Labour and Material Payment Bonds

In a 1963 Meredith Lecture,[1] Me A.J. De Grandpré, then a practising member of the Montreal Bar, spoke on claims under performance, fidelity and other bonds. He stated that:

> ... generally speaking a fidelity bond is a contract of insurance, while a guarantee policy is not a contract of insurance but one of suretyship. ... The surety bonds are not insurance contracts but are purely and simply contracts of suretyship subject of course to the terms of the agreement but also governed by articles 1929 and following of the Civil Code. For instance, contractors' bonds whether bid, performance of labour and material payment bonds, automobile dealers' bonds should not be regarded as insurance policies.[2]

As part of his lecture Me De Grandpré discussed the performance bond.[3] The principal obligation of this kind of bond, he pointed out, is to guarantee to the owner that his building will be finished for the price of the construction contract should the general contractor not complete it. In elaborating on this kind of bond, Me De Grandpré remarked:

> Another aspect of performance bonds which is important to bear in mind is that, without a labour and material payment bond, the Surety Company is not always obligated to pay the outstanding accounts once the contract has been properly performed. The obligation to pay for labour and material will persist, under a performance bond, only if there are privileges entered against the property. Under a performance bond, the Surety Company is not obliged to indemnify the workmen or suppliers of materials who have not registered a lien against the property, either because they have not fulfilled the obligations of the Civil Code relating to the registration of privileges or because the property is not susceptible of being affected by privileges.[4]

The question to be discussed in this note is whether a labour and material payment bond is really a contract of suretyship which permits the application of the principles of articles 1950 and 1959 of the Civil Code.

The question of what a labour and material payment bond is was recently considered in *La Rivière Inc.* v. *The Canadian Surety Co.*[5] The plaintiff, a hardware supplier, sold certain goods to Goldberg Inc., a plumbing contractor. Goldberg Inc. had a plumbing sub-

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[1] "Claims Under Performance, Fidelity and Other Bonds", *The W.C.J. Meredith Memorial Lectures* (1963), 64.

[2] *Ibid.*

[3] *Ibid.*, 65-66.

[4] *Ibid.*, 67.

[5] S.C.M. 755193, Ocober 30 1969.

contract with a general contractor who had itself been engaged to erect a building for an owner. The plaintiff did not notify the owner in writing of its undertaking to supply Goldberg Inc. in order to protect its right of privilege against the owner's property.[6] At the insistence of the general contractor, Goldberg Inc. issued the labour and material payment bond. With the bankruptcy of its co-contractant, the plaintiff sued the bonding company for its unpaid account.

The bonding company contested the plaintiff's claim, stating that it did not come within the terms of the bond. It maintained that the plaintiff could not enforce the bond because of its failure to give notice to the owner. The bond in question was in the standard form in current usage, and provided:

a) that the subcontractor and the bonding company bound themselves to the general contractor for the benefit of the suppliers of the subcontractor to the payment of monies due by the subcontractor;

b) that the subcontractor and the bonding company bound themselves jointly and severally to fulfil the foregoing obligation;

c) that if the subcontractor paid its suppliers for all labour and materials used in the performance of its contract with the general contractor, then the bonding company's obligation would be null and void, otherwise its obligation would remain in full force subject to certain technical conditions.

The plaintiff maintained that even without a privilege the bond was operative, it being intended that this kind of bond was to apply whether or not a privilege existed. The plaintiff further argued that a bond would have no meaning if the claimant thereunder would have to subrogate the bonding company in any privilege it might have, since the very purpose of the bond was to avoid the necessity of having to enforce a privilege as security. The Superior Court upheld the bonding company's position by deciding that a labour and material payment bond was a contract of suretyship. Put simply, it held that the plaintiff in this case had a right to be paid the amount due by enforcing its privilege against the property to which its materials were supplied. Since it did not do so its contract of suretyship contained in the bond was deemed to have been terminated and the plaintiff could not be paid under it. The trial judge added that "even if the bond as it is presently written proves to be

[6] Art. 2013(e) C.C.

an ineffective device to achieve the practical needs of the construction trade, that is a matter that is not relevant to this litigation".[7]

Batshaw,J. reasoned that since the plaintiff had not given the notice to the owner required by article 2013e C.C., and therefore had no privileged claim against the owner's property, it was unable to subrogate the bonding company in all of its rights accruing to the supplier against the debtor and the property of the third party to which it had supplied its materials. Failure on the part of the plaintiff to take the necessary steps to preserve its right of privilege thus caused the suretyship to come to an end.[8] This rule was considered a corollary to that enunciated by article 1950 C.C., which provides that the surety who has paid the debt is subrogated in all of the rights which the creditor had against the debtor.

