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Construction Bonds Guide

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Construction Bonds Guide

I. INTRODUCTION

This guide explains and provides practical advice on bid bonds, performance bonds, labour & material bonds, and construction lien bonds – collectively referred to in this guide as construction bonds.

Understanding the general concepts and principles common to all construction bonds is useful when dealing with any particular type. For that reason, this guide begins by explaining basic construction bond principles followed by a brief description of the basic bond types. Each type is then covered separately with an explanation of its function and advice on its use.

II. CONSTRUCTION BOND BASICS

A. What Bonds Are and Are Not

A construction bond is a written agreement in which one party (the surety) guarantees that a second party (the principal) will fulfil its obligations to a third party (the obligee). If the principal defaults on its obligations, the surety must complete them or pay the completion costs to the obligee. In exchange for guaranteeing the principal's performance, the surety charges the principal a fee called a premium. To ensure the principal "has some skin in the game" and to give the surety some hope of recovering any sum paid out on the bond, the surety normally requires a variety of indemnities from the principal or its owners as a condition of issuing a bond.

Construction bonds are frequently and incorrectly assumed to be a form of construction insurance. They are, in fact, very different. The main distinctions between construction bonds and an insurance policies are:

- A construction bond is a three-party agreement between a surety, principal and obligee. An insurance policy is a two-party agreement between an insurer and an insured.

- The bond is triggered when the principal defaults on its obligation to the obligee. Unless the obligee somehow caused the default, the reason for it (e.g. principal's insolvency, abandoning the work, etc.) is usually irrelevant. In contrast, construction insurance coverage is triggered only by accidental events.

- The bond pays for pure economic loss, meaning the cost of completing the principal's obligation even if nothing is broken or destroyed. On the other hand, construction insurance excludes coverage for completing construction contract obligations. Construction liability and property insurance policies provide no coverage for fixing or finishing defective or incomplete work or materials but instead cover only resulting physical damage to other items.

- A surety that pays out on a construction bond has the right to seek recovery from the defaulting principal – the bond purchaser. In contrast, an insurer that pays out on an insurance policy has no right to recover against the insured – the policy purchaser.

B. Parties to the Bond

The principal is the party who requests the surety to issue the bond and whose obligations are guaranteed. For example, if a general contractor asks a surety to issue a bond to a project owner, the general contractor is the principal on the bond. Similarly, if a subcontractor asks a surety to issue a bond to the general contractor, the subcontractor is the principal on that bond.

The obligee is the party who requires the principal to obtain the bond and who receives the benefit of the guarantee. If the bond is obtained by a general contractor for an owner, the owner is the obligee. Likewise, if the bond is obtained by a subcontractor for a general contractor, the general contractor is the obligee.

A surety is the party who issues the bond that guarantees the obligations of the principal.

For the sake of simplicity, although the obligee need not always be an owner, these terms will be used interchangeably for the rest of this guide. For the same reason, the term "principal" will be used interchangeably with "contractor".

C. Types of Construction Bonds

As noted at the beginning of this guide, construction bonds include bid bonds, performance bonds, labour & material bonds, and construction lien bonds.

Bid bonds guarantee that, if a bidding contractor is awarded a contract in response to a tender and then refuses to enter into the contract in accordance with the terms of the tender, the surety will pay the owner the price difference between the dishonoured bid and the next lowest bid up to the penalty limit of the bond.

Performance bonds guarantee that the contractor that has entered into a construction contract will perform all of its obligations under the contract.

Labour & material payment bonds provide for payment of the bonded principal's subcontractors and material suppliers should the principal not make payments as required.

Construction lien bonds guarantee (normally to a Court) that payment will be made to the lien claimants for whom the bond is posted if they prove their builders lien claims subject to the provisions of the *Builders Lien Act*[1]. Owners post lien bonds so that construction liens can be removed from project lands without waiting for resolution of the lien claims.

D. Making a Bond Effective by Execution and Delivery

To be effective and enforceable, a bond must be signed ("executed") by all the parties, including the surety, and then delivered to the obligee. If the obligee does not receive the signed bond for any reason, the obligee has no right to claim on the bond.

