety Bonds, supra* at p. 11-1

on behalf of each potential claimant. This arrangement allows claimants to sue on the bond by bringing an action against the Surety for payment through the owner, as Trustee[44].

L&M Bonds require that notice be given of a claim within a specified period after payment is due or some other defined event in the construction process. Also, an action must be commenced within a stipulated time after the claimant's work is completed or materials are last supplied.

Sureties should be aware that when issuing an L&M Bond, they are under a duty to keep themselves adequately informed of the Principal's current state of accounts with its subcontractors[45]. In this way, a Surety should be alerted to any financial predicament of the Principal before the Principal abandons or is forced to abandon the construction contract which may result in leaving the subtrades unpaid.

B. Who Can Claim Under a Labour and Material Payment Bond?

A party must normally meet three requirements to successfully claim under an L&M Bond:

(a) the party must bring itself within the definition of "claimant" contained in the bond;

(b) the party must provide appropriate notice to the Surety of the claim under the bond; and

(c) the party must commence an action against the Surety to enforce its claim under the bond within the time period specified in the bond.

The standard form L&M Bond restricts claimants to entities which are in a direct contractual relationship with the contractor "for all labour and material used or reasonably required for use in performance of the contract". A subcontractor who has a contract with another subcontractor will therefore not qualify as a claimant.

[44] see *Citadel General, supra* – trial decision at (1980), 113 D.L.R. (3d) 686 (Ont. H.C.) and note s. 48 of the *Law and Equity Act*, RSBC 1996, c. 253.

It is important to remember that the extent of any bond is set out in its terms. Accordingly, parties to the bond should be aware of the bond's wording and should examine the bond to determine which parties and what responsibilities fall within its scope. For example, a bond claim by the engineering consultant will generally not be successful in the traditional relationship where the engineering firm is employed by the owner and not the contractor. However where the terms of the bond were not viewed as expressly limiting, that consultant might qualify as a claimant. This in turn might expand the Surety's scope of obligations under the bond and correspondingly serve to expand its liability, as was the case in *Campbell Comeau Engineering Services v. Alta Security*[46].

C. Making a Claim Under a Labour and Material Bond

As previously stated it is very important that potential claimants familiarise themselves with the terms and conditions, as well as the limitations, of the L&M Bond. It is particularly important to pay attention to the time limits that are prescribed for filing claims. To be valid, claims must be filed within the stipulated time and it should be noted that a notice of claim must be filed by registered mail with each of the parties to the Bond, namely the Principal, the Obligee and the Surety. If a form other than the standard bond form is used, potential claimants should obtain and carefully review a copy of the proposed bond form from the Principal or Obligee.

The terms of the L&M Bond set out the method for making a claim. A claimant must show:

(a) that the claimant has a direct contract with the general contractor;

(b) that the claimant has complied with the notice provision in the bond; and

(c) the proper amount due to the claimant.

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[45] *Truro (Town) v. Toronto General Insurance Co.*, [1974] S.C.R. 1129
[46] [1996] N.S.J. No. 372 (N.S.S.C.), affirmed [1997] N.S.J. No. 178 (N.S.C.A.) and leave to appeal dismissed [1997] S.C.C.A. No. 358 where the Court found that the terms of the bond were general enough to allow a claim for "soft costs" (ie. engineering and design services plus shop drawings and specs) that were not part of the actual labour and material that went into the physical construction of the works.

General contractors and subcontractors often purchase or lease supplies, materials and equipment from the same supplier for more than one contract and there is a tendency to make payment on a monthly or periodic basis without allocating the payment to specific projects. If a claim is made under an L&M Bond this practice could make it difficult for the contractor to prove that payment had been made for that specific contract covered by the Bond.

Accordingly, general contractors and subcontractors are cautioned to:

(a) make payment on the basis of a specific invoice amount where such invoice applies directly to a specific contract; and

(b) indicate the allocation of the amount of payment applicable to each specific contract when making a bulk payment.

D. <u>Material Variation of the Prime Contract by the Obligee</u>

Ordinarily, a Surety will not be bound by the bond if there has been a material change to the bonded contract unless the Surety consented to the change, the change was not material or such change served to benefit the Surety. What then happens under an L&M bond if the Obligee effects a material change in the construction contract?

L& M Bonds are specific in that they only serve to guarantee the due payment of claimants for labour or material used in the performance of the construction contract. Accordingly, in the case of an L&M Bond, the question then becomes what has the Surety guaranteed under this type of bond in relation to the construction contract itself? Under an L&M Bond, the only performances to be guaranteed are the subcontracts between the general contractor and the subtrades, to which an owner (as Obligee) is not a party. Accordingly, a Surety will still remain liable under the bond. This is because a material change in contract A (the construction contract) to which the Obligee is a party, does not serve to discharge a guarantee in respect of contract B (any subcontracts) to which the Obligee is not a party[47].

