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LETTERS OF CREDIT, BONDS, AND MONEY: HOW SECURE IS YOUR SECURITY?

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I. INTRODUCTION

For local governments, "security" is more than just a favourite blue blanket. It is more than cameras, alarms, and armed guards. The taking of security is a critical element to ensuring performance of contractual obligations or compliance with a bylaw requirement, such as a contractor's promise to construct a community centre for an agreed upon price or a developer's obligation to construct a public road.

This paper examines the use of letters of credit, bonds, and money to ensure the performance of obligations owing to a local government.

II. WHY SECURITY?

Why require security? In this context, the Oxford Dictionary defines "security" as "property etc. deposited or pledged by or on behalf of a person as a guarantee of the fulfilment of an obligation (as an appearance in court or the payment of a debt) and liable to forfeit in the event of default".

A developer's contractual promise is not security (nor is the provision of a promissory note). If a developer defaults on such a promise, the local government's ability to recover resulting losses (such as default correction costs) will depend entirely on whether the developer has sufficient funds to pay for such losses. If the developer refuses or is unable to correct a clear default, the developer is probably without funds. Moreover, local government staff are typically not in a position to properly assess a developer's (or contractor's) financial circumstances at the time an obligation arises, and those financial circumstances can quickly change over time.

To sum up, in the absence of security, a written promise to perform, and related default and indemnity provisions, can turn out to be a paper tiger, leaving the local government with little and perhaps no recourse to address a default, other than at the taxpayers' expense.

III. LOCAL GOVERNMENT POWERS TO REQUIRE SECURITY

A. Security Required under an Agreement

As a creature of statute, a BC local government derives its power from enabling legislation, primarily, the *Community Charter* (Charter) and *Local Government Act* (LGA).

Section 8(1) of the Charter provides that a "municipality has the capacity, rights, powers and privileges of a natural person of full capacity". A municipality exercises these 'natural person' powers when it enters a voluntary contract with another person. The terms of such a contract can include a requirement to provide security to the local government.

A regional district does not have natural person powers, but a regional district's 'corporate powers' in section 263 of the LGA include the powers to make agreements in relation to various matters and, in exercising those powers, a board may "establish any terms and conditions it considers appropriate".

A local government exercises these agreement-making powers when it requires a performance bond (discussed further below) from a contractor who is to build something for the local government. In exercising these powers, a local government has broad discretion to determine the form and amount of security to be required under the agreement, subject to the other party's willingness to agree to provide such security.

B. Security Required under a Bylaw

1. Municipal Bylaws

Sections 8(3) to (6) of the *Charter* provide municipalities with the power to regulate, and in some cases, prohibit and impose requirements, in relation to various matters, including municipal services, public places, trees, and signs. Section 8(8) provides that those powers include the power "to require persons to do things with their property, to do things at their expense and to provide security for fulfilling a requirement".

Section 15 of the *Charter* provides that a municipality's power to regulate includes the power to provide for a system of licences, permits or approvals, which system can, among other things, include the establishment of terms and conditions, which would therefore permit the inclusion of a requirement to provide security to the municipality. For example, a municipality exercises this power when a bylaw includes a requirement to provide a damage deposit in connection with a permit to do work in a municipal highway.

Section 19 of the *Charter* includes rules that apply to security that a municipality requires under a bylaw or as a condition of a licence, permit or approval. Section 19(2) provides that the person providing the security is entitled to choose whether to provide cash or a letter of credit, or another form of security satisfactory to the municipality. Section 19(3) provides that:

- Interest on security becomes part of the security;
- The municipality may only use the security for the purpose for which it was provided; and
- Unused security must be returned to the person who provided the security.