This point was made in a 1996 Ontario case, *Paul D'Aoust Construction Ltd. v. Markel Insurance Co. of Canada*[2]. The bonding company had issued a surety bond to a window contractor who was required under its contract to furnish a performance bond to the owner. The contractor obtained the bond from a bonding company but 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 the owner's possession. The contractor subsequently defaulted on its construction contract obligations and the owner made a claim against the bond. Upon learning the bond had never been delivered to the owner, the bonding company refused to pay. The owner sued the bonding company but the court ruled the bond had no force and effect unless it was signed by the contractor and delivered to the owner.

E. Triggering the Bond

A construction bond is triggered when the principal defaults on the obligation guaranteed by the bond and the obligee follows the proper claim procedure.

The obligee cannot merely suspect a principal is in default of its obligations and leave it to the surety to make a determination. The obligee must make the determination and a declaration (i.e. provide notice) of default to the surety. The surety's obligations do not arise until then[3]. The obligee is not required to first exhaust other options such as suing the principal.

The law requires that the notice given the surety must be clear[4]. Beyond that, the bond usually sets out additional notice requirements. Generally, there is a requirement that the notice be in writing and delivered within a specified time following the default. How strictly those requirements are enforced depends upon whether the surety has provided the bond in exchange for premium, or whether the principal fits within the relief provisions of the *Insurance Act*.[5]

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[1] S.B.C. 1997, c. 45, s. 10.
[2] (1996), 31 C.L.R. (2d) 180 (Ont. Gen. Div.), aff'd (1999), 45 C.L.R. (2d) 65 (C.A.), aff'd [2001] 3 S.C.R. 744 (SCC).
[3] *Marigold Holdings Ltd. v. Norem Construction Ltd*. (1988), 60 Alta. L.R. (2d) 289 (Alta Q.B.).
[4] Kenneth W. Scott & R. Bruce Reynolds, *Scott and Reynolds on Surety Bond*s, looseleaf, 3rd release (Toronto: Thompson Carswell, 1994) [*Scott and Reynolds*] at 11.11(d)(ii).
[5] RSBC 1996, c. 226.

Canadian and American courts recognize a distinction between "accommodation" sureties and "compensated sureties" in determining how strictly the obligee must follow the notice requirements[6]. Accommodation sureties provide guarantees for little or no compensation for the purpose of accommodating others in the accomplishment of their plans. Courts grant accommodation sureties greater protection by allowing them to insist on strict compliance with notice requirements. Compensated sureties, usually bonding companies, provide their guarantees in exchange for premiums. Unlike the accommodation sureties, compensated sureties cannot avoid their bond obligations based on technical defences. If an obligee's notice is late or not in the proper form, the compensated surety will not escape liability unless it can show the improper notice caused the surety significant harm.

The leading case on the different treatment given to notice provisions for accommodation and compensated sureties is *Citadel Assurance v. Johns-Manville Canada Inc.*[7] In that case the Supreme Court of Canada decided that strict compliance with the notice provision of a labour & material payment bond was not required because there was no prejudice to the compensated surety. McIntyre J. said:

> *… 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.*

Even if the bond was issued by an accommodation surety, an obligee could escape the consequences of a late default notice or a notice not in the proper form if the "relief from forfeiture" provisions of the *Insurance Act* apply.[8] Section 10 of the *Act* states,

> 10. If there has been imperfect compliance with a statutory condition as to the proof of loss to be given by the insured or other matter or thing required to be done or omitted by the insured with respect to the loss, and a consequent forfeiture or avoidance of the insurance in whole or in part … and the court deems it inequitable that the insurance should be forfeited or avoided on that ground … the court may, on terms it deems just, relieve against the forfeiture …

Note that section 10 of the *Insurance Act* only applies if the Court "deems it inequitable" that the bond payment be forfeited. If the obligee has engaged in unethical conduct, the Court will not consider the forfeiture "inequitable" and will not grant relief. In the case of *300201 Alberta Ltd. v. Western Surety*[9] the plaintiff, a subcontractor under a labour & materials payment bond, failed to give notice of its claim within the time specified in the bond. The Plaintiff asked the court for relief from forfeiture. However, the court found evidence of a scheme between the principal contractor and the obligee subcontractor regarding the claim and relief was denied.

