The Revay Report

Volume 18
Number 2
May 1999

Published by
Revay and Associates
Limited

Construction Consultants
and
Claims Specialists

*By **Stephen G. Revay***

The lead article of this issue responds to a specific request. Although members of the construction fraternity are familiar with bonds in their everyday applications, apparently many are not familiar with their limitations. This article, of course, is not an exhaustive treatment of the extremely complex topic and is certainly not intended to answer all related questions. It is, nevertheless, sufficiently all encompassing to underscore situations where the construction practitioner requires expert help.

Many contractors and consultants have either already undertaken or are contemplating entering into design/build arrangements. The design/build method of contracting is an area where the responsibility of the surety company and, by way of the frequently demanded indemnity agreement, that of the contractor has been turned on its head.

Perhaps not a typical but certainly a frightening example of what can happen on projects executed under a design/build arrangement is the construction of an American supermarket. Upon completing construction, the building suffered severe differential settling rendering the building useless. The owner of the supermarket sued both the contractor and its surety company. The court found that the problem resulted from design deficiencies and awarded judgement both against the contractor and its surety. In doing so, the court rejected the argument that the performance bond covered construction only and that design deficiency is the responsibility of the design consultant, and should be paid for either by the design consultant or his professional liability insurer. The court held that the terms of the bond secured performance of the entire contract, including design responsibilities, and was not limited to construction only. By arguing that the performance bond does not cover design, the contractor was hoping to limit its liability towards the surety under the indemnity agreement. What made this case even more complicated was the fact that the soil information on which the design was based was supplied to the design consultant by the contractor.

Construction and Bonds

by **Richard A. Row**

INTRODUCTION

Bonds are an important element of the construction process. On large construction projects, contractors are normally required to post bid bonds, performance bonds and labour and material payment bonds before beginning construction and construction lien bonds in the event that construction liens are registered during the work.

Bonds are issued by sureties in return for a fee or premium, paid by the person requesting the bond. Sureties normally require a variety of indemnities as a condition of issuing a bond. If the contractor is requesting the bond, then the corporation as well as one or all of the officers and directors personally would provide an indemnity to the surety. In the event that the surety is required to make payment on the bond, those providing indemnities are legally bound to reimburse the surety for all amounts expended including expenses such as claims investigation and legal fees.

BID BONDS

Tenderers on construction projects are often required to put up bid bonds at the time that a tender is submitted. The purpose of the bid bond is to ensure that a contractor whose tender is accepted enters into a construction contract with the owner. If the winning contractor refuses, the owner is entitled to all or part of the bid bond.

PERFORMANCE BONDS

A performance bond is issued by the surety at the request of the principal (normally the contractor) in favour of the obligee (normally the owner). If the contractor is unable to complete the work and is declared in default of the construction contract, or a part of the work, the surety is obligated to step in and finish the job, or correct the default, subject of course to the limits of the bond. In such a situation, the surety has several options:

1. It can remedy the default if only a part of the overall contract is affected.
2. If the general contractor is in default and no longer available, it can take over the job and finish the work using the subcontractors and material suppliers formerly used by the contractor. In effect, the surety becomes the new general contractor.
3. It can obtain bids from new contractors to complete the work, and with the consent of the obligee, award the contract to the lowest bidder.

The performance bond normally stipulates that any legal action must be commenced within a specified period after the last payment to the principal falls due. This period is normally, but not always, two years.

When the surety steps in to finish the job, it is entitled to the balance of the contract funds still remaining. For example, if the initial construction contract was $1 million and $500,000 was paid to the contractor to the point of default, the surety would be entitled to the remaining $500,000 to complete the job. Any costs for completion in addition to the $500,000 would be paid by the surety up to the limits of the performance bond.

It is also common for general contractors to require subcontractors to post performance bonds where the subcontractor would be the principal and the general contractor the obligee.

LABOUR AND MATERIAL PAYMENT BONDS

These types of bonds are intended to provide for the payment of subcontractors and material suppliers should the principal on the bond not make payments as required. The wording of the bond is important as many only offer protection to those that are in a direct contractual relation with, or have lien rights against, the principal. In such a situation, a material supplier to a subcontractor could not look to a labour and material (L&M) bond posted by a general contractor for payment unless that supplier possessed lien rights with respect to that contractor.