2. Regional District Bylaws

A regional district does not have the broad regulatory authority available to municipalities under section 8 of the *Charter*. There are, however, some specific regional district service-related powers that permit a regional district to, by bylaw, impose security requirements:

- Building Permit Security to Protect Public Property: Section 300 of the LGA applies where a regional district exercises its regulatory powers by bylaw under section 335 to require a person to provide security as a condition of building permit issuance or authorization to move a building under section 298. Section 300 includes the same requirements as section 19 of the *Charter* respecting the form of security, interest, and the return of security, with the additional restriction that the security may only be used to repair or replace a highway (including sidewalks and boulevards), a public work or other regional district property that is altered or damaged as a result of the activity that is the subject of the permit or authorization;

- Security under (Non-Regulatory Service) Licences, Permits and Approvals: Section 335 is authority for a regional district to, by bylaw, regulate and prohibit in relation to a regional district service (other than a regulatory service), including to provide for a system of licences, permits and approvals with terms and conditions. This power would appear to authorize a requirement for security, although neither section 300 of the LGA or section 19 of the Charter apply to such security; and

- Business Regulation Security: Section 326.1 of the LGA authorizes a regional district to regulate in relation to business under Divisions 1 and 3 of Part 2 of the *Charter* and Division 9 of Part 3 of the *Charter*. Division 3 of Part 2 of the *Charter* contains the permit scheme power under section 15, and the security requirements under section 19, both discussed above.

C. Security Required under Statute

There are various LGA provisions that contemplate providing security to a municipality or regional district (and in some cases the approving officer), including the following (section references are to the LGA unless otherwise indicated):

- Performance of the terms of a temporary use permit (Section 496);

- Landscaping conditions, the correction of unsafe conditions or the correction of damage to the environment under a development permit, temporary use permit, development variance permit or a permit under Division 10 of Part 14 (tree cutting permits) (Section. 502);

- Completion of works and services to be constructed as a condition of subdivision or building permit issuance, if to be done after subdivision approval or permit issuance (Section. 509);

- Instalment payment of development cost charges, amenity cost charges or school site acquisition charges (Sections. 559(5), 570.2(5) and 572(4) and the *Development Charge (Instalments) Regulation*) (DCI Regulation));

- Compliance with the terms of a heritage alteration permit (Section. 618);
- Construction of highways in a subdivision plan (*Land Title Act*, Sections. 75(1)(b) and 86(c)(iii));
- Construction of highways and water, sewage and drainage works in connection with a bare land strata plan (*Bare Land Strata Regulation*, Sections. 3(e)(iv), 5(1)(e), 12(b) and 16); and
- Construction of common facilities under a phased strata plan (*Strata Property Act*, Section. 223).

One must look at the applicable section above to determine the particular requirements, if any, as to the form of security, interest on security, use of security and the return of unused security.

IV. HOW MUCH SECURITY?

A. The Nature of the Obligation to be Secured

The introduction to this paper mentions two examples of typical scenarios where a local government requires security. Each of those scenarios involves significantly different levels of financial risk to the local government.

Where a local government enters a contract for a contractor to build something for the local government in exchange for money, the contract will typically provide for payment to the contractor only as work proceeds and only if the local government is satisfied, at least to some extent, with the work done to date. While work may turn out to be deficient, the local government may continue to hold back the unpaid contract price and may also have a protective deficiency holdback. For this reason, performance bonds (as discussed below) are set at some percentage (50%) of the contract price.

Conversely, where the local government, in its capacity as regulator, takes security for a developer obligation owing in connection with a local government permit or approval, such as under an agreement to construct local government works and services following subdivision approval, the developer has already received the full benefit of that agreement (subdivision approval). However, once subdivision approval is issued, the local government has played all of its cards and does not retain any unpaid contract price. For this type of arrangement, security is usually at least 100% of the estimated cost of doing the works and services, plus a contingency amount.

B. Contractor or Developer Financial Capacity

As noted above, a local government will not typically be in a position to properly assess a contractor's (or developer's) financial circumstances at the time of contract signing and those

financial circumstances can quickly change over the course of a contract. Accordingly, the financial capacity of the person incurring the obligation to the local government will not typically be a consideration in assessing the amount of security (except perhaps in limited circumstances, such as when a local government is dealing with the Provincial government).

C. Cost Estimate Uncertainty

A local government will typically want to include some contingency in any cost estimate used to determine the amount of security to be provided for development works and services and in other similar scenarios. The less certain the cost estimate, the greater the contingency. For example, if the developer has not yet completed the detailed design for subdivision servicing works, it will be prudent to require a greater security amount than would be the case to secure fully designed works.