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6 *Supra* note 4 at 2.5.
7 [1983] 1 S.C.R. 513.
8 *312630 B.C. Ltd. v. Alta Surety,* [1995] 10 W.W.R. 100 (B.C. C.A.).
9 (1989), 65 Alta. L.R. (2d) 286 (C.A.).

F. Suing on the Bond

An obligee who intends to sue to enforce a bond payment must do so before the time limit specified in the bond, usually one to two years from the date payment was refused. Relief from forfeiture is not available for missing the time limit to sue.

G. Limits of Surety's Liability

The surety's liability is limited to the actual damages sustained by the obligee up to the face amount of the bond (sometimes called the bond's "penal sum"). Recovery of any damages beyond the face amount of the bond can only be claimed from the defaulting principal.

III. BID BONDS

A. Purpose and Function

Most tender documents require bidding contractors to submit bid bonds. The purpose of these bonds are to ensure that the winning bid will be honoured either by the successful bidder or the surety. This has the beneficial effect of encouraging contractors to only submit bids they can and intend to comply with.

While the bid bond's primary purpose is to ensure the winning bidder will enter into the tendered contract, the bond may also guarantee the winning contractor will provide other security specified in the tender documents, such as performance bonds and labour & material bonds. 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 for any loss.

Bid bonds should not be confused with tender deposits, although both encourage contractors to honour their bids by entering into the tendered contract. A bid bond is a guarantee provided by an outsider to the bidding process, the surety. The bidding contractor is encouraged to honour a winning bid by the indemnities it has provided to the surety. If the contractor fails to honour a winning bid, the surety will pay the owner and seek recovery from the defaulting contractor. Unlike a bid bond, a tender deposit is provided by a party to the bidding process, the contractor. The prospect of forfeiting the deposit encourages the contractor to honour a winning bid.

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, the owner and the surety must execute an agreement to any extension, or the bid bond will simply expire and become unenforceable.

B. Surety Defences to Bid Bond Claims

If an owner has no legal right to accept a particular bid from a bonded contractor, then the surety has no obligation to pay on the bond if the contractor refuses to enter into the tendered agreement. Disputes over owners' rights to accept bids often arise in cases involving tender document mistakes, bid mistakes, and non-compliant bids. A surety may use any of these to defend against payment on a bid bond.

1. Tender document mistakes

If the tender documents contain errors that significantly affect a submitted bid, the owner cannot accept the bid and, therefore, cannot claim on the bid bond if the winning bidder fails to enter into the tendered contract.[10]

2. Bid mistakes

One of the most troublesome questions in bidding and tendering law – and by extension the law concerning bid bonds – is whether an owner can accept a mistaken bid.

This simple - but incomplete - answer goes like this: If a bid contains a significant and obvious error, the owner cannot "snap up" the bid and then claim on the bond when the contractor fails to enter into the tendered contract.[11] However, if the mistake is not apparent and can only be revealed by additional information, the bidder may not withdraw and the bidder's failure to enter into the tendered contract will trigger the bid bond.[12]

There can be numerous complications in applying these deceptively simple rules to real situations. Problems include: (1) distinguishing between patent (obvious) and latent (hidden) mistakes; (2) distinguishing between mistakes that are fundamental and not fundamental to the tendered contract; and (3) determining any owner culpability for the mistake and whether it is enough to allow the bidder to withdraw.

3. Non-complaint bids

A bid may be free of errors and yet fail to comply with the tender requirements. A winning bidder having second thoughts about entering into the tendered contract, or finding itself unable to take on the tendered contract, might argue the bid cannot be accepted because it is non-compliant. The surety can raise the same argument if the owner then claims on the bid bond.

