Construction Bonds:

A Useful Tool in a Local Government's Strongbox

By Adrienne Atherton and Sonia Sahota, P.Eng, Civic Legal LLP

Construction bonds are commonly used for public works infrastructure projects. Broadly speaking, a bond is a three-party agreement between the bonding company (the "Surety"), the service provider, such as a general or subcontractor (the "Principal" or "contractor") and the service recipient or beneficiary, such as the project owner (the "Obligee" or "owner"). Under the bond, the Surety is required to step in and fulfill the Principal's obligations to the Obligee in the event that the Principal breaches its obligations.

The cost associated with securing construction bonds is undoubtedly passed onto owners through the contractor's price for the work. As such, owners should not lose sight of bonds as a possible tool when contractor performance slips. The common types of bonds used in the construction industry in the procurement phase are bid bonds, and in the construction phase are performance bonds, and labour and material payment bonds.

A **bid bond** is commonly used to secure a bidder's obligation under the tender contract (Contract A) to enter into the works contract (Contract B) if selected as the preferred bidder. If the bidder breaches this obligation and refuses to enter into the works contract, then the owner may claim under the bid bond the resultant incremental costs associated with selecting the next highest preferred bidder, or conducting another procurement process.

A **performance bond** secures the Principal's obligation to complete the works required under the contract with the Obligee. If the Principal defaults in its performance of the contract, then the performance bond may be used by the owner to ensure completion.

Regardless of the type of bond, it is vital that all formalities of the formation of the bond agreement are undertaken, such as proper execution, witnessing and sealing if required, to ensure the enforceability of the agreement. Likewise, to ensure recovery under the bond, it is vital to adhere to all terms of the bond, such as notice requirements.

Once notice of a bond claim is provided to the Surety, the Surety largely controls the process of investigating the claim and determining the approach to remedy the Principal's default. Under a typical industry standard bond (such as the CCDC 9), the Surety's options may include: (i) the Surety remedying the default; (ii) the Surety completing the works; (iii) the Surety selecting another party to complete the works; or (iv) the Surety paying out to the owner. The third option is often a preferred choice for surety companies.

Once an owner provides notice of claim under the bond, it is required not to do anything that could prejudice the Surety, such as taking steps to remedy the default without the Surety's consent, terminating project-related insurance, or inadequately securing the work site from theft or damage.

A **labour and material payments or "L&M" bond**, secures the contractor's obligation to pay its subcontractors and suppliers for improvements made on the owner's project. An L&M bond is unique in that the owner acts as a trustee, and the subcontractors or materials suppliers, as the beneficiaries, may claim under the bond should the contractor default in its payment obligations to them.

Owners should be aware of a recent Supreme Court of Canada decision, *Valard Construction Ltd.* v. *Bird Construction,* which has expanded what the construction industry had previously understood the owner's role and potential liabilities to be in relation to an L&M bond. In this case, Bird was a general contractor for an oil sands project and subcontracted with Langford whom supplied an L&M payment bond naming Bird as the trustee.

Langford in turn subcontracted with Valard, but defaulted in its obligation to pay Valard. Valard failed to inquire about a possible L&M bond until after the bond's prescribed notice period for a claim had passed, but proceeded to file a claim nevertheless. Due to the expiry of the notice period, the Surety denied Valard's claim under the bond. Valard then sued Bird for breach of trust.

The Supreme Court of Canada found that Bird knew of the non-payment issue, but had failed to disclose to Valard the existence of the L&M bond. The Court determined that L&M payment bonds were uncommon

on private oil sands construction projects, which was a significant finding, given that the Court concluded as a result that it was incumbent upon Bird to have taken reasonable steps to notify potential beneficiaries, including Valard, of the existence of the L&M bond, such as posting a notice of the bond in the project trailer. In the result, the Court ordered Bird to pay Valard's claim.

Consequently, owners are wise to take steps to notify beneficiaries of the existence of bonds, such as posting a notice of bonds at a project site office, particularly where an owner becomes aware of any concerns that a contractor has not met, or may not meet, its payment obligations. Further, it is important for owners to ensure that Surety agreements, as with other project documentation, are easily accessible during the administration of the contract, and to be alive to and comply with the terms of Surety agreements, such as notice requirements, default provisions, and key dates and deadlines. ◗

This article is intended for general information. If your organization has specific issues or concerns relating to the matters discussed in this article, please consult a legal advisor.

Adrienne Atherton and Sonia Sahota are partners at Civic Legal LLP, a British Columbia law firm with expertise in local government law, land development, construction, procurement, insurance and complex contract matters. Sonia, a solicitor who, prior to becoming a lawyer, practised as a professional engineer for 10 years, and Adrienne, a senior litigator, work as a team in the areas of procurement and construction law to provide clients with a full range of legal services from concept through completion to dispute resolution. Visit www.civiclegal.ca for contact and additional information.