Batshaw,J. began his analysis of labour and material payment bonds by citing the definition of the contract of suretyship contained in article 1929(1) C.C. It provides that "[s]uretyship is the act by which a person engages to fulfil the obligation of another in case of its non-fulfilment by the latter". The main provision of the bond upon which the plaintiff based its case was, as mentioned earlier, that if the subcontractor had paid its suppliers then the bonding company's obligation would be null; if, however, it had not, then the bond was in force. Batshaw,J. agreed that this was clearly an undertaking to pay, subject to certain formalities, in the event that the debtor failed to meet its obligations. He went on to say:

> It is difficult to see, therefore, where any valid distinction can be made between the definition of suretyship contained in the Code and the undertaking of the Defendant Company in its bond...[9]

and

> Bonds of this kind have been called "surety" bonds precisely because that is the function they fulfil and, as in the present instance, the issuer has been referred to as "the surety".[10]

He therefore concluded in dismissing the plaintiff's action:

> ... that the contract of suretyship contained in the Defendant's bond must be deemed to have been terminated because of the Plaintiff's inability to subrogate the Defendant in the legal privilege to which it was entitled in order to recover payment of the amount due by its debtor.[11]

While the appeal from this judgment was pending, it caused much turmoil in the Quebec construction industry. Its effect was to force

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[7] *La Rivière Inc.* v. *The Canadian Surety Co.*, S.C.M. 755193, October 30 1969, 6 *per* Batshaw,J.

[8] Art. 1959 C.C.

[9] *Cf.* f.n.7, 4.

[10] *Ibid.*, 5.

[11] *Ibid.*, 6.

a supplier or subcontractor to do all that was necessary to preserve his right of privilege under the Civil Code [12] in order to make a claim against a bonding company. This in turn caused several problems. Firstly, if rights of privilege had to be conserved by the requisite notice to the owner and registration within the legal delays, what useful purpose did a bond serve? The tradesmen would in all likelihood be paid by the owner of the property subject to the privilege. Secondly, what would happen if the subcontractor's contract contained a renunciation of his right of privilege, as is frequently the case in practice? Similarly, what would be the case if he had signed a grant of priority of hypothec or a renunciation in favour of the first mortgage creditor, which he is almost invariably called upon to do? All branches of government in awarding contracts usually insist that the general contractor furnish a labour and material payment bond, since the Crown or Municipal public property is not subject to the right of privilege. Did this mean that if the contractor became insolvent the suppliers and subcontractors would have no claim against the bonding company because they originally had no right of privilege against the property on which they worked? Finally, it was usually at the owner's insistence that his general contractor obtained a bond, in that the owner did not wish to have his property burdened with privileges should the contractor meet with financial difficulties. In the present case the contractor clearly obliged his subcontractor to issue a bond in order to protect his owner-customer's property from the registration of privileges which would necessarily result in money being held back from him. Therefore, if in order to claim under a bond a privilege must still be registered, the value of the bond would be illusory.

Prior to the *La Rivière* case, there had been only one judgment in Quebec on this question. Mr Justice Marcel Crête, then of the Superior Court, held in *Demontigny* v. *Genial Construction Inc.*[13] — contrary to *La Rivière* — that a claim lies against a bonding company even though one has no privilege. He wrote:

> *Que dire maintenant du recours exercé par les demandeurs contre la défenderesse The Canadian Surety Company?*
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> *Entre autres moyens, celle-ci a plaidé que, comme caution, elle était libérée parce que les demandeurs réclamants avaient laissé perdre leurs privilèges; à cet égard, la défenderesse s'est appuyée sur l'article 1959 C.C. lequel se lit ainsi:*
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> > *La caution est déchargée lorsque la subrogation aux droits, hypothèques et privilèges du créancier, s'opèrer en faveur de la caution.*

[12] Arts. 2013 ff. C.C.
[13] [1970] C.S. 459.

