

## Construction Bonds: What Every Contractor and Owner Should Know

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### INTRODUCTION

Construction projects typically involve multiple contractors with inter-dependent schedules and activities. When one contractor experiences difficulties performing its portion of the work, this may have a significant ripple effect on the entire project. Ultimately, a contractor's default may jeopardize timely completion of the work and significantly increase the cost to complete the project. Alternatively, an owner may hire only one contractor. However, if this contractor defaults in its obligations to perform the work, this could also significantly delay completion of the work and increase the cost of the project. When an owner or general contractor considers the risk of a defaulting contractor unacceptable, it usually will attempt to minimize this risk through the use of construction bonding.

Construction bonding is a method of redistributing the risks associated with construction projects. These bonds generally consist of a three party, or tripartite, agreement between a surety, a principal, and an entity that will benefit from the issuance of the bond.<sup>1</sup> The surety typically issues a bond for a premium related to the value of the bond. The ultimate benefit of the bond is that, if the principal defaults in its obligations tied to the bond, those entitled to benefit from the bond may require the surety to assist with remedying the default. In this respect, the risk associated with the potential default of a contractor, or other project risks, may be significantly reduced by transferring the immediate financial burden of these events to the surety.

This article will provide a general summary of the most common bond instruments encountered in construction projects. These include:

1. Bid Bonds and Consents of surety;
2. Performance bonds;
3. Labour and material bonds; and
4. Lien bonds.

In addition, some comments are provided with respect to contractor default insurance, an increasingly common alternative to conventional construction bonding.

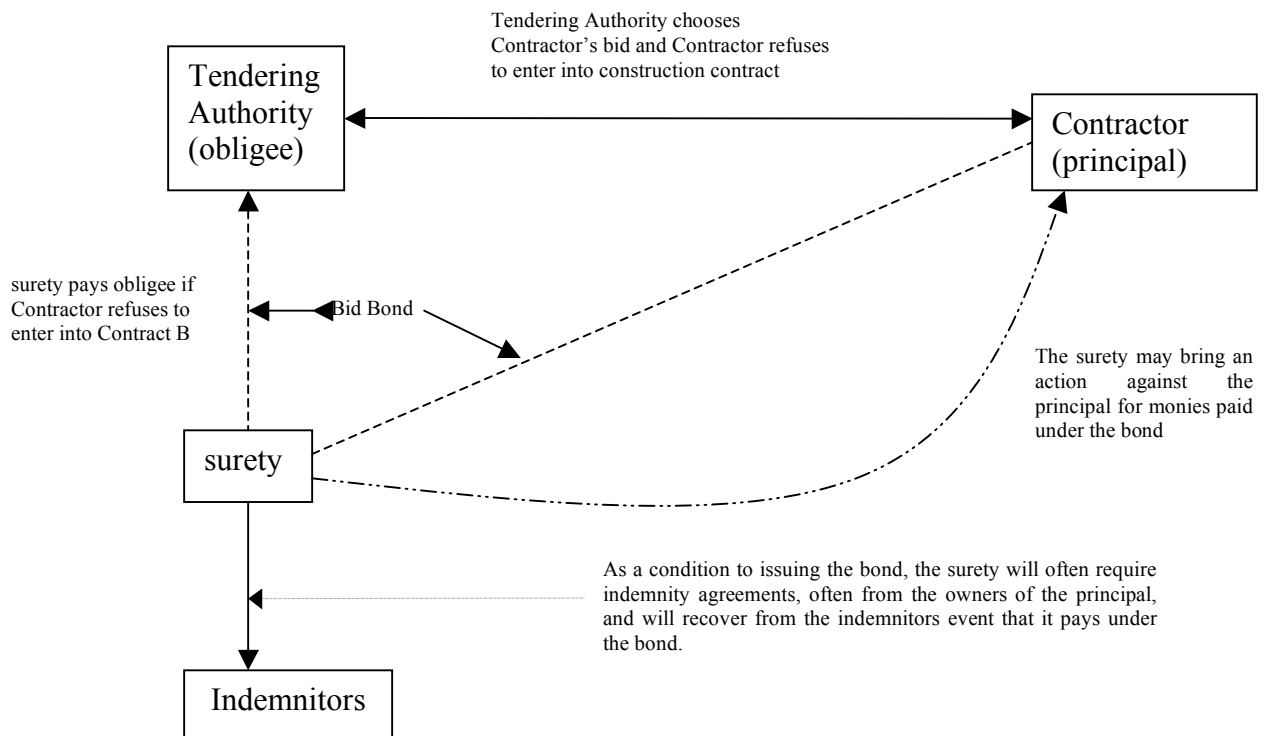
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<sup>1</sup> Westersund, Lowell & Cotton, Barbara "Construction Bonds" (1993) 8 C.L.R. (2d) 109.

However, prior to discussing specific topics relating to these bonding instruments, a comment relevant to all forms of construction bonds is warranted. Specifically, the importance of carefully reading the language used in a particular construction bond cannot be overstated. Although standard form bond forms are almost always used, and referred to in this article, an owner or contractor should always review the language used the bonding instrument to assess the application of the bond. Minor variations in the language could significantly affect the availability of a claim under the bond.

### BID BONDS AND CONSENTS OF SURETY

A Bid Bond acts as a form of security to ensure that the contractor chosen by a tendering authority will enter into the construction contract with the owner. If the chosen contractor refuses to enter into a construction contract with the tendering authority, the tendering authority may seek compensation under the bond for the difference between the tender price of the defaulting contractor and the amount for which the tendering authority contracts with another person, up to the face value of the bid bond. This tri-part arrangement is shown below.



The Canadian Construction Documents Committee standard form bid bond is a common form used in Canada. This bid bond, CCDC 220-2002, describes the surety's obligation as follows:

The condition of this obligation is such that if the principal shall have the bid accepted within the time period described in the obligee's bid documents or, if no time period is specified in the obligee's bid documents, within \_\_\_\_ ( ) days from the closing date as specified in the obligee's bid documents, and the principal enters into a formal contract and gives the specified security, then this obligation shall be void; otherwise, provided that the obligee takes all reasonable steps to mitigate the amount of such excess costs, then the principal and the surety will pay the obligee the difference in money between the amount of the bid of the principal and the amount for which the obligee legally contracts with another party to perform the work if the latter amount be in excess of the former.<sup>2</sup>

The tendering process in Canada is governed by the seminal decision of *Ron Engineering & Construction (Eastern) Ltd. v. Ontario* [1981] 1 S.C.R. 111, a decision which involved a dispute over the return of a bid bond. *Ron Engineering* was summarized by Madam Justice Ballance of the Supreme Court of British Columbia in *Stanco Projects Ltd. v. HMTQ*<sup>3</sup> as follows:

[79] In *Ron Engineering*, the contractor, Ron Engineering, was the low tenderer on a general construction contract. The contractor discovered immediately after the tenders were opened that it had mistakenly neglected to include a significant component of \$750,058 in its bid. The error was invisible in the sense that it was not apparent on the face of the bid documents. Ron Engineering notified the owner of its mistake. The owner would not allow Ron Engineering to revoke its tender and forwarded it a construction contract for signature. Not surprisingly, Ron Engineering refused to sign the contract and demanded the return of its \$150,000 bid deposit. The owner entered into a construction contract with the next lowest bidder and refused to return Ron Engineering's bid bond. Ron Engineering claimed that because it had notified the owner about the mistake before the tender had been accepted, the tender was incapable of acceptance and, accordingly, it was entitled to the return of its bid bond. Until the decision in *Ron Engineering*, a contractor finding itself in such circumstances would have generally been permitted to withdraw its tender without forfeiture of its bid bond at any time before communication of the owner's acceptance. *Ron Engineering* changed all that.

[80] Justice Estey, writing for the Court, described the tendering process as consisting of the formation of two separate contracts: Contract A and Contract B. Contract A governs the manner in which the tender process is to be conducted. Contract B is the substantive construction contract to perform the work that has been bid. According to Justice Estey's analysis, an owner's invitation to tender

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<sup>2</sup> As reproduced in Scott, Kenneth, & Reynolds, Bruce *Scott & Reynolds on Surety Bonds*, loose-leaf (Toronto: Thompson Carswell, 2005) at 9-2.1

<sup>3</sup> *Stanco Projects Ltd. v. HMTQ* 2004 BCSC 1038

amounted to an offer to enter into Contract A. At the moment the tenderer submitted its bid, the owner's offer has been accepted triggering the formation of Contract A.

[81] Once the tenderer submitted its bid, the existence of and obligations under Contract A crystallized, and the tenderer became contractually bound to enter into the construction contract, Contract B, if the owner accepted its tender. Contract A comes to an end when: a tendering authority enters into the construction contract with one of the bidders; the tendering authority rejects all of the bids; or when the irrevocability period of the tenders (if applicable) expires.

Since *Ron Engineering*, tendering authorities have relied on the terms of the Contract A to require their chosen bidder to enter into the construction contract (Contract B). Because the tendering authority can rely on the framework provided by Contract A, this begs the question: How does the tendering authority benefit from the requirement of a bid bond? The answer lies in the tendering authority's ability to recover directly from the surety, up to the full amount of the bid bond, the difference between the tender price of its chosen tenderer and the amount for which the tendering authority ultimately contracts with another party.

When the tendering authority notifies the surety of the principal's failure to enter into Contract B, the surety may raise any defence that is open to the principal.<sup>4</sup> Accordingly, it may appear, at first glance, that the tendering authority gains little by requiring a bid bond as part of its tender process and by attempting to recover funds from the surety. However, a court action involving a breach of Contract A may take months or years to work itself through the court system. Without any security, a tendering authority that successfully brings an action against a contractor for breach of Contract A could face a judgment proof plaintiff at the end of the trial. The bid bond provides security to ensure this does not occur.

Of course, tendering authorities often provide the contractor with the option of providing bid security in the form of cash or letters of credit. The authors of *Scott and Reynolds on Surety Bonds* suggest that there may be a distinction between a tendering authority's rights to a cash deposit and the tendering authority's right to claim under a bid bond. However, the authors further note that there is no logical reason for this distinction and that the issue has not been addressed in Canadian jurisprudence.<sup>5</sup> Accordingly, subject to the particular wording of a bid bond that creates a distinction, owners and contractors are likely safe in the assumption that their legal rights do not turn on whether the bid security is provided by way of a bid bond or by another form of security. Nevertheless, a prudent tendering authority should review the language of the bid bond to ensure that it receives the security set out in its tender documents.

A consent of surety is another instrument utilized during the tender process. The consent of surety is a representation from a surety that, if the tenderer is successful and is awarded the construction contract, the surety will issue performance or labour and material bonds required pursuant to the construction contract. This avoids potential difficulties that may arise where a successful tenderer discovers that it is unable to obtain the bonding required by the contract and the owner is faced

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<sup>4</sup> *Newfoundland (A.G.) v. Guarantee Co. of North America* (1987) 23 C.L.R. 293.

<sup>5</sup> *Scott, supra* at 9-12.

with considering alternative or lesser levels of security or with the sometimes difficult task of awarding the construction contract to another bidder.