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[47] *Truro, supra*. And see *Alberta Concrete Products Co. Ltd. et. al. v. Simcoe & Erie General Insurance Company*, [1978] A.J. No. 838 (Alta. Dist. Ct.) which followed the *Truro, supra* decision.

E. Denial of Claim and the Surety's Defences to Bonds

Just as with Performance Bonds, there are a number of defences which a Surety can raise in defence to a claim against an L&M Bond. Remember that a Surety is only liable if the Principal is liable[48]. Additionally, a Surety is entitled to raise any defence which the Principal would be allowed to raise if that action had been brought solely against the Principal.

The Courts have focused on the central question of whether the Surety has been prejudiced by the actions of the Principal or the Obligee during the time period covered by the bond.

A claimant's right to claim under an L&M Bond might also be jeopardised in the following circumstances:

a. The Bond is not executed properly or is never delivered to the Obligee

As previously stated, the bond has to be signed by all the parties and must be delivered to the Obligee to be valid and binding.

b. Failure to notify

A claimant must give written notice of its claim within the time periods set out in the L&M Bond to preserve its right to sue on the bond. This notice precondition is a key term of the bond and has been heavily litigated. Generally, if a claimant neglects to give proper notice of its claim, it will lose the right to sue on the bond, subject only to a court granting relief from forfeiture to the claimant.

There have been conflicting decisions as to whether a claimant who has failed to provide notice within 120 days could be relieved from forfeiture of his right to claim. The currently accepted principle is that strict compliance with the notice provision of a L&M Bond may not be required so long as there is no prejudice to the Surety[49].

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[48] *Kesmat Investment, supra*

[49] *Falk Bros. and Canadian Surety Company v. Elance Steel Fabricating Co.*, [1989] 2 S.C.R. 778; *312630 B.C. Ltd. v. Alta Surety*, [1995] 10 W.W.R. 100 (B.C.C.A.)

> "… Where, as here, the object of the notice provisions in the 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. The failures complained of in this case in no way affect the relationship between the parties and in no way change the true basis of the bond contract.[50]"

The question of whether or not there was actual prejudice from the delay, is a question of fact that is dependent upon the circumstances of each individual case[51]. Accordingly, the fact that notice was not given timely, may not in and of itself discharge the Surety.

To assist the Surety in processing the claim, the notice should be as detailed as possible and should include copies of all invoices as well as the name of the Principal, the project bonded, the bond number (if available), and a description of the work done or the material supplied to the project[52].

Pursuant to the standard L&M Bond wording, notice must be given within 120 days that the *"claimant did or performed the last of the service, work or labour or furnished the last of the materials for which such claim is made."* The question then arises, what qualifies as the "last of the service, work, labour, or supply of materials"? The decision of the Court in *Canadian Indemnity Co. v. Numan Industries Ltd.*[53] has served to provide the following general principles:

> "(1) The nature of the work relied upon by the claimant will be considered and touch-ups, minor adjustments, purely cosmetic work or work of a minor or insignificant nature, may not be considered to be performance of the last work for which the claim is made;
>
> (2) The work relied upon must be of a substantial nature relative to the nature of the project under contract;

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[50] *Citadel General, supra* – McIntyre J.
[51] *312630 B.C. Ltd., supra*
[52] see *Dunlop Construction Products Inc. v. Fireman's Fund Insurance Co. of Canada*, [1989] B.C.J. No. 392 (S.C.) where the notice letter was not deemed adequate. Also see *Rental Shop Ltd. v. Western Surety Co.*, [1992] N.J. No. 212 (Nfld. T.D.) for the same finding by the Court.
[53] [1989] B.C.J. No. 1951 (S.C.) reversed on appeal [1990] B.C.J. No. 2391 (C.A.)

> (3) The delivery of a Statement of Account charging interest (depending on the payment terms of the contract), may be considered as evidence that the claimant considered its work complete as at an earlier date; and
>
> (4) By extrapolation, the delivery of invoices for the total amount of the contract will be considered as evidence in support of the proposition that work subsequently done should not be considered to be performance of the last work for which the claim is made.[54]"

As previously stated, relief from forfeiture may be available to a claimant for late notice however each case will turn on its own facts, and in particular, the question of whether there has been any prejudice to the Surety. The onus is on the claimant to show that the forfeiture would be "inequitable"[55]. This means that it falls upon the claimant to show that the Surety has not been prejudiced by the claimant's failure to comply with the bond's notice requirements.