Dans le cas sous étude, le créancier désigné au contrat du cautionnement souscrit par The Canadian Surety Company, c'est la commission scolaire; cette dernière n'a renoncé à aucun des droits qu'elle pouvait avoir contre le débiteur principal, Genial Construction Inc.; la commission scolaire a même combattu la demande de privilèges exercée contre elle de sorte que la caution ne peut invoquer les dispositions dudit article 1959 *C.C. pour se décharger; d'ailleurs, il serait étrange que ladite défenderesse puisse prétendre pouvoir exercer, par voie de subrogation, un recours en indemnité contre la commission scolaire, qu'elle s'est précisément engagée à tenir indemne de réclamations pour l'exécution des travaux et la fourniture des matériaux.*[14]

While the *La Rivière* judgment was awaiting hearing before the Court of Appeal, a number of similar cases came to trial before various judges of the Superior Court. The first of these was *C. Howard Simpkin Ltd.* v. *Prudential Assurance Co.*,[15] decided on August 26, 1971 by Lalande, J. He analysed the decisions in *La Rivière* and *Demontigny*, and came to the conclusion that he shared the view expressed in the *La Rivière* judgment. Since a comparative study had now been made by one of their colleagues, the next series of judgments followed the reasoning in *Simpkin*.[16] However, Mitchell, J., in an elaborately reasoned judgment rendered May 3, 1972, came to the same conclusion as had Crête, J. in *Demontigny* v. *Genial*.[17]

On September 15, 1972 the *La Rivière* judgment was reversed by the Court of Appeal.[18] Rinfret, J., supported by Hyde, J., held that *"les droits hypothèques et privilèges dont il est question en l'article* 1959 *C.C., doivent s'entendre de droits, etc., à l'encontre du débiteur principal"*.[19] Casey, J. arrived at the same conclusion but without referring to the articles of the Civil Code on suretyship. It was also thought that it would be *'étrange'* [20] to permit a subrogated surety to exercise a recourse against an owner which it had undertaken to hold *"indemne de réclamation pour l'exécution des travaux et la fourniture des matériaux"*.[21]

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[14] *Ibid.*, 465.

[15] S.C.M. 746049, August 26 1971.

[16] *Simard Beaudry Inc.* v. *The Travelers Indemnity Co.*, S.C.M. 8099968, December 2 1971; *Philibert Bédard Ltée* v. *The Travelers Indemnity Co.*, S.C.M. 791763, April 25 1972; *Val Royal Building Materials Ltd.* v. *The Prudential Assurance Co. Ltd.*, P.C.M. 279854, May 1 1972.

[17] *J.C. Lauzon Ltee* v. *The Prudential Assurance Co. Ltd.*, S.C.M. 804523, May 3 1972.

[18] [1973] C.A. 150.

[19] *Ibid.*, 152.

[20] *Ibid.*, 153.

[21] *Ibid.*, 153, quoting from *Demontigny et al.* v. *Genial Construction Inc.*, [1970] C.S. 459, 465 *per* Crête,J.

In subsequent cases the Superior Court had to consider the judgment of the Court of Appeal. While theoretically able to depart from this judgment if they wished to do so,[22] the judges of the Court of first instance were unanimous in accepting it.[23]

The technology used in labour and material payment bonds is unquestionably that of suretyship. It must be remembered that the contract of suretyship or *cautionnement* was originally a civil contract where one person guaranteed the performance of the obligation of another person out of motives of affection or friendship. He was not paid for exposing himself to the fulfilment of the debtor's obligation. He engaged in an act of liberality or generosity. The courts and the law consequently extended to him the utmost protection. He could not be held liable on an implied engagement and his obligation could not be extended by construction or implication beyond the precise terms of the instrument by which he obliged himself. Consequently, it was the practice of the courts to free the surety from his obligation on technical grounds or because of minor changes in the contract between the creditor and the principal or slight variations in the performance of the contract, whether prejudical to the surety or not. This resulted in the belief that the surety was a "favourite of the law", and his contract *strictissimi juris.*

As a concomitant of the growing complexity of modern business there has developed a commercial bonding business which has been carried on principally by insurance companies. These companies issue labour and material payment bonds, completion bonds and other types of guarantees which secure for the creditors either the execution of the obligation of the debtor by the surety or the indemnification for damages suffered in the event of default on the part of the debtor. Such bonds or guarantees are issued in consideration of the payment of a premium.

