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Only Bricks and Mortar? Your Performance Bond Might Cover More Than You Think

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Players in the construction industry rely on risk allocation to keep the industry functioning. As Covid-19 has reminded us, the world is full of uncertainty; even carefully planned, well-organized projects can be derailed by insolvencies, poor performance, inclement weather, breakdowns in the supply chain, or global pandemics.

For owners, a performance bond is an effective hedge against the negative consequences of unpredictable risks; in fact, on larger projects, owners may require that a general contractor procure a performance bond from a surety as a condition of being awarded the project. Under a performance bond, the owner typically assumes the role of "Obligee" and the general contractor assumes the role of "Principal". If a general contractor defaults under the contract, a performance bond enables the owner to call on the surety to complete the project. The surety can complete the project using one of three options:

1. the surety can remedy the contractor's default;
2. the surety can complete the contract in accordance with the contract's terms and conditions; or
3. the surety can obtain bids to complete the contract in accordance with the contract's terms and conditions, and, in consultation with the owner, award the completion contract to the "lowest responsible bidder".

Among these three options, option 3 is the one most commonly pursued. Once the surety and the owner solicit bids for the remaining work and determine the "lowest responsible" bidder, the surety must make available sufficient funds to pay the "costs of completion" minus the balance of the original contract price. But what do the "costs of completion" include, exactly? Are these costs limited to the cost of labour and material? Case law suggests that the "costs of completion" might be more expansive than you think.

Whitby Landmark Development Inc. v. Mollenhauer

The Ontario Court of Appeal weighed in on this issue in the 2003 decision *Whitby Landmark v. Mollenhauer*. In 1990, Whitby Landmark Development Inc. entered a construction contract with Mollenhauer Construction Limited for the construction of a condominium in Whitby, Ontario. The construction contract included a provision whereby Landmark and Mollenhauer would share any costs savings on the project (75 per cent to the owner and 25 per cent to the contractor). The construction contract also required Mollenhauer to provide Landmark with a performance bond.

Mollenhauer ceased carrying on business before it had completed work under the contract. Landmark completed the work itself, then made a claim under the bond. Landmark demanded payment of the balance of its share of the costs savings under the construction contract, ultimately fixed at $601,972.

The surety refused to pay. Its position was that the bond only covered the costs of completing the physical construction work and did not extend to collateral obligations such as the contractor's obligation to share the cost savings it achieved.

In responding to the surety's argument, the Ontario Court of Appeal noted that the bond provided that the construction contract documents were part of the bond. All benchmarks for actions and obligations under the bond were referenced to the contraction contract. In other words, the surety's obligation was not to complete the construction work, but to complete the *contract* in accordance with the contract's terms. The Court of Appeal wrote: "There is no language in the bond that limits in any way the references to the construction contract or the obligations to complete that contract or to act on a default under that contract." After parsing the specific language setting out the surety's options for completing the contract under the performance bond, the Court of Appeal concluded as follows:

"[Subject] to the operation of the bond in any particular circumstances, I conclude that there is no basis in the language of the bond or in the circumstances surrounding its negotiation or completion to suggest that the cost-sharing provisions of the construction contract are not included as bonded losses."

Whitby Landmark stands for the idea that payment of a collateral monetary obligation that is provided for in a construction contract (such as a cost-sharing arrangement) may become the surety's obligation in the event of a contractor's default. While *Whitby Landmark* specifically referenced a cost-sharing arrangement, it is easy to imagine how this principle could extend to similar collateral monetary obligations provided for in a construction contract. For example, if a contract provides that the contractor is responsible for paying the owner costs incurred as a result of the contractor's delay, and then the contractor defaults as a result of causing delay, arguably the delay costs owed by the contractor form a collateral monetary obligation no different than the obligation to pay the owner a portion of cost-savings. If the latter is considered a bonded loss by the Ontario Court of Appeal, could not the former be considered a bonded loss as well?

Lac La Ronge

The Saskatchewan Court of Appeal adopted a competing approach in the decision 2004 decision *Lac La Ronge Indian Band v. Dallas Contracting Ltd.* Like *Whitby Landmark*, *Lac La Ronge* dealt with a contractor in default, and to what extent the surety's obligation to complete the contract included an assumption of collateral monetary obligations.

At trial, the judge found that the surety's obligation to "complete the Contract in accordance with its terms and conditions" included a contractual obligation to pay $1,000 per day in liquidated damages for late completion of the contract. The trial judge relied on the trial decision in *Whitby Landmark* (among other authorities) in support of his conclusion that the surety was obligated to include payment of liquidated damages in its calculation of the costs of completion.