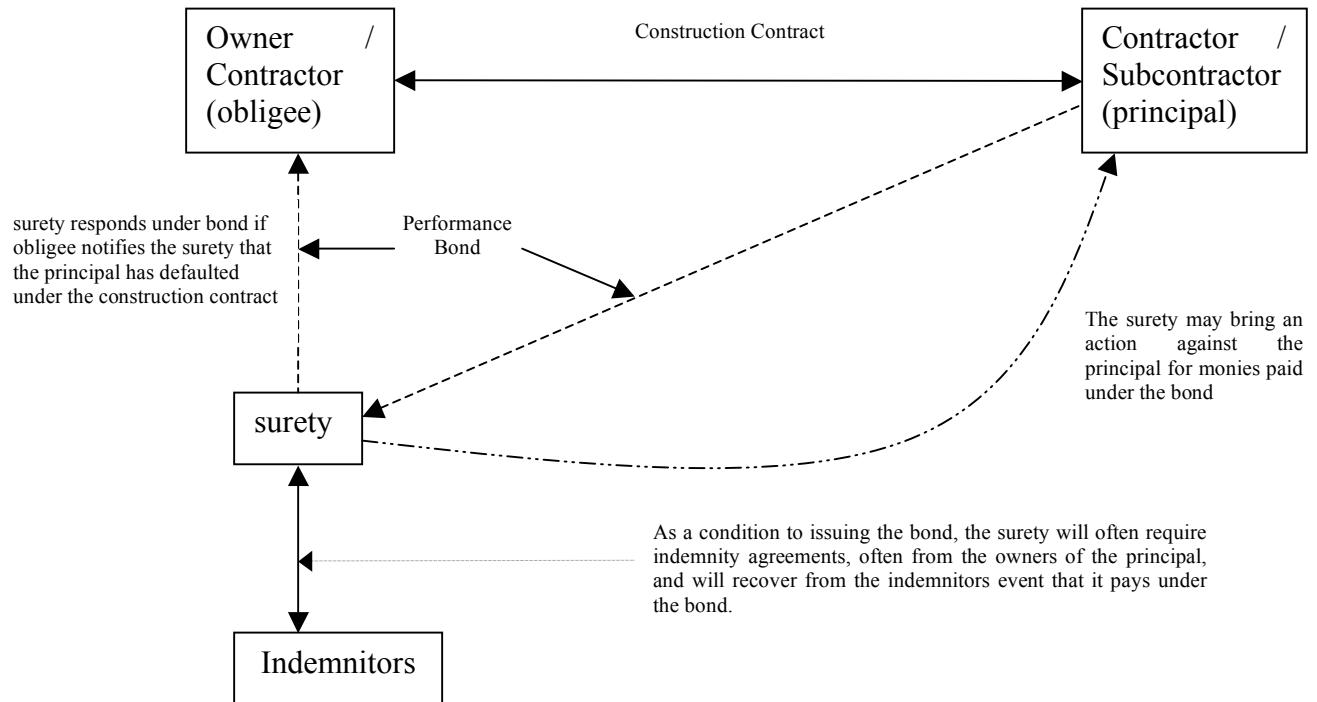
## **PERFORMANCE BONDS**

### **(a) General**

A performance bond is a tripartite agreement between:

- (i) a surety;
- (ii) a contractor (the principal); and
- (iii) the owner or contractor who has a construction contract with the principal (the obligee).

This arrangement is shown in schematic form on the following page.



The standard form CCDC performance bond is representative of a typical performance bond issued in Canada. This bond binds the surety to the obligee in the amount of the bond value. This obligation is extinguished upon the completion by the principal of its obligations under the construction contract. If the obligee declares the principal in default of its obligations pursuant to the construction contract, the surety may be called upon to fulfill its obligations under the bond.

The respective rights and obligations of the surety, the obligee, and the principal according to a standard performance bond are complex and are beyond the scope of this paper. Nevertheless, to ensure that its rights are protected, all contractors and owners should as a minimum understand:

1. The contractual default required to trigger the surety's obligations;
2. Notice requirements;
3. The significance of terminating the construction contract;
4. The surety's obligations on default and proper notice; and

## 5. What a performance bond will cover.

These matters are discussed briefly below.

### (b) Default

Quite often, an obligee will notify a surety that the principal is in default upon the insolvency of the principal. Similarly, construction contracts in Canada typically contain provisions identifying other circumstances in which the parties clearly considered the contract in default. In these circumstances, whether the principal is in default is usually clear.

However, there are circumstances where it is not immediately clear whether or not the principal has defaulted on its obligations in a manner that will trigger the surety's obligations under the bond. For example, it has been held that construction deficiencies typically encountered in a construction contract do not constitute a default triggering a surety's obligations in the performance bond. However, if the contractor refuses to accept the existence of the deficiencies and remedy same in accordance with the contract, this may comprise a default for the purpose of a performance bond.<sup>6</sup> On the other hand, in *Whitby Landmark Developments Inc. v. Mollenhauer Construction Ltd.*<sup>7</sup>, a decision that will be discussed in greater detail below, the Court concluded that a contractor's failure to provide a cost summary to allow distribution of contract savings between the owner and contractor was a default for the purpose of the performance bond. Similarly, in *Lac La Ronge Indian Band v. Dallas Contracting Ltd.*,<sup>8</sup> also discussed in greater detail below, a contractor's failure to perform the work in order to meet a contractual completion date was a default triggering the performance bond.

In circumstances where the alleged default is not expressly described in the contract and where the contractor has not clearly abandoned its obligations under the contract, owners and contractors are well advised to seek legal advice in respect of whether a surety may be called upon to perform its obligations under a performance bond. This advice may be sought prior to engaging the surety, or, alternatively, during or following the surety's own assessment of whether the contractor is in default.

Finally, an obligee under a performance bond should be aware that it is the obligee's responsibility to determine when a contractor's default is sufficiently material to warrant putting the surety on notice of default. An obligee cannot fulfill its notice obligations by suggesting that the principal may be in default and by requesting the surety to assess the situation. Rather, the obligee must determine that the default is material and provide notice to the surety as set out below.

### (c) Notice

Once the obligee determines that the contractor is in default, it must notify the surety of same. While there are no magic words that the obligee must include in the notice, the obligee should

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<sup>6</sup> Scott, *supra* at 10-12.1 citing *Oval (717) Ltd. v. Aegon Insurance Co. (UK) Ltd.* (1997) 54 CON.L.R.74.

<sup>7</sup> *Whitby Landmark Developments Inc. v. Mollenhauer Construction Ltd.* [2000] O.J. No. 3838.

<sup>8</sup> *Lac La Ronge Indian Band v. Dallas Contracting Ltd.* [2004] S.J. No. 531.

ensure that the notice is clear, direct, and unequivocal. In the absence of this clear notice, a surety's obligations may not arise.<sup>9</sup>

However, the Supreme Court of Canada has distinguished between sureties that provide the guarantees of a bond without significant compensation (identified as accommodation sureties), and those, like the sureties that provide construction bonding, that provide the bond for a sufficient fee (identified as compensated sureties). With respect to the latter, the Supreme Court of Canada has held that a surety may not avoid its obligations on the basis of a purely technical defence with respect to a defect in the notice where that defect causes no prejudice to the surety.<sup>10</sup>

One circumstance where an obligee may put itself at risk of losing its rights under a performance bond, when it fails to provide proper notice to the surety, is where it takes steps subsequent to the contractor's default that prejudiced the surety. As will be discussed in greater detail below, a surety may choose between a number of options when the principal defaults. If an obligee takes steps to remedy the default or otherwise materially changes the surety's obligations, including where the obligee substantially delays provision of notice to the surety, this may relieve the surety of its obligations.<sup>11</sup> Accordingly, an obligee should carefully consider the timing of its notice to the surety and take care in taking any steps to remedy a contractor's default absent involvement from the surety.

#### (d) Terminating the Contract

Most standard form construction contracts in Canada, such as the CCDC-2 Stipulated Price Contract, entitle an owner upon a material default on the part of the contractor to:

- (i) Perform the work;
- (ii) Stop the work; or
- (iii) Terminate the contract.<sup>12</sup>

The effect of an owner's decision to choose one of these options over the others has a significant impact on the enforceability of most performance bonds. Specifically, a surety's liability is, at most, coextensive with the principal's obligations under the construction contract. If an owner chooses to terminate a construction contract, the contractor's obligations under the contract are also

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<sup>9</sup> Scott, *supra* at 10-10

<sup>10</sup> *Citadel General Assurance Co. v. Johns-Manville Canada Inc.* [1983] 1 S.C.R. 513 (this decision was with respect to a labour and material bond. However, the distinction between accommodation and compensated sureties would apply equally to other forms of bonds.)

