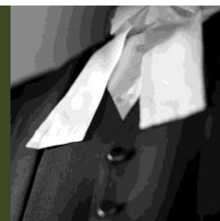
THE LITIGATOR

JUNE, 2007



Performance, and Labour and Material Payment Bonds

Avoiding the Pitfalls of the Surety's Defences to a Bond Claim

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Introduction

I have been asked to speak on the topic of how to avoid the pitfalls of the surety's defences to a bond claim. In speaking to you today I shall attempt to avoid, where possible, boring you with endless legal jargon and instead provide you with some practical advice from someone who primarily acts for sureties. This area of the law can be perilous and the comfort provided by a surety bond can be lost easily if one does not cross one's T's and dot one's I's. However, by being aware of the defences most often raised by sureties you can chart a course that reduces the likelihood that the surety bond ends up as nothing more than a souvenir of a construction project gone wrong.

Today I will focus on the two types of bonds most relevant to the construction industry:

1. Performance bonds; and,
2. Labour and material payment bonds.

Both types of bonds involve a least three parties:

1. The obligee;
2. The principal; and,
3. The surety.

These legal terms are likely unhelpful to most of you so let me put them into context.

In the context of labour and material bonds, the obligee is the person entitled to be paid—e.g. subcontractors or tradesmen. The principal (the contractor) is the person responsible for making the payment. The surety is the person that agrees to ensure that the obligee gets paid if the requirements of the bond are fulfilled.

When dealing with performance bonds, the obligee is the person for whom the obligation will be performed - usually the owner. The principal is the person that is supposed to perform the obligation (the contractor). The surety is the person that agrees to ensure the performance of the obligation.

A bond, simply put, is a contract which enunciates terms and conditions between the parties, primarily enunciating the surety's obligations under a performance bond to the owner, and under a labour and material payment bond to subcontractors. However, owners, contractors and subcontractors have obligations under bonds which if they fail to meet contractually entitles the surety to deny liability under the bond. The legal deniability entitling a surety to deny liability for claims under a bond primarily rests with owners, contractors and subcontractors. The primary focus of this paper is to enlighten all present as to the preventative steps that should be taken to ensure that a surety cannot deny liability under the bond by reason of the acts and/or omissions of owners, contractors and subcontractors. By being aware of the most common surety defences, you can conduct yourself in a way that decreases the likelihood that the surety is entitled to deny liability under the bond.

The most common, and the four defences that I will discuss today, are:

1. The Material Change in the Underlying Contract Defence (a.k.a. the "that's not the contract which I agreed to bond");
2. The Failure to Notify the Surety Defence
3. Timing Defences
4. Reliance Upon Defences Available to the Principal

After discussing these defences four things that should be very clear to you are:

1. Read the bond;
2. Adhere to the bond provisions;
3. Work with your surety; and
4. Keep your surety informed.

Defence 1: Material Change in the Underlying Contract

I turn now to the first defence that I will discuss with you today: the Material Change in the Underlying Contract defence. Basically, this defence amounts to the surety saying that there have been so many changes to the contract it bonded that it has become materially different (in the U.S. they call this a "cardinal change") and thus prejudices the surety. If that is the case then the courts will not require the surety to perform its obligations under the bond. There will be a presumption that prejudice occurred

and the burden will fall upon the obligee (the owner) to show that the surety was not prejudiced by the changes.

Sometimes it is easy to determine if a change is "material." For example, if you contract to build a greenhouse and subsequently decide to put in a subterranean concrete bunker instead, it is highly probable that both the surety and the court will find that to be a material change. The more difficult problem is when you are dealing with minor (or at least what appear to be minor) changes.

Although the outcomes of a construction project are frequently static, many of you know that the processes are not: changing plans, substitutions of materials, and rescheduling because of delays are not uncommon in the industry. Individually, minor changes rarely pose a problem. However, in the aggregate they can amount to a material change (i.e. hundreds of approved change orders). If the court finds that there has been a material change in the underlying contract then it will not require the surety to perform under the bond.

