PERFORMANCE BONDS: WHAT PROJECT FINANCE LENDERS SHOULD KNOW

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As part of the performance security package for construction projects, project finance lenders (as well as project owners, landlords and government authorities) often require performance bonds from the construction contractor as security for the performance of the contractor's obligations. However, certain misconceptions prevail about performance bonds among those outside the construction industry. In this bulletin, we highlight a few key issues that we have encountered on recent project finance transactions, including: failure to negotiate and modify the 'standard form' of bond, issues overlooked during construction, the surety's right to an investigation after a claim for default, cross-default scenarios and the requirement for lenders to 'step-in', the surety's options in curing a default, and limits to the scope of surety's obligations.

Negotiating the Form of Performance Bond

Performance Bonds are issued by sureties in favour of the project owner (called the "obligee") to guarantee that the bonded contractor (called the "principal") will perform its obligations under the construction contract in accordance with the contract's terms and conditions. To add project lenders as beneficiaries to the performance bond, a dual obligee rider or multiple obligee rider is often issued concurrently with the performance bond, naming the project lenders and providing them with the same rights as the project owner (the obligee). Although the performance bonds and obligee riders used in Canada are based on forms published by the Canadian Construction Documents Committee ("**CCDC**") or the Surety Association of Canada it is important to note that these forms are negotiable and, particularly on large projects, often tweaked and modified to address specific concerns or add specific language.[1]

Issues to Consider During Construction

For a bonded project, if the terms of the construction contract are amended or varied, or the scope of work is expanded without the surety's knowledge, the surety can claim that such modifications were prejudicial to it. While it is common for owners and contractors to agree to change orders or variations over the course of a project, this can carry significant risks if the surety is not kept apprised of and does not consent to such modifications. If an obligee and principal vary the underlying contract without the surety's consent, the surety

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may be discharged from its obligations under the performance bond.

While older case law gave sureties significant power in determining whether a variation of a contract would discharge them, courts have since adopted a more balanced approach and taken a larger role in determining whether a surety should be discharged because of a variation. While there is no definitive test for materiality and prejudice, larger changes to a contract or any significant increase to a surety's risk may prompt a court to discharge the surety.[2]

Furthermore, some kinds of variations may be more problematic than others: significant increases to the scope of work, substantial changes to the nature of work, variations of the terms of payment, and extending deadlines and schedules may discharge a surety. For example, an extension may place the surety in a worse position to remedy the default because the status of the project has continued to deteriorate or the surety has released or lost some form of security. Similarly, a modification to the payment terms by front-loading payments may alter the risk profile of the project in a manner that is prejudicial to the surety. As a result, it is critical to keep sureties informed of any proposed variations in the contract so that their consent can be obtained, thus preserving the protection of the bond.

The Construction Contractor's Default and Notice to the Surety

It is important to note that an obligee cannot make a claim under a performance bond unless the principal has materially breached or defaulted in some way in its performance of the underlying construction contract. Furthermore, this default must have actually resulted in a loss incurred by the obligee. Mere disagreements or complaints between the parties will not suffice to justify a claim without an actual breach of the contract.

Once a default has occurred, regardless of the precise terms of the bond, the obligee must give the surety notice of the default. Significantly, giving notice provides the obligee with the opportunity to formally declare the principal in default, which will be a condition to any claim under typical forms of performance bonds. There are no form requirements for such notices at common law, however, the notice must be explicit and unambiguous. Complaints or even express allegations of breaches of contract will not necessarily suffice without a clear declaration of a default under the bond.