Relief against forfeiture will not be available if the claimant does not come to court with "clean hands". In the case of *300201 Alberta Ltd. v. Western Surety*[56] the Plaintiff, a subcontractor, failed to give notice of its claim within the time specified in the bond. The Plaintiff asked the court for relief from forfeiture. The Court found that there was evidence of a scheme between the contractor and the plaintiff subcontractor regarding the claim and accordingly denied relief.

c. One year limitation period

The standard form L&M Bond provides that no suit or action may be commenced under the bond by any claimant *"after the expiration of one (1) year following the date on which the Principal ceased work on the Contract, including work performed under the guarantees provided in the Contract."* Where a claimant fails to file its action within this time period and can not show that there was waiver or estoppel precluding the Surety from relying on the contractual one year limitation period then the claimant's action will not be allowed to proceed[57].

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[54] *Scott and Reynolds on Surety Bonds, supra* at p. 11-22
[55] *Gulf Plastics Ltd. v. Cornhill Insurance Co.*, [1990] B.C.J. No. 1541 (S.C.), affirmed [1991] B.C.J. No. 3310 (C.A.)
[56] [1989] A.J. No. 211 (C.A.)
[57] *Rental Shop, supra*

The critical question is when does time begin to run? The authorities have held that the Principal under the bond has not "ceased work on the Contract" until all of its subcontractors have ceased work on the contract[58]. The rationale behind this rule is that there are some situations were it is conceivable that the Principal's work could be finished and a full year could pass before the subcontractor's work even commenced. In such a case, a subcontractor could lose its right to claim on the bond before its work even began.

In *Controls and Equipment Ltd. v. Ramco Contractors Ltd.*[59] Ramco was the general contractor on a construction project and the defendant, CM Mechanical was a subcontractor responsible for ventilation, plumbing and heating. The Plaintiff, Controls and Equipment ("Controls"), entered into a subcontract with CM Mechanical to provide computerised controls and training. The defendant, Western Surety, issued a labour and material bond for CM Mechanical and its subcontractors. CM Mechanical went into receivership before the project was completed. Controls completed its work and then brought an action in debt against Ramco, CM Mechanical and Western Surety under the debt owing pursuant to the subcontract. This action was commenced more than one year after CM Mechanical ceased work on the project. As such, Western Surety argued that Controls was not entitled to payment from the bond as the bond required an action to be brought within one year of the day CM Mechanical ceased work on the project. Again, the Court held that CM Mechanical had not "ceased work on the project" until all of its sub-subcontractors completed their work. Accordingly Controls was found to be entitled to payment of its debts from Western Surety's bond.

F. Pay When Paid Clauses

As previously stated, a Surety's obligations under an L& M Bond are directly related to the Principal's obligations. This means that if the contractor does not owe money to its subcontractors then accordingly the Surety is not liable for any payments under the bond since the bond's terms will not be triggered.

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[58] *Canadian Glass Industries Ltd. v. A. Faustin Co.*, [1984] A.J. No. 132 (Alta. Q.B.)
[59] [1998] N.B.J. No. 119 (N.B.Q.B.), affirmed [1999] N.B.J. No. 20 (N.B.C.A.)

Some construction contracts contain a "pay when paid clause". This clause serves to provide that the Principal is not obligated to pay the subcontractor unless and until the Principal itself is paid by the owner. The operation of this clause effectively makes payment by the owner to the Principal a precondition of any payments to the subtrades. The subtrades will not be entitled to their monies until the Principal is paid out first. Additionally, the operation of this clause also serves to provide that the Surety will not be liable to the claimant under the L&M Bond since the monies are not yet "duly owed" to the claimant until the Principal has been paid.

The wording of the "pay when paid" clause must be clear and each case will depend on how the clause is specifically set out[60]. In order for the clause to be operative (ie. actually shield the contractor from having to pay the subtrades), it must clearly specify the condition governing the contractor's legal entitlement to payment and not merely the time of payment[61]. As a result of the clause, the subcontractor clearly assumes the risk of non-payment by the owner to the general contractor[62].

G. Subrogation and Assignment of Funds

Upon payment of a claim on a L&M Bond the Surety is subrogated to the claimant's right to recover. As such, the Surety normally requires a claimant to execute a document confirming these subrogation rights and then stands in the shoes of the claimant as a lien claimant to the holdback fund. Even in the absence of such a document, there is a common law right of subrogation pursuant to the general law of suretyship.