With performance bonds it is very important to adhere to the payment schedule set out in the underlying contract. Although some leeway is given for overpayments made in good faith and with the expectation that the project will be completed, overpayments or early payments that do not fit that category will generally be seen as prejudicial to the surety. This is because the payments are seen as reducing the incentives that encourage the principal (the contractor) to complete the work and, as a result, they increase the risk assumed by the surety.

A further reason for adhering to the payment schedule is that if overpayments or early payments occurred but the work remains substantially incomplete, then there is a very real possibility that the obligee (the owner) will end up paying twice for the same work. Of course there are exceptions, the most notable being when the owner makes early payments to a cash-strapped principal for the purpose of ensuring the completion of the project. In such circumstances, the payment will not be seen as prejudicial to the surety. However, the burden will rest on the claimant to prove that the surety was not prejudiced.

Furthermore, you must be careful when granting extensions. Although some slippage in scheduling is expected in construction and courts have found that allowances for minor extensions in time are an implied term of construction contracts, if there is a transfer of something of value in return for granting the extension then the surety may argue that the underlying agreement has been replaced (albeit with the same fundamental terms). In those circumstances the original contract becomes terminated and, along with it, so too does the original bond and the protection it afforded.

Finally, as regards labour and materials bonds the same principles apply however the defence is restricted in scope. The reason for this is because a material change in the underlying contract does not generally affect the surety's liability, which is simply to ensure that payment to the suppliers and labourers occurs.[1]

Defence 2: Failure to Notify the Surety

The failure of the obligee to honour the notice provisions in the bond can result in the surety being relieved of liability. Typically, these provisions require that the surety receive notice of the principal's (contractor) default before the surety is called upon by the obligee (owner). The reason that courts require strict adherence to these provisions is because the surety **has a right to investigate the circumstances so that it can make an informed decision as to which course of action it will pursue**. This is particularly the case with performance bonds where the available options include paying out under the bond, stepping in and completing the work (in the case of performance bonds) or placing the work remaining up for tender. Failing to afford the surety that opportunity prejudices the surety.

Failure to provide timely notice of default does not invalidate the bond. However it may prevent the obligee from succeeding on a claim arising from the default. These notice provisions are in the bond, which is why it is important that you read, understand and adhere to the requirements under

[1] Bluenose Electric Ltd. v. Canadian Surety Co. *(1985), 67 N.S.R. (2d) 98 (T.D.), affirmed 68 N.S.R. (2d) 385 (C.A.).*

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the bond. Remember a bond simply put is a contract detailing the required obligations of the parties therein.

The law is clear that the obligee (the owner) must provide timely notice to the surety that the principal is in default under the contract. The notice must explicitly state that the principal has defaulted materially, that the obligee regards the contract with the principal as terminated and that the surety must begin to perform immediately. In addition, some bonds require that you give notice that you intend to note the principal in default so that the surety has an opportunity to try and rectify the situation before a default occurs.

As well, the law is clear that if the notice comes after it is too late for the surety to exercise its options (e.g. the work was completed by another contractor hired by the owner) then the surety will not be liable.[2] However, there are U.S. decisions which arguably go against this general rule but those cases had unique bond provisions.[3] By promptly notifying the surety of a default—especially a default that you intend to call upon the surety to remedy—you can reduce the likelihood of the court finding that the surety is not liable because it received insufficient notice of the default. Even if upon default by the contractor given the existing state of the work to be completed it is not the owner's then intention to make a claim on the bond, I still recommend giving the surety notice of the default. One cannot predict the future so why prejudice a possible bond claim.

Defence 3: Timing Issues

Defences relating to timing are also available to the surety. For labour and material bonds, timing defences are the primary defence raised. As regards performance bonds, failure to commence an action on time or provide timely notice of default has resulted in the dismissal of the obligee's claims.[4]

However, foreclosure of these defences is entirely within the power of obligees (i.e. owners and subcontactors). There are two key areas where timing issues can be fatal to a claim under the bond:

1. Failure to notify the surety of the principal's default;
2. Failure to bring an action for the claim prior to the expiry of the limitation period prescribed within the bond or the contract[5].