D. Administrative Costs

A local government may wish to include an amount to cover default administrative costs, in addition to the estimate of costs payable to a third party to correct a developer default.

E. Inflation

In cases where a local government could be holding a security for a long period of time (e.g. beyond 1 or 2 years), it is prudent to consider whether the security should be higher to account for potential cost increases over time or whether the underlying agreement (if there is one) should permit the local government to require additional security in the future, with a right to draw down existing security if the developer does not provide the additional security.

If the security is money (either initially or following a letter of credit draw down), interest on the security may, at least to some extent, address time-related cost increases.

V. THE UNDERLYING AGREEMENT

Where security is provided to secure developer (or contractor) performance under an agreement, it is important that the agreement address key security elements, such as the following:

- Scope for Security Use: The agreement should permit the local government to use security to pay its costs of addressing any agreement default, not simply the cost to correct deficient works or to complete works;

- Administration Costs: The agreement may permit security to be used to pay administration costs, which should be set at some percentage of default correction costs;

- Drawdown Triggers: Where security is in the form of a letter of credit, the agreement should:
  - Permit the local government to drawdown the letter of credit:
    - If the local government considers that the developer is in default under the agreement;
    - If the local government receives a notice of non-renewal from the issuer of the letter of credit; or
    - In the event of developer bankruptcy, insolvency or similar events.
  - Permit letter of credit drawdowns without notice to the developer, as this may enable the local government to at least convert a letter of credit into money form in the event that developer financial difficulties result in a stay of proceedings under bankruptcy and insolvency related legislation or a court order;
- Developer Correction Opportunity: While a developer will certainly want an opportunity to correct a default before the local government does so, and the local government will generally be reluctant to step in except when absolutely necessary, consider including a high degree of local government discretion in deciding whether it can step in and correct defaults using security. Allowing the developer to establish correction schedules and uncertain periods to correct defaults clouds a local government's rights to step in and complete work; and
- Interest: Where security is money, or could become money after letter of credit draw down, the agreement should specify the treatment of interest, such as that interest becomes part of the security and can be used as security.

VI. FORMS OF SECURITY — MONEY

Cold, hard cash is the simplest form of security. When a local government holds money as security, it does not need to worry about making proper demand for payment from a bank or surety under letter of credit or bond, nor fear missing a deadline for making such a demand. Of course, money cannot be left in a safe or under someone's desk and needs to be placed in a bank account, with interest accounted for in accordance with the applicable agreement or Charter or LGA provision.

In many cases, a developer may prefer (and in some cases may have the choice) to provide a letter of credit or other security (if permitted or acceptable to the local government), particularly for more significant security amounts.

A local government should not consider money to have been paid and received until such funds have cleared and payment cannot be reversed.

VII. FORMS OF SECURITY — LETTERS OF CREDIT

A. Overview and Purpose

A letter of credit is a written undertaking by a financial institution to pay a specified amount to a designated beneficiary upon receipt of a demand that complies with the letter of credit terms.

Letters of credit generally fall into two categories:

- Documentary Letters of Credit: Used primarily in commercial transactions to facilitate payment for goods or services upon presentation of specified documents; and

- Standby Letters of Credit: Used principally as security to provide funds when the party whose obligations are secured by the letter of credit fails to perform those obligations. This is the form of letter of credit commonly used in local government arrangements.

A letter of credit's effectiveness will depend on the terms of the letter of credit, local government compliance with draw down presentation requirements, and, critically, the financial standing of the financial institution that issues the letter of credit.

The key strength of an irrevocable letter of credit is that it establishes an independent payment obligation on the part of the issuing bank. Independent, that is, of the underlying contract or obligation for which the letter of credit is provided as security. Unlike other forms of security such as bonds, which can permit the surety to assess the merits of a claim before responding, a properly drafted letter of credit generally only requires the presentation of a compliant demand for payment to be made. There is no requirement to prove a default before drawing down the letter of credit. This makes a letter of credit a relatively liquid form of security.