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

As with performance bonds, the surety is only liable for the limit of the bond.

CONSTRUCTION LIEN BONDS

Construction contracts for large projects often require the general contractor to remove any liens that are registered against title to the owner's property. This is normally 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. Then the liens can be vacated from title. The bond then stands as security for the lien. In practical terms, if a construction lien bond is not available the project often comes to a halt as the owner must retain from payments to the contractor the amount of the lien claim and an allowance for costs. Mortgagees will also stop payments until the liens are removed.

SURETY DEFENCES

There are a number of defences which a surety can raise in response to a claim against a bond which has been issued with respect to a construction project. Decisions of courts across Canada focus on one question more than any other. Has the surety been prejudiced by the actions of the principal or the obligee during the time frame covered by the bond?

MISTAKE IN TENDER

If the contractor makes an error in its tender which is obvious on its face, the owner cannot simply grab that tender and then claim on the bid bond. In such a situation, no contract is formed because of the existence of the mistake that both the owner and the contractor were aware. *McMaster University v. Wilchar Construction*[1].

When the mistake is not apparent on the face of the tender and can only be shown by additional data, then the tender is valid and cannot be withdrawn after tenders close. If the affected tenderer chooses not to proceed with the work and enter into a construction contract, the owner is entitled to the proceeds of the bid bond as was the case in *R. v. Ron Engineering*[2]. In this case, the contractor submitted a bid along with a bid deposit of $150,000. The tender documents stipulated that once a tender was submitted it could not be withdrawn until the owner had selected a winner. The contractor, on the opening of tenders learned that it had made a mistake by neglecting to add the cost of labour to the total tender amount. The owner was advised of the mistake but refused to allow the tender to be withdrawn. The contractor refused to enter into the construction contract. The owner seized the bid deposit and awarded the contract to the next highest bidder. As the mistake was one of calculation and not evident on the face of the tender, the court agreed that the tender was not capable of being withdrawn. It should be remembered that many tender documents allow a tenderer to withdraw its tender at any time up until the time tenders close. In such a situation, a tenderer who becomes aware of a mistake, whether apparent or not, could withdraw without penalty up until the close of tenders.

FAILURE TO COMPLY WITH REQUIREMENTS OF TENDER DOCUMENTS

Tender documents often require the winning tenderer to execute the construction contract and provide stipulated bonds and evidence of insurance within a specified time after being notified by the owner that it was the successful bidder.

In *Vaughan v. Alta Surety*[3] the contractor discovered, after its tender was selected, that it had failed to include the cost of a sprinkler system. The contractor carried out negotiations with the owner past the two week period stipulated for executing the construction contract after the award of tender. The owner then selected the next highest bidder to do the work. The low tenderer then agreed to do the work for the price in its low tender. The owner refused and seized the bid bond. The court held that the owner's steps were justified as the contractor had failed to execute the contract within the time set in the tender documents.

EXECUTION AND DELIVERY OF BONDS

In *Paul D'Aoust Construction v. Markel Insurance*[4], the general contractor, D'Aoust, acting as agent for the owner, entered into a contract with a subcontractor requiring the posting of a bond by the subcontractor. The bond was issued by the surety but was never delivered to D'Aoust prior to the subcontractor's default. The resulting claim by D'Aoust against the surety was unsuccessful because the bond had never been delivered.

The opposite result occurred in *Helm v. Simcoe & Erie*[5] where the surety was liable when the contractor failed to sign the issued bond and pass it on the owner.

It is submitted that the D'Aoust judgement is correct and to be preferred as that case considered Helm and numerous other cases in deciding that the surety could only be liable if the bond was executed and delivered to the obligee. Importantly, evidence in the D'Aoust case strongly suggested that the contractor did not deliver the bond as it did not wish to assume certain legal liabilities which would arise upon execution and delivery of the bond.