<sup>11</sup> *Whitby Landmark Developments, supra.* See also *T.S. Manufacturing Co. v. Juniper Lumber Co.* (2000) 2 C.L.R. (3d) 279 (N.B.Q.B.)

<sup>12</sup> Canadian Construction Documents Committee, CCDC-2 (1994) Stipulated Price Contract at General Condition, Part 7



terminated.<sup>13</sup> Because the contractor has no contractual obligations, the surety will likewise have no obligations pursuant to the performance bond.

Accordingly, when an obligee is faced with a defaulting contractor, and if this obligee intends to rely upon a performance bond, the terms of the construction bond should be reviewed carefully to ensure that termination of the contract does not relieve the surety. Moreover, if the obligee has any doubts, it should either: (1) seek legal advice; or (2) exercise its rights to either stop the work or perform the work rather than its right to terminate the contract.

(e) The surety's obligations upon default and proper notice

Once the principal has defaulted under the construction contract and the obligee has notified the surety in clear, direct, and unequivocal terms of the principal's default and the obligee's intention to make a claim under the performance bond, the surety must investigate the claim and, if the principal has defaulted, the surety must act in accordance with the terms of the bond. This typically requires the surety to fulfill one of the following obligations:

- (i) Remedy the principal's default;
- (ii) Complete the contract; or
- (iii) Issue tenders to identify a contractor who will complete the contract.

In addition to these three options, the CCDC Performance Bond Form 221-2002 also enables the surety to pay the obligee the lesser of the bond amount and the obligee's proposed cost of completion less the balance of the contract price.

When a surety chooses to remedy the default, it may provide financing to a contractor experiencing financial difficulties or it may attempt to reconcile a dispute between the obligee and the contractor. In practice, a surety rarely chooses this option.<sup>14</sup>

Because sureties are not in the business of construction, when a surety elects the second option above, completing the contract, the surety will often subcontract the work to another entity. This may include the defaulting principal, some of its employees or subcontractors, or a completely different entity. Where the surety engages the defaulting principal to complete the contract, the surety effectively becomes a buffer between the obligee and the principal.<sup>15</sup>

To ensure that it is not exposed to any liability beyond the value of the bond, a surety choosing the second option will generally require the obligee to confirm that the surety will not be liable beyond

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<sup>13</sup> Albeit the contractor could be liable for damages associated with the termination of the contract.

<sup>14</sup> Scott, *supra* at 10-10. See also Westersund, *supra*.

<sup>15</sup> Westersund, *supra*.

the value of the bond and, when it subcontracts the work, ensure that the subcontracts are assignable to the obligee if the cost of the work reaches the bond value.<sup>16</sup>

The third option is most often selected.<sup>17</sup> When this occurs, the performance bond will generally not respond if the replacement contractor defaults on its contract. Accordingly, an obligee should consider obtaining either a performance bond from this replacement contractor or confirmation from the responding surety that the existing performance bond will respond in the event that the replacement contractor defaults.

A surety's duty to promptly respond to a notice of default was recently addressed in *Lac La Ronge Indian Band v. Dallas Contracting Ltd.*,<sup>18</sup> a case which is typical of the sort of disputes that may arise between a surety and an obligee. *Lac La Ronge* involved the construction of a sewage lagoon. The Lac La Ronge Indian Band entered into a construction contract with Dallas Contracting Ltd. for the construction of the lagoon. Construction did not proceed very well. The progress of the work was slow, there were concerns regarding quality control, and Dallas Contracting ignored directions engineers involved with the project. As the contractual completion date neared, it became increasingly apparent that Dallas Contracting would not complete the work in accordance with the contract. On October 29, 1996, the Band notified the surety that Dallas Contracting was in default.

The trial judge made a number of findings of fact regarding the surety's response to this notice of default. These findings of fact were summarized by the Court of Appeal as follows:

[45] Next, the trial judge made these findings regarding promptness:

1. "[U]ntil the Band made an invitational tender respecting the work yet to be done, ... Western chose not to acknowledge liability to the Band under the performance bond."
2. "Western consistently took the position that Dallas was not in default under the contract and that it was not liable to the Band under the performance bond."
3. Western did nothing to independently assess the status of the project until the end of February 1997 when a consulting engineer confirmed the M.D. Haug report of October 29, 1996.
4. Western did not accept the Band's invitations to meet on October 31, 1996 and November 14, 1996, to discuss the matter.

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<sup>16</sup> Scott, *supra* at 10-8.

<sup>17</sup> Westersund, *supra*.

<sup>18</sup> *Lac La Ronge Indian Band v. Dallas Contracting Ltd.* [2004] S.J. No. 531.

5. “Western backed Dallas in its decision not to agree to the temporary use of the secondary cell.”
6. Western was only galvanized into action by the Band’s notification that if, by March 17, 1997, it had not acknowledged Dallas’s default, the Band would proceed to complete the Contract.”
7. On March 24, 1997, Western acknowledged that Dallas had failed to meet the Contract deadline, “but took the position that the ultimate responsibility for non-completion was a matter that would have to be resolved between the Band, its engineers and Dallas.”
8. “[T]he parties had become entrenched in their respective positions and were continuing the correspondence with the primary objective of positioning their respective clients for the impending lawsuit, not with the objective of reaching a mutually acceptable resolution of the matter.”

The trial judge addressed as follows the Bands’ argument that the surety had not fulfilled its duty to act promptly:

[143] There is another matter I must address. The plaintiff Band emphasizes that the terms of the performance bond require the surety to promptly exercise the options open to it. The case before me is not unlike that before MacKenzie J. in *Kraft Construction Co. (1978) Ltd. v. Guardian Insurance Co. of Canada et al.* (1984), 14 C.L.R. 277 (Alta. Q.B.). Although that case involved a claim against the surety by a general contractor respecting a default by a subcontractor, this factor alone does not distinguish it from the case before me and the term "contractor" could well be substituted for "subcontractor". At p. 281, MacKenzie J. discusses the purpose of performance bonds as follows:

As pointed out by McIntyre J. in the *Citadel Gen. Assur. Co.* case, *supra*, at p. 184 [*Citadel Gen. Assur. Co. v. Johns-Manville Can. Inc.*, [1983] 1 S.C.R. 513], the purpose of a compensated surety, particularly in the construction industry, is to ensure prompt payment for materials and labour supplied. Recognition is given to the fact that in a construction project involving several subcontractors, promptness in the execution of their individual responsibilities is of the essence. The surety is in the business of insuring against the losses that can occur upon the failure of a subcontractor. . . . it was urgent that the plaintiff take action quickly. The plaintiff was therefore entitled to look to the surety to also act quickly.