For example, if a developer provides a letter of credit to a local government to secure obligations under a subdivision servicing agreement and the local government makes a demand for payment to the issuing financial institution that meets letter of credit demand requirements, the financial institution must honour that demand, regardless of developer protests or any assessment of servicing agreement breach.

The only exception to this rule is fraud and, as noted by the Supreme Court of Canada in *Eurobank Ergasias S.A. v. Bombardier inc.*, 2024 SCC 11, the threshold for fraud is high and requires evidence of impropriety, dishonesty or deceit. A dispute about whether the circumstances under the secured contract permit the local government to draw down the letter of credit is not, on its own, evidence of fraud.

B. Key Considerations

Following are comments on some key letter of credit considerations:

- Creditworthiness of the Issuing Institution: The financial capacity of the issuer is critical and, accordingly, it is prudent to only accept letters of credit from Canadian chartered banks or B.C. Credit Unions;

- Irrevocability and Expiry: An irrevocable letter of credit will typically be valid for a specified period of time, but provide that it automatically renews on a periodic basis (annually), unless the financial institution provides a notice of non-renewal to the local government, in which case the letter of credit expires after the specified notice period. It is, therefore, important that the minimum non-renewal notice period specified in the letter of credit be sufficiently long (at least 30 days) to provide the local government with a comfortable amount of time to process receipt of the notice, determine if it will draw down the letter of credit and then comfortably complete the draw down process;

- Unconditional Payment and Documentary Requirements: Local governments must comply strictly with all requirements contained in the letter of credit terms, including any requirements as to the form of demand, authorized signatory, amount claimed, place of presentation of demand and any documentary conditions. It is essential that the letter of credit be 'clean', in that its terms should not require the local government to declare to the financial institution that there has been a default of the underlying secured obligation. In *Gook Country Estates Ltd. v. The Toronto Dominion Bank,* 2001 BCCA 578, the British Columbia Court of Appeal affirmed that only the terms of the letter of credit are material to how it can be drawn down. The courts will not read in or infer additional requirements that are not stated in the letter of credit;

- UCP 600: The International Chamber of Commerce established in 2007, and periodically updates, the Uniform Customs and Practice for Documentary Credits (UCP 600) which contains various rules regarding letters of credit. In order for these rules to apply to a particular letter of credit, the letter of credit must expressly reference and incorporate these rules; and

- Place and Method of Presentation: The letter of credit should clearly identify where and how a draw down demand must be presented to the financial institution. Ideally, the letter of credit should permit draw down presentation at a branch located near the local government's offices or using an expressly authorized convenient presentation method. The local government must ensure that a demand is presented at the correct location, in the required form and before expiry.

C. Procedure for Drawing on a Letter of Credit

Following are some practical and, in some cases, required steps to draw on a letter of credit.

- Review the Instrument: Verify:
  - The letter of credit has not expired;
  - The proposed demand is permitted under the instrument;
  - The amount requested does not exceed the available balance;
  - The presentation conditions (if any) can be satisfied; and
  - Any requirements regarding the signatory, delivery method, presentation location and supporting documents.
- Prepare the Demand: Unless the letter of credit specifies otherwise, the demand should generally be an original letter on the local government's letterhead, signed by the corporate officer or other authorized signatory identified in the letter of credit. The demand should include:
  - The letter of credit's identification number;
  - The issuing bank and designated branch;
  - The local government's name as beneficiary;
  - The amount requested;
  - Any prescribed declaration or wording required by the letter of credit;
  - The date and place of presentation; and
  - Any required accompanying documents.

  Where the letter of credit permits the beneficiary to specify the payment method, the local government may request an electronic transfer to its designated account or another permitted form of payment.
- Present the Demand: The demand must be presented in strict accordance with the terms of the letter of credit, including presentation location, delivery method and times (such as during applicable banking hours), and before the letter of credit expires. Where the original letter of credit or other documents are required, these must accompany the demand.