There are two important rationales supporting these defences. The first is that a person seeking to enforce a contract (i.e. the bond) should be in compliance with the contract. The second is that it is assumed that the surety will be prejudiced by the lack of notice. In the case of performance bonds, the prejudice arises from the inability of the surety to exercise its right to choose the manner in which it will honour the bond (i.e. complete the contract or pay the net face value of the bond).

It has been held that a surety implicitly waived a limitation period within a performance bond for the commencement of an action by negotiating extensively with the owner/obligee subsequent to the contractor's/principal's default and termination.[6] However, I strongly recommend that as an owner you not role the dice even if as owner you are engaged in good faith negotiations with the surety – **commence your action prior to the expiry of the limitation period in the bond**.

[2] *See, e.g.,* Marigold Holdings Ltd. v. Norem Construction Ltd. *(1988), 60 Alta. L.R. (2d) 289 (Q.B.);* New Look Restoration Ltd. v. Osgoode Developments Ltd. *(1993), 8 C.L.R. (2d) 238 (Ont. Gen. Div.);* Homes by Jayman Ltd. v. Kellam Berg Engineering & Surveys Ltd. *(1995), 20 C.L.R. (2d) 161 (Alta. Q.B.), reversed (1997), 36 C.L.R. (2d) 29 (Alta. C.A.).*

[3] *See e.g.,* Kilpatrick Brothers Painting v. Chippewa Hills School District No. 262396, *2006 WL 664210 (Mich. Ct. App. Mar. 16 2006)*

[4] *See, e.g.,* Whitby Landmark Developments Inc. v. Mollenhauer Construction Ltd., *[2000] O.J. No. 1360 (S.C.J.), affirmed (2003), 67 O.R. (3d) 628 (C.A.). See also* T.S. Manufacturing Co. v. Juniper Lumber Co. *(2000), 2 C.L.R. (3d) 279 (N.B Q.B.).*

[5] *See e.g.* Snapping Shoals Electric Membership Corp. v. RLI Insurance Co., *No. Civ A 105CV1714 GET, 2005 WL 3434803 (N.D. Ga. Dec. 14, 2005);* Guarantee Co. of North America v. Gordon Capital Corp., *[1999] 3 S.C.R. 423*

[6] Carle Place Union Free School District v. Bat-Fac Construction Inc. *813 N.Y.S. 2d 748 (App. Div. 2006)*

It is also necessary to give notice of a claim on the bond to the surety. The notice should be sent by registered mail to the surety and the principal. It should contain details about the claim including the name of the principal, the project bonded, the bond number, the amount of the claim, the nature of the services and/or materials supplied and the last date supply occurred.[7] Note that the last date supply occurred is the last date there was substantial supply—minor adjustments and touch-ups do not count for the purpose of calculating the limitation period.[8]

Defence 4: Reliance Upon the Principal's Defences

Finally, the surety can rely on any defences available to the principal (the contractor). These may relate to the formation of the contract itself, its enforceability or the obligee's/owner's failure to perform under the contract. The reason the surety can rely on any defences available to the principal is because the liability of the surety is coextensive with the liability of the principal. In simpler terms: the surety is only liable under its bond if the principal/contractor is liable to the obligee/owner. If the owner is in breach of its obligations to the contractor, the surety is not obligated under the bond to the owner. This is one of the most difficult decisions for a surety when met with a performance bond claim. The contractor whose owners have undoubtedly given a personal indemnity to the surety for any payments made by the surety under the bond will immediately point the finger at the owner for being in breach of its contractual obligations. The contractor will say to the surety "if you honour that bond claim, we are going to deny liability on our indemnity to the surety because the owner is in default, not us". The owner on the other hand will be screaming at the surety to make an immediate decision regarding the bond claim, failing which the owner, to mitigate damages, will hire another contractor to complete the work. It is a tough decision for a surety, one which a surety avoids having to make unless absolutely pressed. The surety will attempt with financial backing and the legal leverage it has with the owner under the bond to reach a compromise to enable the contract to be completed by the original contractor.