The owner might prevail if the tender documents contain a clause giving the owner discretion to accept non-compliant bids. This will allow an owner to accept a bid with immaterial (i.e. minor) defects but the extent to which such clauses may allow acceptance of material defects is still unclear. Some clarity may follow in the wake of the recent Supreme Court of Canada tendering

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[10] *Mawson Gage Associates v. R.* (1987), 13 F.T.R. 188 (F.C.T.D.).
[11] *McMaster University v. Wilchar Construction*, [1971] 3 O.R. (Ont. H.C.); *Belle River Community Arena Inc. v. W.J.C. Kaufmann Co. Ltd.* (1978), 20 O.R. (2d) 447 (Ont. S.C. [C.A.]).
[12] The Queen (Ont.) v. Ron Engineering [1981], S.C.R. 111.

law decision in *Tercon Contractors Ltd. v. British Columbia.*[13] While the case dealt with an owner's ability to rely upon a limitation of liability clause rather than a discretion clause, it could be argued the case generally strengthens an owner's right to insert in the tender documents and rely upon any clearly worded term so long as it is not used in support of highly unethical conduct.

C. Making a Bid Bond 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 his claim by commencing an action within six months of the date of the bid bond. Virtually all bid bonds establish a limitation period within which an owner must commence any action. In the unlikely event that the bid bond does not establish a limitation period, the limitation period will depend upon the limitation period established by the general law for a suit to be commenced under a contract or for pure economic loss. In British Columbia, that time limit is six years.[14]

E. Calculating the Bid Bond Payment

Unless stated otherwise in the bid bond, the surety's liability is limited to the lesser of:

(a) the penalty stated on the face of the bid bond;

(b) the difference between the dishonoured winning bid and the next lowest bid; or

(c) if there are no other bids available for acceptance, the cost of re-tendering the project, plus any difference in price between the dishonoured bid and the new winning bid, plus any cost arising from the consequent delay in completing the project.

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 might bring an action against the defaulting contractor for the difference.

[13] 2010 SCC 4.
[14] *Limitation Act*, R.S.B.C. 1996, c. 266, s. 3(5).

IV. PERFORMANCE BONDS

A. Purpose and Function

The purpose and function of a performance bond was succinctly stated in *Scott and Reynolds:*[15]

> *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.*

On the construction site, a performance bond assures the owner that tasks assigned to the bonded contractor will be completed.

B. Triggering the Performance Bond

As noted in *Scott and Reynolds*, a performance bond is triggered by the principal's default in the performance of the bonded contract. Sometimes, the contract specifies particular events as defaults. More often, default is determined simply by the principal's failure to meet a contractual obligation or by evidence that the principal will be unable to meet future obligations. Typical examples include:

- failure to meet financial obligations such as paying subcontractors and suppliers;
- insolvency;
- refusal to remedy construction deficiencies;[16] and
- failure to meet the project schedule.[17]

The case law provides that "default" refers to only those events that are of such a serious nature that the owner deems it proper to make a declaration of default and to call upon the surety to perform its obligations under the bond. However, even if an owner does not intend to claim on the performance bond for a particular default, the surety should be notified whenever significant problems with respect to the contract arise. Otherwise, a surety confronted with a future default claim might avoid payment on the ground that its ability to fix the problem has been prejudiced by the earlier problems.

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[15] *Supra* note 4 at 10.1.
[16] *Whitby Landmark Developments Inc. v. Mollenhaur Construction Ltd.* (2003), 67 O.R. (3d) 628 (Ont. C.A.) [*Whitby Landmark Developments Inc.*].
[17] *Lac La Ronge Indian Band v. Dallas Contracting Ltd.* (2001), 206 Sask. R. 13 (Sask. Q.B.) [*Lac La Ronge Indian Band*].

The surety's obligations are not triggered until the obligee has provided the surety with a declaration of default.[18] The obligee is not entitled to claim on the bond simply because a default is suspected, leaving it to the surety to investigate and make a determination.

C. Making a Performance Bond Claim

It is very important that an owner follows the right steps to properly advance a claim under a bond. The owner 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.