- Coordinate with the Issuing Financial Institution: Where practical, staff may wish to contact the issuing financial institution in advance to confirm presentation procedures and to identify any administrative requirements. A preliminary telephone call or email may assist with coordination, and copies of the instrument and proposed demand may be provided where appropriate. However, advance notice does not constitute a valid demand unless the letter of credit expressly permits that method of presentation. Courier, electronic or other alternative delivery methods should be used only where the letter of credit authorizes them. Staff should not rely on informal assurances that a particular method will be accepted.

- Record and Administer the Drawdown: Local governments should retain the letter of credit, the demand, proof of presentation, bank correspondence and records of the amount received. Where the underlying obligations remain outstanding, staff should assess whether remaining security is sufficient and whether additional security can be required under the contract.

D. Municipal Administration and Risk Management

Effective administration of letters of credit requires coordination among procurement, finance, engineering, legal and contract-management personnel, as may be appropriate. Local government procedures to administer letters of credit should include:

- Maintaining a register of all letters of credit, including their amounts, issuers, expiry dates and associated contracts and permits;

- Monitoring expiry dates and obtaining extensions or replacement security before expiry;

- Reviewing the wording of proposed instruments before acceptance;

- Confirming the authority required to approve and submit a demand;

- Maintaining a documented process for preparing, reviewing and presenting demands;

- Recording all drawdowns and monitoring the remaining security; and

- Implementing appropriate systems to ensure prompt circulation to appropriate staff of notices received from letter of credit issuers, such as a notice of non-renewal (which will lead to letter of credit expiry if the local government does not draw down the letter of credit during the notice period).

VIII. FORMS OF SECURITY — SURETY BONDS

In the local government context, a surety bond is a three-party agreement under which a 'surety' guarantees to an 'obligee' (the local government) the performance of specified obligations that a 'principal' (developer or contractor) owes to the obligee. However, the typical relationship between these parties is slightly different in the case of labour and material payment bonds, as discussed further below.

A. Traditional Types of Surety Bonds

Following is a discussion of the typical bonds used in the local government context and the particular features of such bonds. Local governments frequently use the first three types of bonds with local government construction contracts. Some B.C. local governments have accepted the fourth type of bond, the servicing bond, a security for the construction of development works and services.

1. Bid Bonds

Local governments often require bid bonds in the procurement context, such as under a call for tenders for a local government project. When used in a tender call, the local government's tender documents will require that each bidder submit a bid bond to guarantee their bid price. If the local government selects a bidder's bid, but the bidder then refuses to sign the project contract, the bond surety is required to pay to the local government the difference between that bid price and the price of the next best bid.

2. Performance Bonds

A performance bond secures a contractor's performance of its obligations under a contract with the local government. If the contractor defaults under the contract and the local government makes a demand under the performance bond, such a bond typically permits the surety to choose one of the following options: (i) remedy the contractor default, (ii) complete the contract, (iii) obtain a new contractor for the local government and pay amounts to that new contractor that exceed the balance of the original contract price, up to the maximum bond amount, or (iv) pay to the local government the lesser of the maximum bond amount and the amount by which the local government's cost to complete the project exceeds the balance of the original contract price.

An important feature of a performance bond is that a surety's obligation is to address a contractor default, if there is in fact a default, and not simply because the local government says so. A surety may therefore refuse to address an alleged contractor default if the surety does not agree that a default has occurred. This is a significant difference from the liquidity feature of a letter of credit.

Moreover, when a surety spends money to address a contractor default, the surety will typically have the right to seek indemnification from the contractor, but the contractor will only provide such indemnification if the alleged default has in fact occurred. Accordingly, while a surety has a financial obligation to the local government under a performance bond, the surety also has a financial interest to properly assess the validity of a local government's claim and may disagree with a local government's assessment of default.

3. Labour and Material Payment Bonds

A labour and material payment bond differs from the other forms of bonds discussed in this paper.

(a) The Unique Nature of the Labour and Material Payment Bond

This type of bond is intended to protect a person who supplies labour or material to a local government contractor from that contractor's failure to pay such a subcontractor or supplier. In addition to helping ensure payment to subcontractors and suppliers, such a bond can also benefit a project by reducing the likelihood of work stoppages, liens and payment litigation.