MEASURE OF DAMAGES WHEN WINNING CONTRACTOR REFUSES TO EXECUTE CONSTRUCTION CONTRACT

In the absence of wording to the contrary in the tender documents, an owner is entitled to damages equal to the difference between the low tender and the next highest should the low tenderer refuse to enter into a construction contract after being awarded the job. This difference may be higher or lower than the amount of the bid bond posted by the contractor.

Many tender documents state that the owner and contractor agree that the amount of the bid bond represents the liquidated damages that the owner would suffer should the contractor fail to do the work. Such wording worked to the detriment of the owner in *Town of Mulgrave v. D.J. Love*[6] where a bid bond for 10% of the tendered price was posted. The difference between the low and next highest tender was significantly greater than 10%. The owner claimed the bid bond and unsuccessfully attempted to sue the contractor for the difference. The court held that the parties had agreed, due to the wording in the tender documents, on the measure of damages being 10% of the tendered price. As a result, the owner could not sue for the actual damages.

PAY WHEN PAID CLAUSES

Some subcontracts contain "pay when paid" clauses that state the contractor's obligation to pay a subcontractor arises only when the contractor receives payment for the work in question from the owner. The subcontract in *Arnoldin Construction v. Alta Surety*[7] contained such a clause and prevented a subcontractor from claiming on an L&M bond.

This decision was overturned on appeal and the surety was found liable under the bond. However, "pay when paid" clauses are common and the surety would have a valid defence should the court uphold such a clause as was the result in a split decision of the Ontario Court of Appeal in *Timbro Developments Limited v. Grimsby Diesel Motors Inc.*[8] which the Supreme Court of Canada refused leave to appeal.

WHO CAN CLAIM ON AN L&M BOND

The wording of most L&M bonds restricts claims to those entities which are in contractual relations with the principal on the bond. This includes engineering consultants as was the case in *Campbell Comecu Engineering Services v. Alta Surety*[9] where the consultant provided engineering services to the contractor which posted the L&M bond. Presumably, no such claim would be successful by the consultant in the traditional arrangement where the engineering firm is employed by the owner and not the contractor.

In *Western Incorporated Electric v. Laurentian*[10] a subcontractor was allowed to bring action against a surety after the subcontractor had obtained judgement against the contractor but couldn't collect. Thus, a surety cannot argue that a claimant must make an irrevocable election when deciding whether to sue the contractor or the surety.

L&M BONDS AND LIENS

A surety who issues an L&M bond cannot demand that claimants against the bond first pursue other measures, such as enforcing lien rights, before looking to the surety for payment. *Citadel Assurance v. Johns-Manville*[11].

Once a surety pays the lien claimants, the surety is then able to step into the shoes of those claimants and enforce their lien claims. *EC&M Electric v. Medicine Hat General*[12].

CHANGES IN WORK

Changes in the work made without the knowledge or consent of the surety will not provide the surety with a defence to subsequent claims providing such changes were done in accordance with the contract between the owner and the contractor as was the situation in *Fifty-Fifty Beatty v. Markwood Construction*[13]. It is submitted, however, that the real question is one of degree as most construction contracts allow for changes in the work and set out the mechanics for effecting such changes. If the changes are of such a magnitude that the work becomes something substantially different from that for which the surety issued the bond then the surety has been prejudiced and should not be liable. *Roman Catholic Episcopal Corp. v. Canadian Surety*[14] held that a surety is discharged from its obligations if material changes are made to the contract without the surety's consent unless such changes were unsubstantial or were to the surety's benefit.

EXTENSION OF TIMETO COMPLETE

As is the case with changes in the work, the surety will be discharged from its obligations if the owner extends the time for completion of the work without the consent of the surety and such extension is done to the prejudice of the surety. It is up to the surety to prove actual prejudice.

In *Credit Heights v. U.S.F.G.*[15] the contractor entered into three separate construction contracts which were all bonded by the same surety. The last contract was extended by two years without the knowledge of the surety before the contractor defaulted. The surety was found liable for the costs of correcting deficiencies in the first two contracts and for the extra costs of completing the delayed third contract where the court found no evidence of prejudice to the surety.

The opposite result was achieved in *St. John's Metropolitan Board v. Vohey & Sons*[16], as could be expected, since the surety suffered actual prejudice from the four year extension to the construction contract.

