



The Risk Management Committee is pleased to provide this risk management article for the members of CDBI. The following article addresses the risks and issues associated with surety bonding claims when a contracting party is deemed to be in default under their contractual obligations. At the last annual CDBI conference in Saskatoon, SK, there was a lively discussion during the one day tutorial on the aspects of surety bond claims as they would pertain to design-build contracts.

The article does reference a general contractor and subcontractor, conducting business in a traditional design-bid-build environment, however, the circumstances and challenges referenced in this paper can readily occur in a design-build contract environment. The article does provide a good example on the complexity of surety bond claims when either an Owner or a General Contractor is seeking recovery from surety bonds and the position taken by the surety companies defending these claims.

The Risk Management Committee of the Canadian Design-Build Institute will continue to circulate articles of this nature to members as they become available. We trust this will be found to be of interest and beneficial to the members.

## **The Extent of a Surety's Obligation under a Performance Bond: An AXA to Grind**

**By Paul Stocco<sup>1</sup> and Eleni Loutas<sup>2</sup>**

Despite the wording set out in a performance bond, the extent of a Surety's obligations to an Owner/Obligee, in the event of a default by the Principal, is unclear. There are two perspectives and each one is represented by a decision of an appellate court.

On the one hand, the Ontario Court of Appeal has held, in the *Whitby Landmark Development Inc. v Mollenhauer Construction Limited* ("Whitby") case, that a performance bond Surety is responsible for all of the Principal's obligations/liabilities under the bonded contract, not just those related to the costs of completing the physical construction e.g. Principal's potential liability for liquidated damages for delay payable to Obligee. By contrast, the Saskatchewan Court of Appeal, in the *Lac La Ronge Indian Band v Dallas Contracting Ltd.* ("Lac La Ronge") case, has held that the scope of a Surety's obligations under a performance bond are limited to completion of the physical work solely.

Recently, the Alberta Court of Queen's Bench, in the *MGN Constructors Inc. v AXA Pacific Insurance Co.* ("MGN") case, has added its views to this debate.

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In *MGN*, the City of Edmonton entered into a development agreement with a developer (“Proland”), who in turn, contracted with a general contractor (“MGN Constructors”) for road construction work. MGN Constructors subcontracted some of the work to a subcontractor (“Sprague Rosser”), and as part of its subcontract, Sprague Rosser was required to provide a performance bond. The performance bond was issued by AXA and it named both MGN and Proland as Obligees.

MGN Constructors and Sprague-Rosser eventually had disagreements about the quality and timeliness of the work performed by Sprague-Rosser. The failure of Sprague Rosser to perform the work caused the City of Edmonton to hold Proland in default of the development agreement. This then set off a chain reaction which culminated in MGN Constructors terminating Sprague Rosser’s subcontract. MGN then made a claim on the AXA performance bond seeking damages for completion of the deficient and incomplete work and for all other damages suffered by MGN as a result of the default and termination i.e. fees, carrying costs, and overhead.

AXA applied to dismiss MGN’s claim on a number of grounds; however, AXA’s summary dismissal application was unsuccessful before the Master. AXA then appealed the matter to the Court of Queen’s Bench and AXA made a number of arguments including: the bond was no longer valid given that the subcontract had been terminated by MGN Constructors; there had been a material variation to the subcontract such that it prejudiced AXA; MGN had failed to comply with its obligations under the subcontract by failing to pay monies owed to Sprague Rosser when due; to the extent that MGN Constructors’ claims were for matters other than the completion of the physical work, these claims were not covered by the performance bond.

In rejecting AXA’s argument that the termination of the subcontract by MGN Constructors effectively prevented AXA from implementing any remedies under the bond, the Court noted that MGN Constructors’ contract had been terminated further up the contract chain. The Court also noted that if the termination of the subcontract was caused by the actions of Sprague Rosser i.e. the failure of Sprague Rosser to complete the work properly, then AXA could not take advantage of the default of its own Principal and claim that the performance bond would not respond. Further, the Court held that the fact that the subcontract had been terminated did not, in and of itself, give rise to prejudice being suffered by AXA and there was no evidence to show that AXA had actually been prejudiced.

AXA also argued that there had been material changes to the subcontract (e.g. change orders were issued that increased the subcontract amount; an extension of time had been granted by MGN Constructors in favour of Sprague Rosser). AXA argue that these changes gave rise to prejudice. The Court also rejected this argument on the grounds that there was no evidence before the Court that would support a finding of prejudice. The Court noted that increases to the contract price, or extensions to contract schedule were not, in and of themselves, material changes that exposed AXA to greater risks.



Each change would have to be assessed on its own and actual prejudice had to be proved.

AXA also argued that MGN Constructors had failed to comply with its obligations under the subcontract. The Court also rejected this argument as the evidence before it was inconclusive on this point.

Lastly, AXA argued that the claims being advanced by MGN Constructors represented more than just “sticks and bricks” and as such, were not covered by the performance bond. Despite the Court having already denied AXA’s appeal on the grounds noted above, the Court went on to examine the competing caselaw regarding the extent of a Surety’s obligations as represented by the *Whitby* and *Lac La Ronge* cases.

The Court held that it was not necessary to decide the appeal on the basis of the competing caselaw; however, if it were necessary for the case to be decided on the basis of either the *Whitby* or *Lac La Ronge* case, the Court stated that it preferred the approach of the Ontario Court of Appeal in the *Whitby* case. The Court reasoned that AXA could not fulfill its obligations expressly set out in the bond, namely, “arrange for completion of the subcontract in accordance with its terms and conditions” unless AXA was fully responsible for all of the contractual obligations and not just the completion of the physical work. The Court also stated that if AXA had wanted to exclude certain obligations under the subcontract, then it could have easily said so in the express terms of the performance bond. The Court noted that the surety industry had done nothing to change the wording in a standard performance bond to clarify the uncertainty about what is, and what is not, covered. In fact, the Court suggested that the industry could create two types of bonds with different pricing: one bond type for only “bricks and mortar” and another type of bond to cover all other contractual obligations.

The decision in *AXA* will undoubtedly fuel further discussion about the extent of a surety’s obligations under a performance bond, and hopefully, it will give rise to changes in the wording of performance bonds generally. In the meantime, in Ontario, sureties are exposed for all contractual liabilities including physical completion of the work and liquidated damages for delay. By contrast, in Saskatchewan, sureties are only liable for the completion of the work. Until the Supreme Court of Canada renders a decision, the uncertainty regarding the extent of a surety’s obligation under a performance bond will remain.

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