[144] The court concluded that instead of promptly taking the steps required of it under the bond, the surety entered into prolonged discussions with the plaintiff about the matter and left the plaintiff with the impression that it was not accepting liability but was taking a "wait and see" attitude. The plaintiff had no alternative but to secure its own subcontractor and the surety could not later complain that the work could have been completed at a lower cost.

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...I previously outlined the desperate time constraints on the Band at the time the negotiations were taking place with Western respecting the Dallas bid. Those findings need not be repeated here but are applicable to this issue. In the circumstances, I conclude that Western did not act "promptly" within the meaning of the bond. A similar conclusion was reached in *Halton Region Conservation Authority v. Toronto Underground Contractors Ltd.*, [1982] O.J. No. 599 (Q.L.)(H.C.).

On appeal, the Saskatchewan Court of Appeal noted:

...(i) by the time Dallas was declared to be in default, no work could be done on the project because of winter freeze-up; and (ii) until sometime in March, everyone believed that there were more than sufficient funds remaining from the original Contract price to complete the work. Both factors call into question the trial judge's finding that Western failed to act promptly to complete the Contract.

[47] In the same October 29, 1996 letter which declared Dallas to be in default, the Band's lawyers advised "in the opinion of the engineers the work, particularly on the primary cell, cannot possibly be completed in accordance with the terms of the contract by that time [November 12, 1996]." Winter freeze-up had occurred and it was common ground that it was not possible to continue the work, let alone complete it, until the following spring.

[48] This Court has held in *Saskatchewan Housing Corp. v. Canadian surety Co.* that a surety cannot be required to satisfy an impossible scheduling obligation. In this case, not only was it not possible to complete the Contract by November 12, 1996, it was not possible to commence work to complete the Contract at all until the following spring.

[49] While the trial judge was clearly dissatisfied with Western's failure to recognize, and accept, Dallas's default until March 24, 1997, he did not conclude that Western had caused or increased the Band's loss. Thus, Western's actions, timely or otherwise, have no consequence.

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[54] For these reasons, I conclude that the trial judge erred in concluding that Western had breached the Bond by failing to act "promptly." In order for a surety to breach its obligation to act promptly, there must be some steps that it can take to remedy the default and complete the contract or obtain a bid for completing the contract.

Accordingly, a surety's obligation to promptly respond to a notice of default as expressed in *Lac La Ronge* may be summarized as follows: A surety has a duty to respond promptly to a notice of default. However, this duty will vary according to the circumstances. A surety does not breach its obligation to respond promptly where the obligee suffers no prejudice because of a delay by the

surety in responding or where the surety could not have reasonably known that the obligee would suffer any prejudice as a result of a delay on the part of the surety to respond.

When the surety proposes a replacement contractor, the obligee has some discretion to refuse to accept the proposed contractor. This was also addressed by the Court in *Lac La Ronge Indian Band v. Dallas Contracting Ltd.* As described above, in *Lac La Ronge*, Dallas Contracting defaulted under its construction contract with the Band. The surety ultimately put forth Dallas Contracting, with an engineering firm as its subcontractor tasked with monitoring the work, as the replacement contractor. The Band refused to enter into a “replacement contract” with Dallas Contracting on this basis and a lawsuit eventually ensued including the Band, the surety, and Dallas Contracting. One of the issues before the Court was whether the Band could reject the proposal by the surety to use Dallas Contracting as a replacement contractor. At trial, the Court held as follows:

[135] Western also maintains that it met its obligations under the performance bond by arranging for the subsequent supervised tender by Dallas. As noted previously, the terms of the bond provided Western with two options to meet its obligations to the Band in the event of a default by Dallas. The first was to complete the work itself by using its own contractor. The second was to do so indirectly by finding the “lowest responsible bidder” to complete the work. *Ellis-Don Construction Ltd. v. The Halifax Insurance Company* (unreported decision dated June 8, 1995, Ont. Gen. Div.), affirmed [1998] O.J. No. 4554 (QL) (C.A.), considered what was meant by this term. Chapnik J. held that **the term should be assessed objectively from the totality of the evidence to determine whether there was any technical, practical or financial inability on the part of the proposed tenderer to perform the contract in a satisfactory manner.** He concluded that the evidence in that case did not display any such inability.

[136] Again, this question is one of fact, not one of law. I conclude, as a fact, that the evidence in the case before me that I outlined previously, clearly displays the practical inability on the part of Dallas to perform the contract in a satisfactory manner. As a secondary matter, the evidence establishes that the financial position of Dallas at that time, quite understandably, was not the best. Lien proceedings were in progress because Dallas had not paid all of its subcontractors and suppliers from the advances that the Band had made to it.

[137] A third but significant factor is that Dallas and the Band were gearing up for litigation. It is one thing to expect an owner to give a defaulting contractor another chance if the nature of the default is such that it does not destroy the confidence of the owner in that contractor and as well if the contractor has acknowledged its failures and has genuinely agreed to change its ways. But it is quite another to expect an owner to give a contractor another chance when the default is denied and the determination of that issue will involve the parties in litigation.<sup>19</sup>

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<sup>19</sup> *Lac La Ronge Indian Band v. Dallas Contracting Ltd.* [2001] S.J. No. 280 (Q.B.).

The Court held that the Band had properly rejected the surety's proposed replacement contractor. This finding was upheld on appeal.<sup>20</sup>

Further guidance is provided by the trial decision in *Ellis-Don Construction Ltd. v. Halifax Insurance Co.*,<sup>21</sup> cited above in *Lac La Ronge*. *Ellis-Don* involved a performance bond with Ellis-Don Construction as obligee and its subcontractor as principal. The principal defaulted and the surety submitted a bid for a replacement contractor to Ellis-Don Construction. Ellis-Don rejected the proposed replacement contractor and obtained its own replacement contractor without involvement from the surety. In addition to the principals cited above in *Lac La Ronge*, the trial judge noted:

...the performance bond imposed a positive duty on the parties to confer, that is, to make reasonable efforts to jointly determine the most appropriate bidder, more specifically, which company was the lowest responsible bidder.<sup>22</sup>

Therefore, before an obligee rejects a proposed replacement contractor, it should:

- (i) Conclude that there is a technical, practical or financial inability on the part of the proposed tenderer to perform the contract in a satisfactory manner; and
- (ii) Fulfill its obligation to attempt to work with the surety to determine the most appropriate bidder.