The Surety Association of Canada recommends that the owner provide the surety with the following documents and information at a minimum:[19]

- a complete copy of the contract between the owner and contractor with respect to the subject project;
- copies of change orders issued with respect to the contract;
- copies of all progress billings with respect to the contract;
- a summary of all payments made including the date of each payment;
- an up-to-date summary of the contract accounting between the owner and principal;
- all evidence in connection with the termination of the contract or the declaration of default confirming that it was done in accordance with the terms of the contract;
- copies of any claims for a lien or written notices of claims received;
- any other documents that would assist in establishing the validity of the claim; and
- a specific explanation as to the grounds upon which the contractor was declared to be in default.

D. Surety's Performance Bond Obligations

The surety has a duty to investigate the alleged default and is entitled to a reasonable period of time to do so plus a reasonable period to remedy any default. Before a surety can be liable for delay, it must be demonstrated there were some steps the surety could have taken at the time in question and that the obligee suffered some prejudice because of the surety's failure to act faster.

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[18] *Supra* note 3.
[19] Surety Association of Canada, *Making a Claim Under a Performance Bond*, online: Surety Association of Canada <www.surety-canada.com>.

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 the principal's indemnitors, to fully investigate the default. In conducting the investigation, it is important that the surety communicate with the principal to assess its position with respect to the default before undertaking any work or incurring any expense. If the surety completes the work or makes a payment where the principal had a legitimate defence to a claim in default, the surety will have breached its duty to the principal and its indemnitors and will have relieved them from liability to reimburse the surety for its costs.

If the investigation confirms the default and that the principal has no legitimate defence, the surety has a duty to the principal and the indemnitors to complete the work in the most cost effective way. Generally, the surety's options are to: (1) assist the principal in remedying the default; (2) make its own contract with another contractor to finish the work; (3) issue tenders on behalf of the owner and pay the owner any additional costs of the new contract; or (4) pay the owner the amount for which the surety has determined it is liable up to the penal amount of the bond. There are conflicting case decisions on whether a surety must also pay any liquidated damages owed by the defaulting principal.

The surety may assist the principal by negotiating a solution with the owner or, in limited cases, by providing the principal with needed financing. Sureties prefer not to function as a bank, and therefore, the financing option is usually employed only when a project is near completion.

Sureties do not like operating as general contractors either and so they rarely make an agreement with another contractor to finish the principal's job. Again, this option is usually taken only when a project is near completion.

If a project is far from completion, the most common option employed by a surety is to re-tender the work on behalf of the owner and pay the owner for any added cost of the new contract. Sureties prefer this option because it brings its obligations under the original performance bond to an end. Unless the surety is provided with a premium for a new performance bond, it will not guarantee the performance of the new contractor.

In exercising the re-tendering option, the surety must ensure that it exercises reasonable diligence in selecting a replacement contractor. If the original principal's performance bond has "responsible bidder" language, the obligee may reject the new winning bidder if there are good reasons to believe the new contractor cannot complete the contract. Reasons might include the new contractor's lack of financing, insufficient workforce, scheduling difficulties, or inadequate technical skills.

As noted, there are conflicting case decisions on whether – in addition to ensuring the work is completed – the surety must pay any liquidated damages arising from the principal's default. In *Whitby Landmark Developments Inc.,* the court held that the surety is liable for all of the principal's contractual obligations including liquidated damages unless there is clear language to the contrary in the bond. On the other hand, in *Lac La Ronge Indian Band,* the court held that there was no presumption that the surety was liable for liquidated damages. Given the conflicting case law, obligees outside of Saskatchewan should at least claim liquidated damages and see what happens.

E. Limitation Periods

Performance bonds generally provide that an action under the performance bond must be commenced within two 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 owner would be to make a claim on a performance bond immediately upon default by the contractor.

If there is no limitation period provided for under the performance bond, the limitation period is that established by the statutes of the various provincial jurisdictions. In British Columbia, the time limit is six years.[20]

F. Surety Defences to Performance Bond Claims

Common surety defences to performance bond claims are that: (1) the principal is not actually in default; (2) the construction contract has been materially altered since the surety issued the bond; (3) the owner has acted to the prejudice of the surety; and (4) the owner has misled the surety as to the risk it was undertaking when it issued the bond.

