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CONSTRUCTIVE THINKING

A BONDING EXPERIENCE:

Protection Through Performance Bonds and Labour & Material Payment Bonds

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Owners may expose themselves to substantial risks if they fail to require performance and labour and material payment bonds for a construction project. If a contractor defaults, prior to completion of the project, this typically increases an owner's cost of construction and almost certainly delays completion. Further, an owner may have limited recourse against a defaulting contractor particularly if the contractor becomes insolvent after the default. Consequently, a prudent owner should consider requiring the posting of bonds for any construction contract.

A bond is a risk management tool designed to ensure responsible contract performance and financial security. Construction bonds protect an owner against certain risks in the event the contractor defaults in its obligations. The bond issuer guarantees that the contractor will satisfactorily perform its contractual obligations. As the use of construction bonds has become routine, it is not unusual to require a bond (or bonds) as a condition precedent to the awarding of a contract to a contractor. Thus, many contractors obtain quotes for all the bonds required for a specific project in advance of tendering so that the amount of the bond premiums are known and included in their bid.

There are four main types of bonds available in the construction context: bid bonds, performance bonds, labour and material payment bonds, and construction lien bonds. This article will explain performance bonds and labour and material payment bonds.

The following terms are commonly used in performance and labour and material payment bonds:

> "Principal" is the party that is deposits the bond with the Owner. Often, this party is the general contractor.
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> "Obligee" is the party to whom the bond is payable in the event of a default by the Principal. Often, this party is the Owner.
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> "Surety" is the party that issues the bond which guarantees the performance of the Principal's contractual obligation.
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> "Penal Sum" is the amount of the bond which the Surety agrees to make available in the event of the default by the Principal. The other obligations of the Surety, in the event of a default by the Principal, are set out in the bond.

Performance Bonds

A performance bond indemnifies the Obligee up to the Penal Sum of the bond in the event that the Principal defaults under the construction contract. The performance bond is not intended to cover the payment of labour and material claims, which would be covered by a separate labour and materials payment bond as discussed below. Rather, the performance bond secures the completion of project.

When the Principal defaults under the contract, the Obligee is required to provide written notice of the default which would include the timing of the default, the particulars of the default, and the contractual provisions that have been breached by the Principal. Upon proper notice of the Principal's default, the Surety is required to investigate the default, in good faith, in a timely manner. The bond will set out the options which are available to the Surety when a claim is made on the bond by the Obligee. On condition that the Principal is actually in default, as alleged by the Obligee, the Surety has a number of options available to it. They are as follows:

1. remedy the default by either paying the damages incurred by the Obligee as a result of the default

In remedying the default, the Surety may elect to provide interim funding, or other forms of support, to the defaulting Principal in order to assist the Principal in completing the contractual obligations.

2. remedy the default and complete the contract

Even though the Surety is not in the contracting business, it may retain a replacement contractor to remedy the default and complete the contract. In doing so, the Surety will demand payment of any outstanding monies due and owing by the Obligee to the defaulting Principal, and the Surety will then seek recovery of any extra costs from the Principal directly.

The Surety may also act as a conciliator between the Obligee and the defaulting Principal. Adopting this approach allows the Principal to continue to perform the contract, but under the guidance and supervision of the Surety--despite being found in default by the Obligee. Often, the "reappearance" of the defaulting Principal gives the Obligee concern that the default, which the Principal caused in the first instance, will not be corrected, or that the relationship between the defaulting Principal and the Obligee is impossible to fix following the default. With this approach, the Surety must be very skilled at managing the relationship between the Obligee and the defaulting Principal.

3. solicit bids from other contractors for the completion of the contract.

This is the approach that is most favoured by Obligees. The Surety and Obligee work together to select the lowest responsive bidder through a public re-tendering of the remaining scope of work; however, because the nature of the situation is often urgent, several contractors will typically be asked to bid to complete the project. The contractors often include the contractors who initially bid on the project and other contractors known by the Surety or Obligee to be experienced in the type of construction required. The new contractor may be required to obtain a performance bond of its own for the completion work. The Obligee will be required to pay the balance of the contract price to the new contractor and the Surety will then make funds available to the Obligee under the bond to make progress payments. Once the bond amount has been reached, the remaining cost is the Obligee's responsibility.

In the three scenarios described above, the Surety is responsible for the "hard' costs arising from the Principal's default. The Surety may also be responsible for "soft" costs associated with the default. These soft costs may include extra internal costs and expenses for project contract administration, extra consultant fees, and legal fees. However, some sureties may be inclined to only cover hard completion costs rather than any soft costs. In all instances, the total funds available to respond to the Principal's default are limited to the Penal Sum of the bond. Lastly, there is an important limitation period in the performance bond. In order to advance its claim on the bond, an Obligee must commence its action within 2 years from the time that the last payment under the contract falls due failing which its claim will be barred.

Labour and Material Payment Bonds

A labour and material payment bond guarantees that all unpaid subcontractors and suppliers (referred to as "Claimants" in the bond) to the Principal will be paid for labour and materials which they furnished to the project. With a labour and material payment bond, the Obligee is safeguarded from claims by the Claimants. In advancing a claim under the Labour and material Payment Bond, a Claimant must prove that materials and/or services were supplied to the project. Further, there are also important limitations and timelines contained in the bond, with which the Claimant must comply.

Surety's Defences to Performance Bond Claims

If the Surety is called upon to respond to a claim on a bond, it will first investigate whether there are any defences available to preclude the Surety from paying out under the bond.

In the context of a performance bond, the construction contract between the Obligee and Principal is incorporated by reference in the performance bond. The Surety will only respond to the default provided that the Principal is actually in default. Often, a Surety will dispute the Obligee's declaration of the Principal's default. Further, a Surety will only respond to a demand on the bond if the Obligee has met all of its obligations under both the bond (e.g. giving the required notice in the required time) and the contract (e.g. paying the monies owing to the Principal when due). If the Obligee fails to provide adequate notice of its claim to the Surety, the Surety may claim that it has been prejudiced and that the Surety has lost its ability to investigate, and possibly remedy, the alleged default of the Principal.

Another ground upon which a Surety may rely to deny a claim on a performance bond is that the Surety has not been notified of changes to the contract or changes to the work which materially affect the Surety's risk. Courts have found this to be a valid defence in cases where:

- additional work substantially increased the contract price,
- there are changes to payment terms (dates for progress payments and the release of holdbacks, for example),
- the Principal, or its subcontractors, are inexperienced to do the work, and
- there are unreasonable changes to the completion time that are within the Principal and Obligee's control.

Consequently, the Obligee should notify the Surety, in writing of, and obtain its written consent to, any material and/or prejudicial changes to the terms of the contract.

In conclusion, there are clear benefits to an owner in requiring a contractor to deliver performance and labour and material payment bonds in respect of a construction project. Simply possessing a bond is meaningless. An owner must fully understand the roles and responsibilities of each party to the bond, as well as the conditions and limitations in the bond which could affect an owner's rights. Bonds are only one aspect of a comprehensive risk management strategy for any construction project.

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