Landmark Ontario Appeals judgment in construction dispute permits rescission of surety bond

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There has been a recent change in the way surety bonds will be treated in the construction industry as a result of the Ontario Court of Appeal decision in *Urban Mechanical Contracting Ltd. et al v. Zurich Insurance Company Ltd., 2022 ONCA 589 ("Urban")*. The decision makes it possible for a surety to rescind a bond agreement that was based on fraud or misrepresentation and collusion, even if the result would harm innocent third parties making claims against the bonds. The ruling stated that the issue of rescission should be decided by considering all the facts and circumstances of a particular matter.

Surety bonds are used primarily in the construction industry to protect an owner from the failure of a contractor to meet their mutually agreed upon result in a mutually agreed upon time frame. It is not uncommon for a general contractor to hire multiple sub-contractors to complete one large job. Problems often arise when a sub-contractor has difficulties performing their part of the work causing delays all the way down the chain of production and ultimately resulting in a job that is not completely satisfactory or timely. A construction surety bond redistributes the risk so that the immediate burden of a failure of one party to perform falls on the surety. However, unlike when a claim is made against an insurance policy, a loss that is paid for by the surety bond

is fully recoverable from the principal (or the person whose obligation is guaranteed).

Rescission is an equitable remedy that is sometimes used in contract matters. It is provided to a party to a contract that has been wrongfully induced into entering the contract and will void the contract and treat it as if it was never made. The idea is that the parties will be restored to the position they were in prior to entering the contract. It is available to parties to a contract that was made because of a misrepresentation of a material fact. In essence, a false statement about a material fact was made by one party to the other to induce them to enter into the contract.

Urban was an Ontario Court of Appeals decision involving the development of a patient care tower for St. Michael's Hospital in which Bondfield Construction Company Limited ("Bondfield") was hired as the construction contractor. The appellants in the matter are a group of subcontractors (the "Trades") hired by Bondfield and the project's lender Bank of Montreal. Zurich Insurance Company Ltd. ("Zurich"), the surety that issued the bonds in connection with the project, was the respondent in the matter.

Zurich alleged that prior to issuing the bonds in question, it found evidence that fraud was utilized to allow Bondfield to secure the contract for the construction project and therefore stopped payment to the Trades under the payment bond and sought an action for rescission due to fraud. In turn, the Trades sought a declaration that the payment bond could not be rescinded as it would interfere with their rights as innocent third parties. Bank of Montreal also sought a declaration that the performance bond could not be rescinded.

The Trades argued that their statutory rights under the Construction Lien Act could not be undermined by equitable remedies such as rescission, but Zurich argued that the Trades were potentially parties to the fraud thereby spoiling their

rights under the Construction Lien Act. The appellants further argued that rescission is not available when the rights of innocent parties could be negatively impacted.

The Court of Appeal ruled that the impossibility of restoring parties to their pre-contract position when third-parties have an interest in the property surrounding the contract and the adverse effect on third parties when rescission is grated are not an absolute bar to rescission and whether a court may order a rescission remedy depends on the facts and circumstances of the particular case and more specifically, a court should be more likely to do so when there has been fraud rather than innocent misrepresentation. Zurich was allowed to continue seeking rescission as a remedy and its issuance will be determined by the trial judge.

The result of *Urban* is something that those in the construction industry should pay close attention to. It has cleared the way for sureties to pursue the rescission of bonds by alleging there was a material misrepresentation in the bonded contractor's disclosures.

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