1. No default

Following its investigation, the surety may conclude the principal was not in default. For example, the surety's investigation might reveal:

- the particular item of uncompleted work is outside the scope of the construction contract and not covered by proper change orders or change directives;
- the owner consented to the alleged default;
- the owner improperly withheld progress draws and so the principal was justified in refusing to continue the work; or
- the contractor could not commence or finish its work because necessary precedents outside the contractor's control (e.g. drawings & specifications from the obligee's consultants, the work of other trades, materials supplied by others, etc.) were missing or incomplete.

If the owner does not agree with the surety's findings, the owner may sue the contractor, the surety, or both to prove the default and secure payment on the performance bond.

[20] *Limitation Act*, R.S.B.C. 1996, c. 266, s. 3(5).

2. Material change to contract

The surety bonds a specific contract and takes the risk that the contractor will not perform its obligations under that contract. The owner cannot increase the risk without the surety's consent and, for that reason, a change to the contract without the consent will release the surety unless the change is unsubstantial or benefits the surety.[21]

What constitutes a "material change" depends on the interpretation of the construction contract. Most construction contracts assume that there will be changes to the scope of work, and would include a "Changes in the Work" clause in the contract. An example of a material change is 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 occur where the owner has agreed to waive any delay or adjust the construction schedule.[22] The surety should be notified and its consent sought in any of these circumstances.

3. Owner's actions have prejudiced surety

Aside from agreeing to modify the construction contract, the owner may engage in other actions which prejudice the surety and free it from the obligation to pay on a performance bond. Common examples include improper payments to the contractor, delayed default notice, and fixing the default without the surety's knowledge or consent.

Payments made contrary to the payment schedule in the contract may discharge the surety. This could happen where the owner advances funds to the contractor to ease the contractor's cash flow problems and the advances are out of proportion to the work that has been completed or when the owner has paid the contractor despite deficiencies in the work. Courts have held that the owner has prejudiced the surety in such circumstances because it has less ability to persuade the contractor to complete the work.[23] However, where an owner advanced payment to the contractor, 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.

If an owner delays notifying the surety of the contractor's default and the surety suffers prejudice as a result, the surety may be relieved of its performance bond obligations. This happened in *Whitby Landmark Developments Inc.,* where the contractor became insolvent at the time of substantial completion of the project but owed construction cost savings to the owner. The failure to repay the costs savings was a default under the performance bond but, by the time the owner declared default and notified the surety, the contractor's remaining assets had been dissipated, depriving the surety the opportunity to recover any bond payout. The surety refused to pay on the bond and the owner sued. The trial judge ruled the owner had breached its

[21] *Truro (Town) v. McCulloch*, [1974] S.C.R. 1129, (*sub nom. Truro (Town) v. Toronto General Insurance Co.*); *Five-Fifty Beatty Street Ltd. Partnership v. Markwood Construction Ltd*. (1987), 17 B.C.L.R. (2d) 72 (B.C.S.C.), aff'd (1989), 33 C.L.R. 231 (B.C.C.A.).
[22] *St. John's Metropolitan Area Board v. William J. Vokey & Sons Ltd*. (1988), 30 C.L.R. 75 (Nfld. S.C.T.D.), aff'd (1991), 44 C.L.R. 243, (*sub nom*. *St. John's Metropolitan Area Board v. Vokey (William J.) & sons Ltd.*).
[23] *Mulgrave (Town) v. Simcoe & Erie General Insurance Co*. (1977), 73 D.L.R. (3d) 272 (N.S.S.C. [Appeal Division]).

obligation to promptly report the default, the surety had been prejudiced, and as a result the surety had no obligation to pay on the bond. The Ontario Court of Appeal upheld the ruling.

The surety may also be discharged from its obligations if an owner elects to remedy the principal's default without the surety's knowledge and consent and then claims on the performance bond for the cost. In these circumstances, the owner's actions interfere with the surety's ability to select the most cost effective remedy for the default.