A labour and material payment bond permits such a subcontractor or supplier to demand payment from the surety, even though the local government is the 'obligee' under the bond. For this purpose, the bond deems the local government to be a 'trustee' under the bond.

(b) The Duty to Notify

Ideally, the bond will include a term expressly providing that the local government's status as 'trustee' does not create any obligations or duties to any subcontractor or supplier, including to provide notice of the existence of the bond or the trust under the bond.

In the absence of such a clause, a local government may, depending on the circumstances, have a duty to disclose the existence of a labour and material payment bond to suppliers and contractors.

In *Valard Construction Ltd. v. Bird Construction Co.,* 2018 SCC 8, the Supreme Court of Canada held that an obligee/trustee under a labour and material payment bond can have a duty to notify sub-contractors and suppliers of the existence of the bond, so that they are aware of the bond and claim deadlines under the bond. In that case, the Court noted that the affected subcontractor had attended daily meetings at the contractor's trailer at the project site and that the posting of a notice in the site trailer would have satisfied this notice obligation. The Court observed that this disclosure duty will depend on the particular circumstances and that, "[i]n some circumstances (where, for example, the industrial practice is such that the use of labour and material payment bonds to offset the risks arising from unpaid subcontractors are common), it may well be that very little, or even nothing, will be required on the part of a trustee to notify potential beneficiaries of the trust's existence" (para. 29).

To address this potential duty, it is prudent for a local government to place a notice at the project work site advising of the existence of the bond (or attaching a copy). If the local government becomes aware of contractor payment problems, it is also prudent to make efforts to provide a copy of the bond to subcontractors and suppliers.

4. Servicing Bonds

Some B.C. local governments have accepted a surety bond as security for works and services to be provided by a developer as a condition of subdivision approval or building permit.

There are at least two different versions of this type of bond, each providing for a different surety response where the local government declares a developer default under the bond. In one version, the surety may choose whether to correct the developer default or to pay to the local government an amount sufficient to correct the default, subject to the bond's financial limit. In the other version, the surety is required to pay the amount demanded by the local government, subject to the maximum amount specified in the bond. This second version is clearly preferable, as the surety would appear to have a much more limited basis to dispute a local government's payment demand.

However, neither version has the important features required under section 7(4)(b) of the DCI Regulation for on-demand surety bonds, as discussed below, which are intended to provide such bonds with the liquidity of a letter of credit. If a local government is prepared to accept a surety bond as security for works and services, the prudent course is to only do so where, at minimum, the surety and the bond meet the requirements under section 7(4) of the DCI Regulation (even though DCI Regulation does not apply to servicing requirements and the local government is not obligated to accept a bond as security for servicing requirements).

B. Bond Terms

Key bond elements to review include:

- Bond Financial Limit: The maximum amount for which the surety may be liable;
- Bond Deadlines: Expiry date, notice and claim deadlines, deadlines to commencing legal proceedings;
- Identification Underlying Contract: Clear identification of the local government contract that is secured under the bond;
- Local Government Obligation to Comply with Underlying Contract: Requirements for the local government to comply with its obligations under the underlying contract;

- Notice and Claims Procedures: Steps the local government must take before exercising bond rights, such as to formally notify the contractor of a default under the underlying contract; and

- Execution and Delivery: Whether the bond has been signed and whether the surety has affixed its seal to the bond.

C. Financial Limit under Bond

Recovery under a bond is limited to losses covered by the bond and to the bond's stated financial limit.

Where the local government's losses exceed the bond limit, it will need to pursue the contractor directly for the balance. The local government should also take reasonable steps to mitigate its losses. It is not generally required to exhaust all other sources of recovery before making a claim against the surety.

D. Surety Defences

The potential grounds upon which a surety might dispute or avoid a bond claim include:

- Improper execution or delivery of the bond;

- Failure to provide timely notice of default to the surety or to comply with the claims procedure specified under the bond;

- Taking steps in relation to a contractor's default that prejudice the surety's rights under the bond;

- Failure to give the surety the opportunity required under the bond to investigate, remedy the default or exercise its available options;

- Making material changes to the underlying contract without the surety's required consent;

- Payments made not in accordance to the contract payment requirements or contrary to the terms of the bond;

- Local government failure to perform obligations in the underlying contract; and

- Missing a bond deadline to commence a suit or action under the bond.