When litigation arising out of such compensated surety bonds first came before the Courts, it was dealt with in the same manner as the traditional accommodation suretyship or *cautionnement* because of the similarity in the language and in the obligations of the parties. However, in the last number of decades a change has taken place. It has been realized that they are made for the purpose of

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[22] See Friedman, *Stare Decisis at Common Law and Under the Civil Code of Quebec,* (1953) Can. Bar Rev. 724, 746.

[23] *La Cie. Canadienne Grandwood de L'est Ltée* v. *The Travelers Indemnity Co.,* S.C. Beauharnois 12065, October 10 1972; *Outremont Plumbing and Heating Co.* v. *The Aetna Casualty and Surety Co.,* S.C.M. 05-814147-71, December 21 1972; *Spancrete Ltd.* v. *The Travelers Indemnity Co.,* S.C. Beauharnois 12019, April 4 1973.

gain to the surety in language selected by him, and that consequently the traditional favoritism accorded the accommodation surety is neither required nor justifiable. The courts were solicitous for the accommodation surety because he was overtaken in misfortune resulting from his having accommodated another. A compensated surety would solicit the sale of its protection for purposes of gain, and he would assume that losses would occur for which he must pay. In these circumstances, it has been held consistently that unless an injury is shown to result, the compensated surety will not be liberated on technical grounds.

American doctrine and jurisprudence have attempted to determine the exact nature of the compensated surety contract, and the conclusion has been reached that it is either a contract *sui generis* or a contract in the nature of, or similar to, an insurance policy; and that the rules to be applied to it are similar to those of insurance contracts. The contract must therefore be construed most strongly against the surety or bonding company. In fact, performance bonds and other contracts of suretyship issued by surety companies having the right to furnish security for hire or compensation have frequently been treated in the same manner as contracts of insurance. The courts have come to construe the obligations of the compensated surety quite strictly, like those of an insurer.[24] It is also to be noted that while a labour and material payment bond has characteristics of suretyship and of insurance, it also has certain characteristics of a 'stipulation pour autrui'.[25] This view was accepted in perhaps the first in the series of Quebec cases in which the argument was raised.[26] In that case the Court enforced the payment bond in favour of the owner of a building who had personally paid the claims of a number of privileged creditors whose accounts had not been looked after by the general contractor. As has been mentioned, however, this view was implicitly rejected in *La Rivière Inc.* v. *The Canadian Surety Co.*

From the foregoing, it appears that the 'suretyship' argument invoked by the bonding companies seems to be settled for the moment. A number of the cases referred to herein may still be appealed. In the *La Rivière* judgment, one of the judges of the Court of Appeal took the unusual step of commenting on the cases pending before the court to which opposing counsel had referred. He stated that he

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[24] Simpson, *Handbook on the Law of Suretyship* (1950), 101-112. *Corpus Juris Secundum*, Vol. 72, 583, 591, 605, 606. Appleman, *Insurance Law and Practice* (1943), Vol. 10, 80.

[25] Art. 1029 C.C.

[26] *Tucker* v. *The Federation Insurance Co. of Canada*, S.C.M. 371161, July 19 1962.

endorsed the view in the *Demontigny* case but did not accept the others.

In addition to the reasoning expressed by the Court of Appeal in *La Rivière,* the position may be taken that a labour and material payment bond is not a contract of suretyship at all but a contract *sui generis* to which the articles of the Civil Code on suretyship should not be applied. On the practical level, it is interesting to note that bonding companies seem ready now to rewrite their traditional bonds so that a valid privilege is no longer a prerequisite to a claim under a bond.

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