Next, the surety must be given the opportunity to investigate and respond to the default and any unilateral action by the obligee may prejudice the surety's position thus discharging the surety. It is therefore generally advisable to involve the surety as quickly as possible upon the occurrence of a default. This does not mean, however, that an obligee must notify the surety of all problems with the construction project to maintain the protection of the bond, unless this is a term of the bond itself. While courts have suggested that obligees should involve sureties when there is a non-trivial or major problem, an obligee will generally have the power to determine whether a breach is so significant that it wishes to notify the surety and declare the principal in

default.[3]

The Obligee's Default and Lender Step-in

Obligees must also consider whether they are themselves in default under any provisions of the underlying construction contract before making a claim to the surety. This is especially important if the obligee's performance is an express condition under the bond's terms, which is the case in the typical CCDC form of performance bond and the Surety Association of Canada form of performance bond. Where such a term exists, the obligee's compliance with the contract is critical to maintaining the liability of the surety. Even at common law, a court may treat an obligee's duties under the construction contract as conditions precedent to claiming under the bond.

If both the obligee (the owner) and the principal (the contractor) are in default and the project lender makes a claim to the surety pursuant to a multiple obligee rider, the surety may require that the lender first cure the obligee's default as a condition precedent to claiming under the bond. To ensure the continued compliance by the obligee of its obligations, the surety may further require that the project lender first exercise its step-in rights and step-in as the obligee before it honours the performance bond. Some sureties have even taken the position that a lender's exercise of step-in rights is a condition in its own right before such lender has the ability to deal with the surety even pursuant to a multiple obligee rider. Although the merits of such reasoning are uncertain, case law is silent on this matter and, given the urgency in which such situations would arise, it is difficult to assess how such a dispute would play out.

The Surety's Rights and Options

As noted above, once a notice of default has been delivered to the surety, the surety will first and foremost require reasonable time to investigate the claim and make an independent assessment as to the veracity of the default claim. The typical CCDC form of performance bond used in Canada does not specify any time limit for this investigative process and, depending on the size and complexity of the project, the progress of construction, and the complexity of the default claim and any counterclaim, it could be reasonable to expect the investigation to take several days or weeks, if not months.

Once the surety concludes its investigation and agrees that a default has occurred, it has a number of different options to rectify the default. It is important to note that, although every performance bond contains a penal sum, representing the maximum liability of the surety (often equal to 50% of the contract price), paying this sum is typically just one of several options available to a surety and practically the very last option that the surety would entertain after exploring all others. The surety will not generally be required to simply pay the penal sum unless it fails to execute one of its other options. The standard options commonly included in performance bonds are:

1. Remedy the default: One option is that the surety may seek to remedy the default in some way, for instance, by working with the principal (the existing contractor) and the obligee to resolve disputes between the parties.
2. Obtain bids: Failing option 1, the surety is most likely to solicit bids for completion of the construction on the terms of the existing construction contract and then offer these bids to the obligee who may enter into a new contract for completing the project.
3. Complete the contract: If the surety is not able to procure reasonable bids or if the bids are not reasonably acceptable to the obligee, the surety may attempt to complete the construction contract itself by hiring a new contractor and executing a completion contract.
4. Payment of the Penal Sum: Finally, if none of the foregoing options are feasible or practical, the surety can discharge its obligations under the Performance Bond by paying over the penal sum of the bond minus the balance of the contract price.

Which option a surety chooses to pursue upon accepting the default affects both its involvement in the project but also its right to any monies held by the obligee for the completion of the original contract. The most important distinction is whether the surety completes the contract itself or offers the obligee bids for completion contracts with third parties. Where a surety decides to complete the project itself, the obligee must pay the surety the balance of the contract monies as a condition for completion. This balance, together with the remaining amount under the penal sum of the bond, forms the surety's maximum budget and expenditure on the project. If both are exhausted, the surety would then expect to assign the rest of the completion contract back to the obligee.

The situation is very different when the surety decides to provide bids for completion contracts. In such circumstances, the surety would generally have no direct entitlement to the balance of the contract price. However, the obligee will be expected to exhaust that balance of the contract price in payments to the new contractor before turning to the surety for contribution up to the remaining room under the penal sum of the bond. Finally, it is also important to note that the surety may also have entitlement to the contract funds through the obligee's set-off rights as part of its subrogatory rights as a surety.