These guidelines are subject to the specific language of the bond. Both *Lac La Ronge* and *Ellis-Don* involved performance bonds where the surety was obligated to propose a "responsible bidder." This is the language found in the CCDC performance bonds in common use in Canada. However, once again, an obligee should carefully review any performance bond to confirm the surety's obligation and the obligee's right to reject a proposed replacement contractor. If the bond does not require the surety to propose a "responsible bidder," the obligee's right to reject a proposed replacement contractor may be limited.

- (f) What does the Performance Bond cover?

Another major issue addressed by the Court in *Lac La Ronge* was the surety's exposure to liability in excess of the cost to remedy defective work and to engage a replacement contractor to complete the contract. This involved the surety's potential exposure to the liquidated damages set out in the contract between Dallas and the Band and the Band's increased engineering and project related costs.

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<sup>20</sup> *Lac La Ronge Indian Band v. Dallas Contracting Ltd.* [2004] S.J. No. 531 (C.A.).

<sup>21</sup> *Ellis-Don Construction Ltd. v. Halifax Insurance Co.* unreported, (June 8, 1995), Doc. 70809 (Ont. Gen. Div.)

<sup>22</sup> For further discussion of these principles, see Scott, *supra* at 10-26.17 and Scott, Kenneth "Surety Bonds" (2000) 50 C.L.R. (2d) 19.

As part of its assessment, the Saskatchewan Court of Appeal distinguished the facts in *Lac La Ronge* from the circumstances in *Whitby Landmark Developments Inc. v. Mollenhauer Construction Ltd.*<sup>23</sup> In *Whitby*, the obligee and the principal entered into a maximum price construction contract where difference between the actual construction costs and the maximum contract price would be shared between the obligee and the principal. Following construction, it was apparent that the obligee had overpaid the principal on the basis that the anticipated savings were greater than expected. However, before the obligee enforced its contractual right to receive payment of its share of the savings from the principal, the principal ceased operating. Accordingly, the obligee sought to recover the payment from the surety on the basis that the principal had not provided an accounting summary as required by the contract and that the surety should therefore be liable to “complete the contract.” On the obligee’s theory, the surety’s obligation to “complete the contract” included an obligation to pay the obligee its share of the difference between the actual construction costs and the maximum contract price.

At trial in *Whitby*, Justice Lamek of the Ontario Superior Court of Justice concluded that the obligee had failed to provide proper notice and was therefore unable to recover under the bond. However, Justice Lamek also noted that the obligee would have been able to recover these funds from the surety but for its ineffective notice. More specifically, Justice Lamek concluded:

¶ 14 I begin with the observation that the bond is in the form selected by Zurich. The form is once again a product of the Canadian Construction Documents Committee. It was “endorsed” by the Canadian Construction Association. But it was printed under the name “Zurich Indemnity Company of Canada” and, in my view, was the form of bond adopted by Zurich and presented to Mollenhauer. If, therefore, there be any ambiguity in the language of the bond (and I see no ambiguity), it must be construed against Zurich. If Zurich intended to restrict the obligations that it undertook or to eliminate certain of Mollenhauer’s contractual obligations from the scope of the bond, it could easily have done so. It did not. Instead, Zurich issued a bond that obliged it, in the event of Mollenhauer’s default, to “complete the Contract in accordance with its terms and conditions”. It would be difficult to formulate a provision that would more easily embrace all of the obligations of Mollenhauer under its contract with Landmark.

¶ 15 It is true that item numbered “2” on the face of the bond is more readily understood as referring to Mollenhauer’s construction obligations. But item “1” discloses no such restriction on its scope.

¶ 16 In my view, therefore, and subject to what I shall say about the other defences raised by Zurich, the bond was intended to respond to a claim such as the one now asserted by Landmark.

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<sup>23</sup> *Whitby Landmark Developments Inc. v. Mollenhauer Construction Ltd.* (2000) 2 C.L.R. (3d) 1 (Ont. S.C.J.).

The trial decision was upheld on appeal.

In *Lac La Ronge*, the Saskatchewan Court of Appeal distinguished *Whitby* on the basis of subtle differences in the contractual obligations owed to the obligee by the principal and the relation of those obligations to the specific damages sought against the surety. The Court of Appeal ultimately held that the Band was not entitled to recover from the surety the liquidated damages or the increased engineering and project related costs incurred by the Band. The Court of Appeal found support for its decision in a number of American authorities where courts dismissed similar claims against sureties.

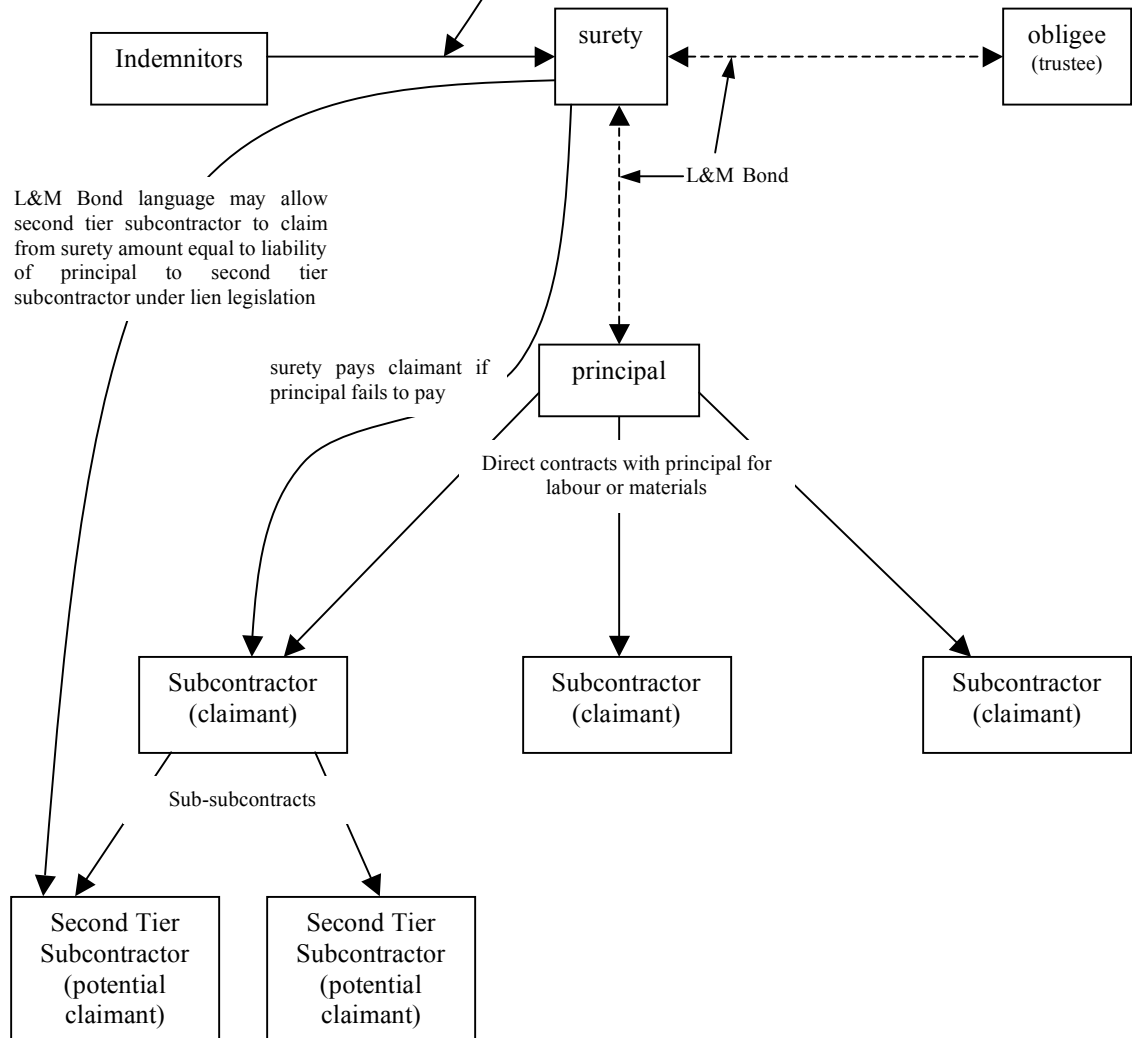
Unfortunately, the conflicting decisions in *Whitby* and *Lac La Ronge* may be simply explained on the basis of the particular language in the respective contracts. Accordingly, it does not appear that either decision conclusively determines whether a surety may be liable in any given circumstance for any costs beyond the cost to remedy defective work and to engage a replacement contractor to complete the contract. Rather, in any given circumstance, the surety's liability will turn on a close examination of the language used in the bond, the language of the construction contract, and the damages sought. Without question, this interpretation will involve a principled analysis of the purpose of a performance bond and the jurisprudence involving similar claims.