Aside from a missed bond deadline, these circumstances may not always discharge a surety and the specific impact will depend on the bond wording, the underlying contract terms and prejudice to the surety.

E. Claims Administration and Risk Management

Upon becoming aware of a potential contractor default, staff should review the applicable bond, identify the applicable deadlines and consider whether to notify the surety. Following such a notice, the surety will generally investigate the alleged default and determine how it will respond to the demand.

To preserve the local government's rights, staff should:

- Maintain complete tender, contract and bond documentation;
- Document contractor performance, payment records, deficiencies and notices of default;
- Track and monitor deadlines under the bond and any bond expiry provisions;
- Notify the surety promptly and comply with all notice and claims requirements;
- Obtain the surety's required consent before making material contract changes;
- Allow the surety the opportunity required under the bond to investigate and exercise its available remedies;
- Consider bond rights and remedies before terminating the contractor, engaging a replacement or undertaking completion work; and
- Seek legal advice promptly in relation to the above, where appropriate.

IX. FORMS OF SECURITY – ON-DEMAND SURETY BONDS

With the recent enactment of the DCI Regulation, the "on-demand surety bond" has emerged as an available form of security (and is mandatory in some cases under the DCI Regulation). Like any surety bond, an on-demand payment bond is a three-party contract between a surety, a principal (the developer) and an obligee (the local government). For a developer, such a bond can be less expensive to obtain than a letter of credit. However, from the local government's perspective, a properly drafted on-demand payment bond is intended to function like a letter of credit, in that the bond obligates the surety to make payment to the local government on receiving a demand for payment made in accordance with the bond terms and precludes the surety from disputing whether the developer is in fact in default under its obligation to the local government.

A. The DCI Regulation

The DCI Regulation permits a developer to pay a development cost charge, amenity cost charge or school site acquisition charge in instalments (if a charge equals or exceeds $50,000, unless a

bylaw permits all amounts to be paid in instalments). Under the DCI Regulation, a developer may pay ¼ of the charge when normally due and the balance within 4 years or before issuance of an occupancy permit and satisfaction of all occupancy permit conditions, if earlier.

Section 7 of the Regulation requires that the developer provide a "surety" for the deferred payment in the form of: (i) an on-demand payment bond from an insurer authorized under the *Financial Institutions Act*, (ii) an irrevocable letter of credit from a bank or from a credit union or trust company authorized under the *Financial Institutions Act* or (iii) a "security duly assigned". While the DCI Regulation does not permit the local government to require or prohibit a form of security, the local government's financial officer may refuse to accept an offered "surety" if the financial officer is not satisfied that, on default, the balance of the charge will be recoverable.

However, section 7(4) of the DCI Regulation provides that the financial officer cannot refuse to accept an on-demand surety bond provided by an insurer authorized under the *Financial Institutions Act* if the bond has the following requirements:

(a) the insurer who issues the bond has one of the following credit ratings:
  (i) a rating of at least A- from AM Best;
  (ii) a rating of at least A+ from Fitch Ratings;
  (iii) a rating of at least A1 from Moody's;
  (iv) a rating of at least A (high) from Morningstar DBRS;
  (v) a rating of at least A+ from S&P Global Ratings;

(b) the bond provides the following:
  (i) the insurer must pay the local government the balance of the charge within 15 business days after the local government demands payment from the insurer in accordance with subparagraph (ii);
  (ii) a demand referred to in subparagraph (i) must be made in writing and must include
    (A) a statement that the local government has determined that the developer has failed to pay the balance of the charge in accordance with section 4 (b); and
    (B) the balance of the charge;
  (iii) a payment referred to in subparagraph (i) must be made despite any objection by the developer, and the insurer may not assert any defence or other grounds for not making the payment;
  (iv) the insurer may not terminate its obligations under the bond unless:
    (A) the insurer gives written notice to the local government and the developer at least 90 days before the date on which the insurer intends to terminate its obligations; and
    (B) the developer deposits another surety in accordance with this section at least 30 days before the date on which the insurer intends to terminate its obligations.