(Limits to) The Scope of Surety's Obligations

Despite being a fundamental issue regarding performance bonds, the scope of a surety's liability is arguably one of the most contentious. While the amount of the bond itself determines the surety's ultimate liability for any default by the principal, there are conflicting lines of authority on what that sum may be applied to.

In some instances, Canadian courts have adopted a restrictive approach and held that a surety is only responsible for completing the actual building/construction work, and not responsible for any additional

obligations contained in the construction contract (such as payment of liquidated damages, sharing of any profits, etc.). Under this approach, the surety's liability is limited to the "bricks-and-mortar" obligation to complete the construction project and does not include other obligations or damages claims derived from the underlying construction contract. The Saskatchewan Court of Appeal notably adopted this position in *Lac La Ronge Indian Band v. Dallas Contracting Ltd.*[4]

In other instances, courts have taken the position that a surety is responsible for all of the principal's obligations under the construction contract. This line of case law holds that, where the construction contract is incorporated into the bond by reference, as is commonly done, the surety will be liable for not only the construction work but also any other terms or obligations of the principal, which may allow for a variety of damages claims. The Ontario Court of Appeal adopted this approach in *Whitby Landmark Developments Inc. v. Mollenhauer Construction Ltd.*[5]

Given the uncertainty around the scope of the surety's obligations beyond the "bricks-and-mortar" construction, it is advisable not to rely on standard forms of performance bonds as security for any financial obligations. These may be secured by negotiating the terms of the bond to add express language regarding financial obligations that could sway a court's view of the scope of the surety's obligations or, alternatively, by other forms of performance security (such as liquid bonds or letters of credit) that more directly address such obligations.

A related but slightly more complex issue is, if the bonded construction project has been completed, whether a surety remains liable for warranty provisions in the contract. Again, case law remains unclear on this point. However, a prominent line of authorities has held that, since the terms of the bond supersede the terms of the construction contract, even valid claims under warranty provisions will not be allowed if they fall outside the limitations term of the bond.[6] As such, to ensure that warranty obligations are covered, it may be critical to have express language in the performance bond regarding these obligations and the warranty period.

As indicated by the foregoing key issues that we have experienced on recent transactions, the issues that performance bonds can raise in the course of a project are complex and fact-specific. Please contact us if you have any questions or comments with respect to any of the above information.

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[1] In Ontario, for certain infrastructure projects where a procurement process was initiated after July 1, 2018, a new form of performance bond (Form 32 under Section 85.1 of the *Construction Act*, RSO 1990, c C.30) has been prescribed that will be discussed in a future bulletin.[ps2id id='1' target=''/]
[2] See *Marigold Holdings Ltd v Norem Construction Ltd* (1988), 89 AR 81, 60 Alta LR (2d) 289 (QB). But see *MGN Constructors Inc v Axa Pacific Insurance Co*, 2013 ABQB 216 [*MGN Constructors*].[ps2id id='2' target=''/]

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[3] See *MGN Constructors, supra* note 2; *Thomas Fuller Construction Co (1958) v Continental Insurance Co (1970)*, [1973] 3 OR 202, 36 DLR (3d) 336 (H Ct J).[ps2id id='3' target=''/]
[4] *Lac La Ronge Indian band v Dallas Contracting Ltd*, 2004 SKCA 109.[ps2id id='4' target=''/]
[5] *Whitby Landmark Developments Inc v Mollenhauer Construction Ltd* (2003), 67 OR (3d) 628, 178 OAC 49 (CA).[ps2id id='5' target=''/]
[6] See *Fraser Gate Apartments Ltd v Western Surety Co* (1998), 54 BCLR (3d) 1, 160 DLR (4th) 577 (CA); *Cooperative D'Habitation Antigonish v Laurentian General*, 13 CLR (3d) 97, 2001 CarswellOnt 3346 (Sup Ct J).[ps2id id='6' target=''/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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