Defences Relating to the Contract Itself

Firstly, if the underlying contract is unenforceable then the surety will be released from its obligation. Circumstances that result in unenforceable contracts include invalidity, impossibility and illegality.

If the underlying contract is invalid for any reason then the surety will not be liable on the bond because the sureties liability is an accessory to the principal's liability. A corollary of this is that the liability of the surety cannot extend any further than that of the principal and, more often than not, is limited to the penalty provision of the bond. That said, the British Columbia Court of Appeal has upheld a decision finding that it is possible for the surety to be liable in excess of the bond penalty if it did not act "promptly".[9] I disagree with this decision and find support for such disagreement in U.S. jurisprudence (there are far more U.S. decisions in bonding litigation than Canadian decisions).

In *Simmons, Inc. v. Pinkerton's, Inc.*,[10] the Seventh Circuit Court of Appeal approved of its earlier decision in Orange Co. v. Brown[11] and stated "surety liability is contractual and cannot exceed the amount of liability expressly assumed in the surety contract."[12]

Similarly, *General Auth. for Supply Commodities v. Insurance Co. of N. Am.* upheld the traditional view that the surety's liability should not extend beyond the express terms of the contract. In making its decision the court stated:

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[7] *Kenneth W. Scott and R. Bruce Reynolds,* Scott and Reynolds on Surety Bonds, *looseleaf ed., (Toronto: Thomson Carswell, 2005) at §11.7(a),*

[8] Canadian Indemnity Co. v. Numan Industries Ltd., *[1989] B.C.J. No. 1951 (S.C.), reversed [1990] B.C.J. No. 2391 (C.A.)*

[9] John Laing & Son (Canada) v. United States Fidelity and Guarantee Company *(5 April 1969) (unreported) (B.C. C.A.).*

[10] *762 F.2d 591 (7th Cir. 1985).*

[11] *181 Ind. App. 536, 393 N.E.2d 192 (1979).*

[12] Supra*, n. 1 at 608.*

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> As the New York Court of Appeals long ago made clear "when the meaning of the language used has been thus ascertained, the responsibility of the surety is not to be extended or enlarged by implication or construction, and is strictissimi juris." Backus, 117 N.Y. at 201, 22 N.E. 759 (N.Y. 1889); see also Davis Acoustical, 22 A.D.2d at 843; Mendel-Mesick-Cohen-Architects, 74 A.D.2d at 713, 426. Because "the liability of a surety cannot be extended beyond the plain and explicit language of the contract," Mendel-Mesick-Cohen-Architects, 74 A.D.2d at 712….[13]

There are U.S. decisions which also are in line with the B.C. Court of Appeal decision. However, many of those cases also involve bad faith claims against the surety.

Similarly, if a valid contract becomes impossible to perform then the parties will be relieved of their obligations to perform. So too will the surety be relieved of its obligation because the surety's obligation does not exist independently of the underlying contract. Note that it is not enough that the contract will be onerous to perform. It must be impossible. The contract may set an impossible schedule,[14] it may require the works to be constructed on land that the obligee no longer has the right to build on,[15] or it may require the application of a specific method that, in fact, is impossible of performing[16]. In all these situations the surety will not be liable.

Release of the surety will also occur if the underlying contract is illegal. There are two ways that a contract will be considered illegal. The first type are those that cannot be performed legally. For example, if the plans and specifications included in the underlying contract do not comply with the building code.[17] The second type are those contracts that can be performed legally but are made with the intention of violating the law. For example, a contract to construct an addition to a bawdy house was held to be illegal and unenforceable.[18]

An issue that arises with labour and materials bonds is the problem of the "unnamed principal". Specifically, if a person claiming under the bond shares both the risks and the profits of the project then the person will be considered an unnamed principal who is unable to make a claim under the bond.[19]

Defences Relating to Performance

Defences relating to performance of the underlying contract that the surety may raise include:

1. There was no default by the principal/contractor; and,
2. The obligee/owner is in default.

The defence based upon the principal not being in default more frequently arises in the context of performance bonds. However, it can arise in the context of a labour and materials bond. For example, if the underlying contract includes a "pay when paid clause" whereby a subcontractor (who is the obligee) only gets paid when the principal gets paid and the principal has not been paid then the subcontractor will not have a valid claim against the surety.