## **LABOUR AND MATERIAL BONDS**

A labour and material bond provides security for subcontractors (claimants) of the principal in the event that the principal fails to pay its subcontractors when payment is properly due. The basic function of a labour and material bond is to allow the project to remain free of liens if the principal fails to pay its subcontractors or suppliers. The relationship between the principal, surety, obligee, claimants, and indemnitors is shown below:



As a condition to issuing the bond, the surety will often require indemnity agreements, often from the owners of the principal, and will recover from the indemnitors event that it pays under the bond.



To qualify as a claimant under a standard labour and material bond, a subcontractor of the principal must establish:

- (i) That it has a direct contract with the principal;
- (ii) For labour or material or both;
- (iii) Which is used or reasonably required for use in the performance of the contract between the principal and the obligee<sup>24</sup>

Whether the bond will respond to claims brought by sub-subcontractors of the principal, and the amounts that a sub-subcontractor may claim, depends upon the specific wording of the bond.

A typical labour and material bond will specify the manner of notice and the required recipients of the notice. However, a claimant's right to recover under the bond will not be defeated solely on the basis of a failure by the claimant to strictly comply with the form of notice provided this does not prejudice the surety.<sup>25</sup>

A typical labour and material bond also includes deadlines within which a claimant must provide notice to the parties described in the bond and within which the claimant must commence an action to claim under the bond. Under a standard form CCDC labour and material bond, the claimant must provide notice within 120 days of the date that it should have been paid and must commence and action to enforce the bond within one year of the date that it ceased work under its contract.

Project participants have occasionally attempted to use a performance bond to achieve the same protection afforded by a labour and material bond. These claims were based on the default by the principal of its contractual obligations to pay all subcontractors and suppliers and the suggestion that the surety should, pursuant to a standard performance bond, complete the contract and pay these subcontractors or suppliers. This claim was successful in *Dawson & Hall Ltd. v. United States Fidelity*.<sup>26</sup> However, the authors of *Scott and Reynolds on Surety Bonds* suggest that *Dawson* was incorrectly decided and cite several decisions where similar claims were dismissed.<sup>27</sup>

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<sup>24</sup> *Campbell Comeau Engineering Ltd. v. Alta surety Co.* (1997) 30 C.L.R. (2d) 116.

<sup>25</sup> *Citadel, supra.*

<sup>26</sup> *Dawson & Hall Ltd. v. United States Fidelity* (1963) 38 D.L.R. (2d) 53 (B.C.C.A.).

<sup>27</sup> *Scott, supra* at 7-16.

## LIEN BOND

Lien legislation in Canada allows for the discharge of liens upon the substitution of the security provided by the lien against title with another appropriate form of security. Lien bonds are often used to provide this security in place of cash or a letter of credit. Lien legislation varies from province to province and the use of lien bonds in conjunction with these different legislative schemes is beyond the scope of this article. Owners and contractors are well advised to seek legal advice when dealing with the filing and the discharging of liens.

## CONTRACTOR DEFAULT INSURANCE

The last ten years have seen the increasing emergence of Contractor Default Insurance as an alternative to traditional forms of construction bonding. Contractor Default insurance is also known as Subcontractor Default Insurance, Default Insurance or Subguard®, the trade name used by Zurich North America for its Contractor Default Insurance.

The surety Association of Canada indicates that the first contractor default insurance appeared in 1996 in the United States.<sup>28</sup> One American writer has attributed the development of Contractor Default Insurance to: “(1) a perception that surety companies do not resolve claims in a timely manner; (2) a desire by contractors to have more control of the situation when they believe a subcontractor or supplier has defaulted; and (3) the insurance industry’s interest in developing innovative new products to capture greater market share.”<sup>29</sup> A number of insurers have attempted to market these products.<sup>30</sup> However, at present, Zurich appears to be the primary source for this coverage through its Subguard® product.

Given the relative infancy of Contractor Default Insurance as compared to traditional construction bonding and other forms of insurance, much of the commentary regarding the use of contractor default insurance is somewhat speculative. For example, as of January 2006, no reported Canadian Jurisprudence has mentioned Contractor Default Insurance.<sup>31</sup> Accordingly, it is too early to determine whether contractor default insurance will adequately remedy any perceived problems with traditional construction bonding.

