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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 becomes insolvent and is subject to receivership.

This is a follow up article to one that was published in 2012 by CDBI. The original article is attached to these updated comments to assist with your understanding. The article does reference a general contractor, 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 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.

What's on the Horizon Part II?:
By Paul Stocco

In the case of ***Re Horizon Earthworks Ltd.***[1], the Alberta Court of Queen's Bench attempted to clarify the entitlement of competing claimants to monies "earned but not yet paid" by the MD of Greenview ("MD") to an insolvent contractor ("Horizon"). Like many construction contracts that allow an owner to pay an unpaid subcontractor directly upon receipt of notice of an unpaid account, the MD's contract with Horizon allowed the MD to pay unpaid subcontractors of Horizon directly. At the time that the MD attempted to pay the Horizon's unpaid subcontractors directly, Horizon was already bankrupt. The Alberta Court of Queen's Bench held that the provisions of the ***Bankruptcy and Insolvency Act*** ("***BIA***") prevented the MD from making that payment. Essentially, the Court held that the MD could not pay, in the face of a claimant with a registered priority security interest or a priority creditor as per the ***BIA***, "earned but not yet paid" funds to unpaid subcontractors of Horizon. The Court then directed that the withheld monies be paid to the secured creditor in accordance with the priority scheme in the ***BIA***. The matter was then appealed by the MD to the Alberta Court of Appeal.[2]

[1] 2011 ABQB 799
[2] 2013 ABCA 302

Before the Court of Appeal, the MD argued that the contract wording (which allowed the MD to pay unpaid subcontractors directly), when combined with the wording found in the labour and material payment bond which allowed the MD to commence an action on behalf of unpaid claimants, created a special relationship between the MD and the unpaid subcontractors such that the MD was exempted from having to adhere to the priority scheme in the ***BIA***.

The Court of Appeal rejected this argument on the grounds that there was no special relationship created between the MD and the unpaid subcontractors by virtue of the wording in the contract or the labour and material payment bond that would exempted the payment from the application of the ***BIA***.

However, the Court of Appeal could not determine whether, at the time of Horizon's bankruptcy, any monies were actually owed by the MD to Horizon. As a result of this uncertainty, the Court of Appeal remitted the matter back to trial for determination of this issue. In other words, the Court of Appeal held that if the MD owed money to Horizon at the time of Horizon's bankruptcy, those monies would become the property of the Trustee in bankruptcy.

For potential creditors of general contractors (i.e. unpaid subcontractors), this decision is an important reminder that the provisions of the ***BIA*** cannot be avoided in the event of the contractor's bankruptcy. Even if the wording in the prime contract allows a willing owner to pay an unpaid subcontractor directly, it is unlikely that an owner can do so. If the owner holds, at the time of the contractor's bankruptcy, any monies earned but not yet paid to that contractor, those funds will become part of the bankrupt contractor's estate to be distributed by the Trustee in bankruptcy as per the priority scheme in the BIA.

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Paul V. Stocco is a partner and the head of the Construction Law Team for the Alberta based law firm of Brownlee LLP. Paul's practice involves providing advice to his clients on issues relating to all aspects of construction contracts including design-build and P3s, and construction procurements involving tenders and RFPs. Paul also represents clients involved in construction litigation at all levels of Courts. Paul is the editor of Brownlee LLP's Constructive Thinking newsletter and is a member of the Law Society of Alberta and the Law Society of Upper Canada (Ontario). The Construction Law Team at Brownlee LLP practices in conjunction with a number of lawyers at the firm whose practice includes Municipal Litigation and Corporate Commercial Litigation.

What's on the *Horizon*? (Part I): Case comment: *Re Horizon Earthworks Ltd.*
By Paul Stocco

Horizon Earthworks Ltd. ("Horizon") was an Alberta based contractor that specialized in road construction. In or about November, 2009, a Receiver was appointed in respect of Horizon's property. Subsequently, in April, 2010, Horizon was assigned into bankruptcy.

At the time that Horizon was assigned into bankruptcy, it had several incomplete projects throughout Alberta including a project for the Municipal District of Greenview ("Greeniew"). As part of the contract with Greenview, Horizon was required to post a Performance Bond and Labour and Material Payment Bond--each in the amount of $761,662.22. Prior to delivering the said bonds, Horizon had executed an indemnity agreement with its bonding company, namely, Western Surety.

Just prior to Horizon having been assigned into bankruptcy, Western Surety sent Greenview a letter indicating that as a requirement of the indemnity agreement, Horizon had assigned, to Western Surety, all funds due to Horizon under its contract with Greenview. In or about December, 2009, Greenview declared Horizon to be in default. At the time Greenview declared Horizon in default, Greenview estimated that there was $774,260.92 unpaid to Horizon. Greenview then made a claim on the Performance Bond for costs to complete the project.

Western Surety arranged for a replacement contractor to complete the outstanding work. As a consequence of Horizon's bankruptcy, Greenview received notices from unpaid subcontractors/suppliers of Horizon. These notices totaled approximately $922,807.12. Western Surety paid these claims under the Labour and Material Payment bond and took an assignment of the claims.

At all times, Horizon had two primary secured creditors. Both held security (i.e. a GSA) over all present and after acquired personal property of Horizon. The indebtedness owed to the secured creditors was greater than the funds on hand with Greenview. Eventually, the 2 secured creditors and the Receiver entered into an agreement wherein the Receiver assigned its interest in the Greenview receivable to the 2 secured creditors, and in exchange, the 2 secured creditors gave a credit against Horizon's indebtedness.

The secured creditors and Western Surety each made a claim to the funds held by Greenview.

In its application to the Alberta Court of Queen's Bench, Greenview, with the support of Western Surety, proposed that the funds it held be paid to Western Surety given that Western Surety had, in effect, "stepped into the shoes" of the unpaid subcontractors of Horizon. By contrast, the secured creditors made claim to the funds by virtue of the assignment by the Receiver to them of the Greenview receivable and by virtue of the GSA.

In its decision, the Court rejected Greenview's proposal on the grounds that the payment by Greenview would have the effect of preferring the unsecured creditors over secured creditors. The Court characterized Greenview's proposal as a "private reorganization" that violated the provisions of the ***Bankruptcy and Insolvency Act***.

Further, the Court also held that by virtue of the secured creditors having entered into the GSA with Horizon in May, 2008, the GSA granted the secured creditors a security interest in all of Horizon's present and after acquired property including accounts receivable. The secured creditors registered their security interest in accordance with Alberta's ***Personal Property Security Act*** prior to Horizon entering into the contract with Greenview. By contrast, Western Surety had taken no steps to register its indemnity agreement with ***PPSA***. As such, Western Surety could not take priority over the secured creditors.

The result in this case clarifies the entitlement of the competing interests in the monies "earned but not yet paid" by an Owner to an insolvent contractor. In order to have any hope of establishing an entitlement, a party must register under the ***PPSA***, to the extent possible, its interest in the funds, or be entitled to a priority to those funds by virtue of the ***BIA***. This result also underscores the need for sureties to "know their client". Sureties should underwrite the risk properly and obtain the appropriate forms of security, and take proper steps to perfect the security interest.

The decision also leaves some question unanswered. For example, if the unpaid subcontractors to Horizon had been lien claimants, and the surety had taken an assignment of the lien claims, would that have made a defence in the entitlement of the surety to the funds held by the Owner?

The case is under appeal; therefore, what lies on the horizon is unclear.