It should be noted in situations of multiple contracts all bonded by one surety that the surplus funds from one contract are not available to satisfy the claims of subcontractors arising from the other contracts, even though all the contracts relate to the same project. *Alberta Government Telephone v. Great Lakes Casualty*[17].

OVERPAYMENT OF CONTRACTOR

When a contractor defaults, the surety is required to step in and have the work completed. In such a situation, the surety is entitled to the balance of the contract funds plus any monies owing to the contractor for work approved but not paid. Obviously, if the contractor has been overpaid, there is less money than there should be available to the surety. As a result, the surety is prejudiced and not liable for any claims relating to the default. This happened in *Nickle Investments v. Great American Insurance*[18] where the surety was not liable when the owner, knowing that the contractor was in financial difficulty, made the final payment and looked to the surety to correct deficiencies in the work. In such a situation, the owner should have retained out of the last payment sufficient funds to correct the deficiencies.

A similar result was reached in *Town of Mulgrave v. Simcoe & Erie*[19] where the court held that the surety was not prejudiced by two extensions in the time to complete, but was from the overpayment of the defaulting contractor.

REPLACEMENT OF ARCHITECT

In *Fifty-Fifty Beatty v. Markwood Construction*[20] it was held that a surety is not prejudiced when the owner replaces the architect during construction.

LATE PROGRESS PAYMENTS TO CONTRACTOR

Fifty-Fifty Beatty v. Markwoods Construction[21] also held that late progress payments during construction does not constitute prejudice.

LIMITATION PERIODS

L&M bonds normally require that the notice of claim be provided within a specified period. If the notice is late, the surety involved will plead the contractual limitation defence. In response, the claimant will rely on provisions of the appropriate Insurance Act which provides relief from forfeiture in the case of late notice. Unless the surety has suffered actual prejudice from the delay relief will normally be granted as was the situation in *312630 B.C. Ltd. v. Alta Surety*[22].

Another issue involves the commencement of time for giving notice. In *Controls and Equipment Ltd. v. RAMCO*[23] the mechanical contractor posted an L&M bond which required that any claim be made within one year after the principal ceased work. The contractor defaulted but a subcontractor continued to work and then made its claim more than one year after default by the contractor but less than one year after the subcontractor finished its work. The court held that the limitation period did not commence until the subcontractor was finished even though the contractor defaulted earlier. Reasonably, the court found that the work of a contractor (principal) included the work of all of its subcontractors.

Performance bonds also require that an action be commenced within a set time from a defined event such as substantial or total completion of the work or when the last payment was due the contractor (principal). The important consideration is whether the surety has been prejudiced by any delay. If not, then the defence will fail.

The courts considered the limitation period of one year from completion of the work in *Lunenberg Home v. Duckworth*[24] and held that the time had never commenced as the contractor never finished its work due to its default. A similar result was reached in *Maidstore v. Loosemore Excavating*[25] which considered the one year limitation which ran from the time that the last payment was made or was due to the contractor. Since the contractor defaulted, the last payment was never paid or due. Hence the limitation period never began.

The limitation defence has not been an effective defence for sureties. Relief is provided against forfeiture in the absence of prejudice to the surety although such relief is not available if the claimant does note come into court with clean hands. In *300201 Alberta Ltd. v. Western Surety*[26] a subcontractor made a late claim on an L&M bond and asked the court for relief from forfeiture. Evidence was provided at trial of a scheme between the subcontractor and the contractor regarding the claim. Relief was denied.

It should be noticed that there is a significant difference in the remedies available to defeat a limitation defence. Relief from forfeiture is only granted in the absence of prejudice. On the other hand, if the limitation period never commences, prejudice is not a factor and the surety could face indefinite liability.

Ironically, while sureties are routinely denied the protection of the limitation period, they have been found liable for claims because of that same period.

In *Canadian Indemnity v. Numan*[27] the contractor defaulted on a construction

contract for which an L&M bond existed. A subcontractor gave notice of its claim after the 120 day period stipulated in the bond. The subcontractor then sued both the surety and the contractor. The surety settled with the subcontractor, without the knowledge of the contractor. The surety then commenced an action against the contractor for the amount paid the subcontractor. The surety's claim was denied by the court as the surety, in the face of its limitation defence against the subcontractor's claim, paid anyway.