4. Misrepresentation

If, before the performance bond is issued, the owner makes any material misrepresentation (or withholds information that should be disclosed) that misleads the surety as to the risk it is undertaking and the surety is prejudiced as a result, the surety may be entitled to refuse payment on the bond.[24]

V. LABOUR & MATERIAL PAYMENT BONDS

A. Purpose and Function

A labour & material payment bond provides security for the principal's subcontractors and suppliers in the event the principal fails to pay them. Because the bond provides the subcontractors and suppliers with a convenient alternative to filing liens, it is less likely liens will be filed and pursued. That being said, an unpaid supplier or contractor can simultaneously pursue payment under a lien and the bond.[25] Therefore, while labour & material bonds do not guarantee a project will remain lien free, these bonds reduce the odds of lien claims.

The principal's obligation to pay its subcontractors and suppliers is a typical requirement of the principal's construction contract. Thus, the reader may legitimately ask why a performance bond cannot perform the function of a labour & material bond. That is, if the principal defaults on the construction contract by failing to pay its subcontractors and suppliers, why cannot the obligee owner claim on the performance bond to pay these debts? While there are some conflicting court decisions on whether a performance bond can function as a labour & material payment bond, *Scott & Reynolds* make a convincing distinction between the two bond types:

> *The underlying* [construction] *contract may contain a contractual commitment that the principal pay its labour and material suppliers. If the principal defaults and there is only a Performance Bond, then the surety is not liable for the failure of the principal to comply with such a clause. The reason is that the obligee has an obligation as against the surety to mitigate its damages and is not entitled to specific performance of the underlying contract, and save for its obligation under the applicable lien legislation to pay the appropriate holdback, the obligee has no liability to labour and material suppliers. Were it to pay such suppliers such*

[24] *Doe v. Canadian Surety Co.*, [1937] S.C.R. 1.
[25] *Dominion Dewatering Ltd. v. Guarantee Co. of North America* (1987) Fedak L.J.S.C. (Ont. S.C.) [unreported].

> *payment is gratuitous and not recoverable under the surety bond. As well, to allow recovery would turn a performance bond into a labour and material payment bond. If the obligee wants a labour and material payment bond it is able to specify that requirement as part of the tender call and the cost will be part of the construction price.*[26]

Labour & material bonds are more often required in the public sector, but their use is increasing in the private sphere. The form of the labour & material bond will depend on the specific requirements of the owner. As with performance bonds, the wording of these bonds may vary and so it is important to obtain a copy of the bond in question and carefully read its provisions to determine the liability of the surety.

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

To claim under a labour & material payment bond, the claimant must:

- have a direct contract with the principal (i.e. no subcontractors);
- for labour or material or both; and
- which is used or reasonably required for use in the performance of performance of the contract between the principal and the obligee.[27]

With most other bonds, the potential claimant is the obligee who is a party to the bond. Labour & material payment bonds differ in that the potential claimants, the principal's subtrades and/or material suppliers, are not parties to the bond. Instead, this form of bond refers to the contract between the principal and the obligee but is designed to ensure payment by the principal of the accounts of the subtrades and material suppliers on the contract.

As a general rule, people who are not parties to a bond cannot enforce it. To get around this problem, the standard wording of labour & material payment bonds makes the obligee owner the trustee, on behalf of the claimants, of the rights against the surety and permits the claimants to sue on the bond in the name of the owner as trustee.

C. Triggering the Bond

If the bonded principal fails to pay the accounts of its subcontractors and suppliers when due, the surety's obligation arises.

If the subcontract between the principal and the claimant subcontractor or supplier contains a clause which provides that the principal is not obligated to pay the subcontractor unless and until the principal itself is paid (commonly known as "pay when paid" clauses), the labour and

[26] *Supra* note 4 at 7.5.
[27] *Campbell Comeau Engineering Ltd. v. Alta. Surety Co.* (1996), 30 C.L.R. (2d) 116 (N.S.S.C.).

material bond surety will not be liable to the claimant if the circumstances are such that the "pay when paid" clause is operative.

D. Making a Claim

Typical labour & material bonds require that notice of a claim be given within a specified period - usually 120 days - after payment is due or some other defined event in the construction process. Also, if the surety neglects or refuses payment, the claimant must commence an action within a stipulated time - usually one year - after the claimant's work is completed, the claimant's materials are last supplied, or the principal ceased work.

