The Inter-Relationship of Risk Management Provisions in Construction Contracts

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One of the primary purposes of a construction contract is to identify, manage and limit risk. Parties to construction contracts are often quick to insert many of the standard risk management clauses, but sometimes fail to give adequate consideration to the inter-relationship between these various clauses, which can lead to unexpected results when problems arise during the job. For example, the relationship between a maximum liability clause and the requirement for a contractor to obtain a performance bond in a stipulated amount is frequently overlooked. The potential result is the amount available under the bond may be far lower than anticipated and thus afford far less protection than expected.

The concept is best illustrated by a practical example. Consider a $50 million pipeline construction contract containing a requirement the contractor obtain a 50% performance bond and a clause limiting the contractor's liability to the owner to $10 million. The owner in this example may sign the contract believing that it has managed its risk by insuring there is a $25 million performance bond available in the event of a contractor default. However, a surety called upon to answer for the contractor's default may point to the maximum liability clause and take the position only $10 million is available under the bond - and it may be right.

Surety bonds concern secondary liability in the nature of a guarantee, being "on default" as opposed to "on demand" instruments. The authors in *Scott & Reynolds on Surety Bonds* (Thompson Carswell: Toronto, 1994) at 2-11 explain that in a surety bond, "a principal … contracts with a surety to indemnify a third party, the obligee, in the event the principal fails at his task … and the surety effectively assumes the obligation of the principal in the event of such failure." In the result, a surety is only liable if the principal is also liable. The purpose of a performance bond is to guarantee the completion of the contract following the contractor's default. Upon such default the surety must choose one of the options available to it under the wording of the bond. The surety's liability is limited by the amount of the bond.

Returning to our example, given the requirement to furnish a 50% performance bond, the surety is potentially liable to the pipeline company up to the penal sum of the bond, being $25 million. However, the matter is not that straightforward. The fact of secondary liability means the surety is not liable unless its principal is liable. The corollary of this concept is that the surety is entitled to and may raise any defence which the principal could have relied on had the action been brought against the principal. The concept is expressed in *Scott & Reynolds on Surety Bonds* at 7-1:

> "The surety's rights are the rights of the principal under the bonded contract and the surety's obligations can be no greater than those of the principal under the bonded contract. The surety's rights accrue to it because it succeeds to the rights of the principal, and the surety's obligations are limited because the obligee's cause of action against the surety for breach of its obligations is for damages and requires the obligee to mitigate its damages … The surety's obligations are further limited by the wording of the bond itself …"

Based on this fundamental principle of suretyship, there is a strong argument that the surety's liability to the pipeline company is capped at $10 million on the basis this is the maximum liability of the contractor pursuant to the underlying contract.

This was the result in *Trenton Works Lavalin Inc. v. Panalpina Inc.*, [1995] N.S.J. No. 78 (N.S.C.A.). The underlying contract in that case concerned the shipping of rail cars from Halifax to Dar es Salaam. The liability of the shipper was limited to $500 per unit. The shipper was required to furnish a performance bond in the amount of $2,927,574.00. During loading, a rail car was damaged beyond repair for a loss of $74,240.00. At trial, the court found the shipper liable for only $500 based on the limitation of liability, but held the surety liable on the performance bond for the entire loss of $74,240.00. In allowing the surety's appeal, the Nova Scotia Court of Appeal stated the following:

> "As a general rule the obligation of a surety is no greater than that of the principal pursuant to the terms of the contractual obligations of the principal that are guaranteed by the surety. As a corollary of that principal [sic] the surety has the benefit of any defence available to the principal. This would include any limitations on liability."

In the result, the surety's liability was reduced to $500.

The notion that the obligee is limited on a claim pursuant to a performance bond by the maximum liability clause of the underlying contract is consistent with the concept of primary and secondary liability in suretyship. The surety does not have independent liability, but rather simply provides a guarantee and security for the liability of the principal.

In the end, parties seeking to manage risk and obtain protection through the use of performance bonds would be well advised to review the relationship between the bonding requirements and any limitations of liability or maximum liability provisions found elsewhere in the contract.