At common law, a surety is not liable if the obligee/owner breached the underlying contract.[20] Consequently, it is important that the obligee not

[13] General Authority for Supply Commodities, Cairo, Eguypt v. Insurance Co. of North America, *951 F. Supp. 1097 (S.D.N.Y. 1997).*

[14] *See, e.g.,* Saskatchewan Housing Corp. v. Canadian Surety Co. *(1988), 64 Sask. R. 158 (C.A.).*

[15] *See, e.g.,* Enercon Limited now General Concrete Limited v. Canadian General Insurance Company, *[1978] O.J. No. 285 (H.C.).*

[16] *See, e.g.,* Yorkshire Water Authority v. Sir Alfred McAlpine & Son (Northern) Ltd. *(1985), 32 B.L.R. 114 (Eng.).*

[17] One Hundred Simcoe Street Ltd. v. Frank Burger Contractors Ltd., *[1967] 1 O.R. 195 (H.C.), varied (1968), 60 D.L.R. (2d) 602, [1968] 1 O.R. 452 (C.A.), affirmed (1969), 2 D.L.R. (2d) 735n (S.C.C.).*

[18] Miller v. Moore *(1911), 17 W.L.R. 548, 3 Alta. L.R. 297 (C.A.).*

[19] St. Paul-Mercury Indemnity Company v. United States, *238 F. 2d 691 (La. App. 1982);* American Fidelity Fire Insurance Co. v. Atkinson, *420 So. 2d 691 (La. App. 1982).*

[20] Royal Bank v. Salvatori, *[1928] 3 W.W.R. 501 (P.C.).*

breach the underlying contract. This applies whether the bond explicitly states that the obligee must not be in breach to rely upon the surety—such as in the CCDC Performance Bond—or whether it is silent on that issue. Similarly, the surety will not be liable for additional costs incurred because of a faulty design or method specified by the obligee.[21]

Other defences available to the principal that the surety can rely upon include the failure of the obligee to provide plans and specifications free from defects or—particularly with labour and materials bonds—that there was a failure to mitigate (because unused materials or equipment was left on site).

Concluding Remarks

It should be evident that a number of potential pitfalls await obligees (i.e. owners/ subcontractors) asserting claims against a surety. The defences discussed above—the material change defence, the failure to notify defence, the timing defences and the defences available to the principal - share one important characteristic: their availability (or more accurately, their lack of availability) is largely in the power of the obligee.

What then as an obligee (whether you are an owner, contractor or subcontractor) can you do to foreclose many of these defences? It's really quite simple:

1. Read the bond;
2. Adhere to the bond;
3. Work with your surety; and
4. Document your dealings with the surety.

Reading the bond will inform you of the notice requirements you must meet otherwise you run the risk of losing the benefits the bond provides you. Having read the bond and made yourself aware of what you need to do to comply with its terms, it is important that you then adhere to those terms. For example, if it sets out a payment schedule then adhere to that schedule. If it says that as a creditor you must file a claim within 120 days then ensure that you file your claim within 120 days.

Finally, in writing keep the surety in the loop and work with it. In the case of performance bonds, this involves giving the surety notice of and obtaining permission for any contractual variations that are not trivial. If you have a contractor or subcontractor that appears to be in financial difficulty such that it is a very real possibility that the job will not be complete unless payments are made early, then it is imperative that you let the surety know and obtain the permission of the surety before making the payments early.

Much of this advice may seem obvious. However, I have been kept very busy over my career because people fail to do the obvious. Thank you for having me here today, and hopefully my lecture will ensure that I will not see you in the future across the discovery table with me asking you questions in a legal action with me being counsel for a surety.

All the best.

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[21] *See, e.g.,* Halton Conservation Authority v. Toronto underground Contractors Ltd., *[1985] O.J. No. 1463 (C.A.).*