Contractor Default Insurance provides the insured contractor with insurance funds upon the happening of the insured event, usually the default of a subcontractor. The writers have reviewed

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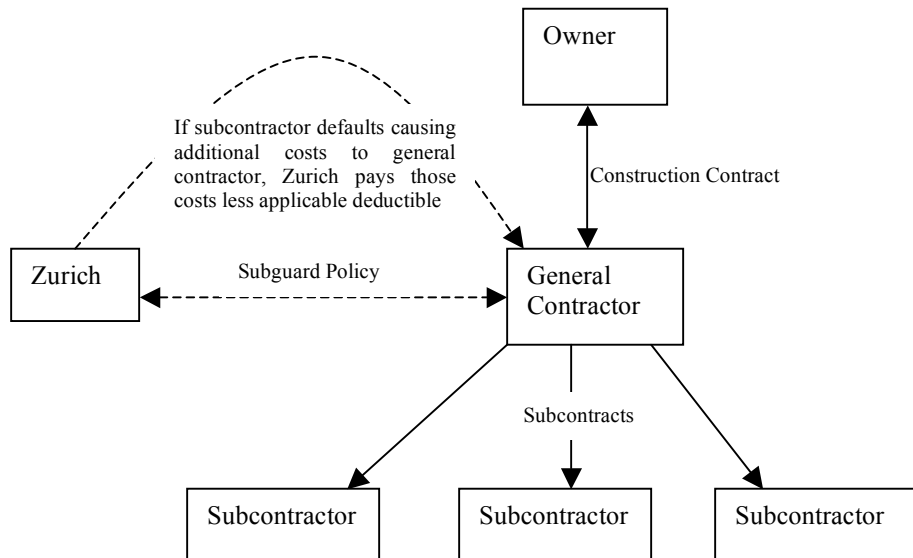
<sup>28</sup> Available online: surety Association of Canada Website: <http://www.surety-canada.com/contractors/riskcon.html> (date accessed: 11-Jan-06).

<sup>29</sup> Noteboom, Lowell J., “Subguard” Subcontractor Insurance – What is it? Is it an appropriate alternative to Surety Bonds?” available online: <http://www.legalist.com/mnlawyers/support/noteboom.html> (date accessed: 12-Jan-06).

<sup>30</sup> Ibid.

<sup>31</sup> This comment is based upon a search of the Quicklaw Canadian Judgments database on January 12, 2006.

a Subguard® policy issued to one of Canada’s larger civil contractors. The framework of this policy is shown schematically below:



Contractor Default Insurance is not without its critics. The surety Association of Canada has summarized its views on the relative benefits of surety bonds and contractor default insurance and has noted several shortcomings of contractor default insurance. This comparison, which is available online, is reproduced below.

Issues	surety Bonds	Default Insurance
<b>Prequalification and Underwriting Services</b>	<ul style="list-style-type: none"> <li>Impartial, rigorous process performed by surety to screen out unqualified contractors</li> </ul>	<ul style="list-style-type: none"> <li>Minimal prequalification performed by the insured</li> </ul>
<b>Coverage</b>	<ul style="list-style-type: none"> <li>Performance and payment bonds each cover 50% or 100% of contract</li> <li>No deductible</li> <li>Premium is only charge (fee)</li> </ul>	<ul style="list-style-type: none"> <li>Limited to aggregate limit, each qualifying loss limit, indirect loss sub-limit, and co-payment</li> <li>Deductible and co-payment apply</li> </ul>

	<ul style="list-style-type: none"> <li>for services)</li> <li>No sub-limits on covered damages</li> <li>surety pays loss</li> </ul>	<ul style="list-style-type: none"> <li>Liquidated damages, acceleration, &amp; delay costs are created separately and subject to separate limit</li> <li>Insured must pay losses initially, then seek reimbursement from insurer</li> </ul>
<b>Exclusions</b>	<ul style="list-style-type: none"> <li>None</li> </ul>	<ul style="list-style-type: none"> <li>Purchase orders / subcontracts</li> <li>Losses by inaccurate warranties or covenants</li> <li>Defaults prior to issuance, but during contract term</li> </ul>
<b>Term of coverage</b>	<ul style="list-style-type: none"> <li>Cannot be cancelled by any party</li> <li>Provides protection against legitimate claims until time expires as stated in contract or until statute of limitations expires</li> </ul>	<ul style="list-style-type: none"> <li>Insurer may cancel policy for certain reasons</li> <li>Restriction on length of coverage</li> </ul>
<b>Claims</b>	<ul style="list-style-type: none"> <li>If default occurs, the surety completes, arranges for, or pays for contract completion up to the amount of the bond</li> <li>Subs &amp; suppliers are provided direct payment protection</li> </ul>	<ul style="list-style-type: none"> <li>Insured must manage completion of the contract, then file claim</li> <li>Subs &amp; Suppliers may not make a direct cla</li> </ul>
<b>Risk</b>	<ul style="list-style-type: none"> <li>surety holds the risk for contract completion &amp; payment to subs &amp; suppliers</li> </ul>	<ul style="list-style-type: none"> <li>Insured retains portion of the risk through deductibles and co-payments</li> </ul>
<b>Legal</b>	<ul style="list-style-type: none"> <li>Established history of case law</li> <li>Terms &amp; conditions defined in bond language &amp; case law</li> </ul>	<ul style="list-style-type: none"> <li>No history of case law, legal precedence, or claims history</li> <li>Terms &amp;</li> </ul>

Despite the criticisms of contractor default insurance, the product seems to have some definite advantages over traditional construction bonds. For example, after paying its deductible, an insured general contractor may be entitled to compensation for costs that would not be covered

under a typical performance bond. For example, the insured general contractor may be entitled to compensation for additional legal and other professional services required because of the subcontractor's default. Typical performance bonds do not compensate the obligee for these sorts of costs, as demonstrated by the result in *Lac La Ronge*, supra.

Moreover, contractor default insurance is a form of first party insurance. When a first party insurer receives notice from its insured of a potential claim under the policy, the insurer has a duty to act in good faith throughout the assessment of the claim. If an insurer fails to fulfill its obligation to act in good faith, this may give rise to punitive damages against the insurer. Punitive damages are awarded by the Court to punish the wrongdoer and, on occasion, Canadian Courts have awarded very high punitive damages against an insurer. The risk of these punitive damages is a strong incentive for any insurer to fulfill its obligations of good faith in assessing the claim.

This duty of good faith with respect to surety bonds has not been recognized in Canada. In the United States, there are conflicting authorities from state to state. Therefore, whether Canadian Courts will conclude that a surety owes a duty of good faith is far from certain. On the other hand, we can conclude with confidence an insurer offering Contractor Default Insurance will owe its insureds a duty of good faith.

Ultimately, time will tell whether contractor default insurance is a suitable substitute for traditional bonding.