The Saskatchewan Court of Appeal disagreed with the trial judge on this point. The Court of Appeal noted that where a surety is found liable for failing to respond to a performance bond claim, liability flows from the surety's failure to respond to the bond claim *as a whole*; not a failure to adopt one option for completion over another. Damages owed by the surety should be the same regardless of which of the 3 options for a completion the court uses to determine the extent of the surety's liability. The Court discussed option 3, in which "balance of the contract price" is defined as "the total amount payable by the Obligee to the Principal under the Contract, less the amount properly paid by the Obligee to the Principal" and analyzed the implications of this wording as follows:

[65] The phrase is not "amount payable by the Obligee to the Principal." It is, rather, the " *total* amount payable by the Obligee…less the amount properly paid." The total amount payable by the Obligee to the Principal under the Contract is the amount of the Contract.

Relying on principals of contractual interpretation, as well as the need for commercial certainty arising from the widespread use of an industry-standard performance bond, the court concluded that the surety's obligation under the performance bond is to "complete the work" rather than "perform all obligations under the Contract."

***Whitby Landmark vs. Lac La Ronge* – Who's Winning?**

The appellate decisions in *Whitby Landmark* and *Lac La Ronge* are over 15 years old, but the differences between these decisions reflect a live, unsettled issue in the case law.

Essentially the debate is this: is the surety's obligation under a performance bond an obligation to pay for only the remaining bricks-and-mortar construction work (the *Lac La Ronge* approach) or is it a broader obligation to complete the contract, and in doing so, provide the owner with the same collateral benefits it would have received if the contractor had not defaulted under the contract (the *Whitby Landmark* approach).

The debate has been most recently considered in two decisions out of Alberta: the 2013 decision in *MGN Constructors Inc. v. AXA Pacific Insurance Company*, and the 2017 decision in *Vermilion & District Housing Foundation v. Binder Construction Limited*.

In *MGN*, Justice Graesser was not able to reach a decision on the scope of the performance bond based on the evidence available to him; however, he considered the debate between *Whitby Landmark* and *Lac La Ronge*, and wrote that he preferred the *Whitby Landmark* approach:

[126] Were it necessary for me to decide the case on this basis, I prefer the reasoning of Justice Lamek at trial and the Ontario Court of Appeal in ***Whitby Landmark***, and the trial judge's reasoning in ***Lac La Ronge,*** to that of the Saskatchewan Court of Appeal. I fail to see how a surety can arrange for completion of the contract in accordance with its terms and conditions unless it is responsible for any acceleration costs to meet the original schedule, and any delay damages the owner is entitled to if the schedule is not met. Otherwise, that would mean in cases where it is not possible, even by herculean acceleration efforts, to complete the work on schedule after the Principal's default, the blameless owner would be unable to deduct its legitimate delay damages from the amount otherwise owed to the defaulting Principal. That in my view distorts a fair interpretation of "the amount properly paid by the Obligee to the Principal".

In *Vermillion*, Justice Nielsen also considered the debate between *Whitby Landmark* and *Lac La Ronge* and also adopted reasoning that favours *Whitby Landmark*. The issue in *Vermilion* was whether lost income related to forgone rent (resulting directly from remedial work) was within the surety's obligations under the performance bond. Justice Nielsen noted that payment of lost income resulting from the correction of deficiencies was a contractual obligation of the contractor, and was therefore part of the cost of completing the contract:

[315] In my view, it would have been within the reasonable contemplation of both Vermilion and Guarantee Company that if it was necessary to carry out remedial work in relation to the work of Binder pursuant to the Construction Contract, such remedial work might result in some loss of income to Vermilion. In my view, such losses would fall within the "cost to complete" the work as set out in option 4 of the Performance Bond. Such costs fall within the indemnity obligations of Binder pursuant to General Condition 9.2.1 and the obligation to pay for damage resulting from corrections made during the warranty period pursuant to General Condition 12.3.5.

Conclusion

While the debate over the extent of the surety's obligations under a performance bond continues, it is notable that, in the two most recent decisions to consider the competing positions, the judge in each case adopted the more expansive approach reflected by *Whitby Landmark*.

However, the debate over the extent of the surety's obligations becomes meaningless if the owner calling on the bond fails to adhere

to their own obligations in the first place. In *Whitby Landmark*, the owner's success on the cost-sharing issue became a moot point after the court found that the owner had not given the surety timely notice of the contractor's default. This underscores a point that may be obvious but is nevertheless essential: owners and contractors must familiarize themselves with the terms and conditions of their contracts (including performance bonds), and scrupulously observe all notice periods. Defective notice given to the surety of a contractor's default may leave an owner unable to collect any costs at all from a surety, let alone collateral costs.

Provided that notice is given in a proper form, and within the correct time period, case law suggests that owners in Ontario have a reasonable prospect of collecting more than just their bricks-and-mortar costs from their sureties. If you are faced with a contractor that has defaulted, or potentially defaulted, under contract, it is advisable to inform your surety as soon as possible to thoroughly mitigate all potential losses.

This information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

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