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[60] for a discussion on "clarity" see *Harris Steel Ltd. (c.o.b. Harris Rebar) v. Seaboard Surety Co. of Canada*, [2003] O.J. No. 1739 (Ont. Sup. Ct.)
[61] *Timbro Developments Ltd. v. Grimsby Diesel Motors Inc.* (1988), 32 C.L.R. 32 (0nt. C.A.), leave to appeal refused [1988] S.C.C. No. 281, *R&G Masonry Ltd. v. Maxim Construction Inc.*, [1997] P.E.I.J. No. 111 (P.E.I.S.C.) and *Arnoldin Construction & Forms Ltd. v. Alta Surety Co.*, [1994] N.S.J. No. 145 (N.S.S.C.), reversed [1995] N.S.J. No. 43 (N.S.C.A.) where the Court of Appeal found the language was not clear enough – Hallett J.A. at para. 28 – "An intention so important cannot be buried in obscure language that would not alert the subcontractor that payment for the subcontract work was conditional on the owner paying the contractor." See also *Builders Supplies Ltd. II v. 1489683 Ontario Ltd.*, [2005] O.J. No. 3470 where it was held that an oral representation supposedly made to the subcontractor did not qualify as a "pay when paid" clause.
[62] *Timbro Developments, supra* at p. 33

8. CONSTRUCTION LIEN BONDS

Construction Contracts for large projects generally require that the general contractor remove any liens for unpaid work that are registered against title to the owner's property. The Construction Lien Bond therefore is intended to stand in the place of the owner's property under the *Builders Lien Act*[63] and serves as security to clear liens against the title of the build site property filed by unpaid workers (usually being various subcontractors).

A. Definition

A Construction Lien Bond is essentially a guarantee by the Surety (and the Principal) to the Court that if a lien claimant is judged to have a valid lien claim subject to the *Builders Lien Act* and if the Principal fails to make payment on that claim, the Surety will make the required payment, up to the penalty or the maximum amount stated in the Construction Lien Bond.

B. Using a Construction Lien Bond

A Construction Lien Bond serves as security to clear liens against the title of the build site property. This is generally accomplished by issuing and posting with the court (pursuant to s. 24 of the *Builders Lien Act*) alternative security by way of a Construction Lien Bond in an amount equal to the size of the lien plus an allowance for costs. Once the Construction Lien Bond has been posted with the Court, the liens can be vacated from the title to the owner's property.

As a practice note to contractors posting Construction Lien Bonds to vacate liens, the Courts require that it be shown that such alternative security is adequate and reliable based on a lien claimant's entitlement to be adequately secured. As such, contractors should include recent financial evidence about the Surety in their supporting s. 24 application documents to show that the Surety is solvent as well as the extent to which the Surety has the required financial assets to support the bond.

[63] SBC 1997, c. 45

Currently there is no prescribed or set form of Construction Lien Bond in British Columbia. Accordingly, contractors should seek legal advice on the form and contents of such a bond before submitting the bond to Court.

Construction Lien Bonds can also be used as a form of security between all parties to the lien where there is a mutual agreement to do so. In such a case, the parties agree to post the bond with a lawyer instead of making a s. 24 application. The fact that the Principal and Surety are jointly and severally bound to the named lawyer, in trust, rather than the Court Registry must be clearly stated in the bond. Additionally, the terms of the agreement between the parties must be clear and should provide that:

> "(1) the security is posted in lieu of a payment into court under s. 24 of the Builders Lien Act;
>
> (2) the lien bond stands in the place of the lands as security for the lien claim;
>
> (3) the posting does not add to or detract from any substantive rights of the lien claimants, the owner, or the person posting the security; and
>
> (4) the lien bond will be held in trust until further agreement of all parties or court order.[64]"

9. CONCLUSION

Bonds are now widely used in the construction industry based on their benefits to owners, contractors, subcontractors and material suppliers.

In summary some of the primary benefits of bonding are as follows:

(a) bonds provide comfort to an owner that:

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[64] The Continuing Legal Education Society of British Columbia, *British Columbia Builders Liens Practice Manual*, (Vancouver: CLE Society of BC, 1999) at sec. 11.17

(i) the contract bidder will perform the work for the amount of the bid, notwithstanding the financial strengths of the contractor;

(ii) the work will in fact be completed;

(iii) the subtrades will be paid notwithstanding financial problems of the contractor; and

(iv) unpaid lien claims will be resolved and promptly removed from the owner's title;

(b) bonds provide comfort to material suppliers and subcontractors that their accounts will be paid and thereby permit such parties to supply work, material and services on credit;

(c) bonds provide comfort to general contractors that subcontractors will perform their work in accordance with the terms of the subcontract and that their subcontractors accounts will be paid; and

(d) bonds also assist the general contractor in convincing the owner that it has the financial where-with-all to complete the work under the Construction Contract.

Above all else remember that bonds are documents which contain legal rights and obligations. When dealing with bonds, proper legal advice should be sought in order to reduce or eliminate the risk of liability.

Hannelie Stockenstrom

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T. 604.643.3145 / hgs@cwilson.com

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