Determining when the time period commencers for giving notice or commending action is not always a straightforward exercise. Courts have had to consider whether a principal is considered to have "ceased work" on a project if its subtrades are still working, and whether the time limit for suing on the bond has ever begun to run if the principal never finishes its work or its work is never certified complete.

In the 1998 New Brunswick case of *Controls and Equipment Ltd. v. RAMCO*,[28] the court examined the meaning of "ceased work". RAMCO was the general contractor on a construction project and CM Mechanical was a subcontractor responsible for ventilation, plumbing and heating. Controls subcontracted to CM Mechanical to provide computerized controls and training. A surety issued a labour and material bond naming CM Mechanical as principal and RAMCO as obligee. CM Mechanical went into receivership before the project was completed but Controls carried on and completed its work. More than one year after CM Mechanical ceased work, Controls brought an action in debt against RAMCO, CM Mechanical and the surety for the debt owing on the subcontract. The surety argued that Controls was out of time to sue on the bond because the time limit was one year from the day CM Mechanical ceased work. The New Brunswick Court of Queen's Bench decided, and the New Brunswick Court of Appeal agreed, that CM Mechanical did not truly "cease work" on the project until all of its sub-subcontractors completed their work. Controls had sued within one year of completing its subcontract work and so was within time and entitled to payment of its debts from the surety's bond.

The Nova Scotia Supreme Court went further in *Lunenburg Home for Special Care Corp. v. Duckworth*[29], ruling that the time limit for suing on a labour and materials payment bond had never commenced as the principal contractor never finished its work due to its default.

The Surety Association of Canada recommends that claimants provide the surety with the following documents and information at a minimum:[30]

- a complete copy of the contract with the principal;

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[28] (1998), 200 N.B.R. (2d) 280 (N.B.Q.B.), aff'd [1999] N.B.J. No. 20 (N.B.C.A.).
[29] (1973), 33 D.L.R. (3d) 711 (N.S. S.C.).
[30] Surety Association of Canada, *Making a Claim Under a Labour and Material Payment Bond*, online: Surety Association of Canada <www.surety-canada.com>.

- copies of all change orders issued with respect to the contract;
- copies of all invoices and/or progress billings submitted to the principal;
- copies of all statements of accounts rendered to the principal;
- a summary of all payments made including the date of each payment;
- evidence of the last date upon which the labour and/or material was supplied to the project (i.e. delivery slips, time sheets, etc.);
- evidence and documentation supporting other amounts claimed which have not been agreed to or authorized in writing under the contract or within a change order;
- a copy of any claim for lien;
- a Workers Compensation Board clearance letter (current), if applicable; and
- a statutory declaration with respect to the claimant's own subcontractors and suppliers.

As with other construction bonds, the surety is only liable for the limit on the bond.

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 a labour & material payment bond this practice could make it difficult for the contractor to prove that payment had been made for the contract covered by the bond. For this reason, 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.

E. Subrogation and Assignment of Funds

Upon payment of a claim, the surety on a Labour and Material Bond is subrogated to the claimant's right to recover. 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.

VI. CONSTRUCTION LIEN BONDS

A. Purpose and Function

Construction contracts for larger projects generally require that the general contractor remove any liens that are registered against title to the owner's property. In practice, this is generally accomplished by issuing and posting with the court 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. The construction lien bond then stands as security for the lien.

A lien bond deposited with the court is available for payment of the vacated liens regardless of whether the owner has paid holdback monies into court.[31] If the bonded principal does not defend the lien claims, the court may allow the surety to intervene and defend.

VII. CONCLUSION

Bonds are effective tools for ensuring that tender bids and construction contracts are honoured. However, like any tool, getting the most out if a bond requires an understanding of how it works, proper maintenance, and proper use.

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[31] *Northern Air Construction Ltd. v. York (Borough) Public Library Board* (1985), 50 O.R. (2d) 201 (Ont. S.C. [Divisional Court]) (*sub nom. Northern Air Construction Ltd. v. Canadian Great Lakes Casualty & Surety Co*.).