NOTICE OF DEFAULT

L&M and performance bonds each require that notices be given of claims. In the case of performance bonds, the surety is to be given a notice of default by the contractor. This notice is necessary so that the surety can carry out a timely investigation of the situation and take steps to protect its position. The surety will want to determine if the contractor is legally in default of the construction contract and if so, how the default can best be corrected. In the absence of such notice, real or implied, the surety will have a strong defence against any claims.

A technical breach of the notice requirements will not protect the surety. In *Kraft Construction v. Guardian Insurance*[28] the performance bond required that the notice of default be given by registered mail. The claimant gave two notices, both by telex, advising that a new subcontractor would be engaged on a cost plus basis to complete the work. The court, in allowing the claim, held that notification by telex instead of by registered mail constituted a technical breach. The claimant was paid the bond limits plus interest.

If the obligee fails to give notice of default to the surety, but instead engages another contractor, without the consent of the surety, to complete the work, then the surety is not liable. *Fraser Gate Apartments v. Western Surety*[29].

Actual notice of default in writing may not be necessary as in certain cases the courts will hold that notice was provided by the facts of the case. In *Petwa Canada v. Logan Stevens*[30], a subcontractor which had posted an L&M bond defaulted, owing a material supplier a substantial sum. The supplier did not provide the surety with a written or verbal notice of default. The surety was aware before default that the supplier was the main provider of materials. As a result, the claim was allowed as the surety was not prejudiced.

LIABILITY TO SURETY

In addition to those who have provided indemnities to the surety and who are thus liable to pay to the surety all amounts paid out to claimants, the surety can also look to others to cover losses.

In *City of Prince Albert v. Underwood McLellan*[31] a reservoir wall collapsed while under construction. It was found that the collapse was caused by negligent supervision by the owner's consultant and negligent construction by the contractor. The surety paid the claim and then was entitled to step into the shoes of the owner and sue the engineering consultant.

CONCLUSION

Bonds form an important and often ignored aspect of the construction process. Bonds usually represent the only source of funding to compensate for the bankruptcy or default of a contractor or subcontractor. This source is often not available as no one has kept the surety aware of developing problems and provided a timely notice of default.

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ENDNOTES

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3 (1990), 42 C.L.R. 305 (Ont. H.C.).
4 (1996), 31 C.L.R. (2d) 180 (Ont. Gen. Div.).
5 (1979), 108 D.L.R. (3d) 8 (Alta. C.A.).
6 [1995], N.S.J. No. 199 (N.S. S.C.).
7 (1994), 13 C.L.R. (2d) 307 (N.S. S.C).
8 (1988), 32 C.L.R. 32
9 (1997), 34 C.L.R. (2d) 305 (N.S. C.A.).
10 (1993), 8 C.L.R. (2d) 13 (B.C. S.C.).
11 [1983], 1 S.C.R. 513.
12 (1987), 35 D.L.R. (4th) 80 (Alta. Q.B.).
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15 [1987], O.J. No. 95 (Ont. H.C.).
16 (1991), 92 Nfld. & P.E.I. R. 147 (Nfld. C.A.).
17 [1985], 5 W.W.R. 186 (Alta. C.A.).
18 [1974], I.L.R. P.1-607 (Ont. H.C.).
19 (1977), 73 D.L.R. (3d) 272 (N.S. C.A.).
20 Supra, endnote 13.
21 Ibid.
22 [1995], 10 W.W.R. 100 (B.C. C.A.).
23 (1998), 200 N.B.R. (2d) 280 (Q.B.).
24 (1973), 33 D.L.R. (3d) 711 (N.S. S.C.I.).
25 Unreported decision Ont. Gen. Div. 1997 File # 97-GO-39578 (Windsor)
26 (1989), 65 Alta. L.R. (2d) 286 (C.A.).
27 (1991), 36 C.L.R. 315 (B.C. S.C.).
28 (1984), 57 A.R. 118 (Q.B.).
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31 [1969], S.C.R. 305.

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