The credit rating requirements of subsection (a) are obviously important and a financial officer is not obligated to accept a bond from a surety who does have one of these credit ratings.

However, the requirements of paragraph (b) are equally important. It is the inclusion of these mandatory terms that are intended to ensure that the bond functions in a manner similar to an irrevocable letter of credit. If these terms are not included in the bond, the financial officer is not required to accept the bond. The following are mandatory terms:

- Require insurer (surety) payment within 15 business days of local government demand and despite any developer objection;
- Prohibit the insurer from asserting any defence or other grounds for not making payment; and
- Prohibit bond termination unless:
  - The insurer provides 90 days' notice to the local government; and
  - The developer provides another surety in accordance with section 7 of the Regulation at least 30 days before the intended termination date.

As noted, if a proposed bond does not meet these mandatory requirements, a financial officer is not required to accept the bond as security for the deferred payment. Moreover, the financial officer *ought* not accept the bond, given the critical importance of these requirements.

B. Using On-Demand Surety Bonds for Other Purposes

Aside from the noted circumstances under the DCI Regulation, the Charter and the LGA do not require a local government to accept an on-demand surety bond for other purposes, such as for security under a works and services agreement.

Of course, local governments may come under pressure to consider this less expensive type of security and may even choose to incorporate on-demand surety bonds into policies relating to acceptable security. In doing so, it will be essential for such policy to only accept on-demand payment bonds from sureties and on terms that, at minimum, to meet the requirements of section 7(4) of the DCI Regulation (even though the DCI Regulation only applies to development charge instalment security).

X. OTHER FORMS OF SECURITY

Sometimes a developer will propose an alternate form of security, such as a mortgage of property or a third-party guarantee. While a detailed discussion of these other forms of security is beyond the scope of this paper, local governments should be extremely cautious about accepting alternate forms of security for many reasons, including:

- Financial Capacity of Guarantor: A local government is unlikely to be in a position to assess the financial capacity of a person proposing to guarantee another person's obligations to the local government, and that financial capacity can change over time;

- Value of Secured Property: Similarly, while a local government may be able to obtain comfort (e.g., an appraisal) as to the value of secured property, such as land to be mortgaged, that value can change over time and can also be affected by liens (such as for unpaid taxes) that may have priority over the local government mortgage;

- Enforcement Litigation: Realizing on a mortgage and other similar security will involve foreclosure or other litigation proceedings and the ability to recover related costs will depend on the value of the secured property; and

- Red Flag: It ought to be a red flag if a developer is unable (due to financial institution or surety refusal) or unwilling (due to project cost pressures) to obtain a bond or letter of credit.

For a more detailed discussion of alternate forms of security, please see the classic 2009 Young Anderson Seminar Paper written by Raymond Young, K.C., and Christina Reed: Is Your Security Worth the Paper It's Written On.

XI. ATHENTICITY CHECK

In this age of increasingly complex financial fraud, a local government should verify the authenticity of a letter of credit or bond with the issuing financial institution or surety, recognizing that the contact information provided in a fraudulent letter of credit or bond may be the contact information for someone who is participating in that fraud.

A local government should complete such a check before it confirms that it has received the required security (e.g., wait for confirmation of the letter of credit or bond before issuing a subdivision approval).

XII. CONCLUSION

This paper has provided an overview of a local government's powers to require security, the typical types of security, and certain practical matters to consider when taking security. With that overview in mind, local government staff should always:

- Review the local government's power to require the security – what security is permitted? Who chooses?

- Generally, be wary of accepting non-standard types of security;

- Review the terms of the agreement or permit to be secured – Ensure such terms adequately authorize the local government to exercise rights under the security instrument;

- Review the proposed security instrument – review a draft of the instrument to ensure it meets local government requirements and review the submitted security instrument to ensure it meets those requirements and is properly executed;

- Verify security instrument authenticity with the issuing financial institution or surety;

- Establish security monitoring and tracking systems, including for security instrument deadlines, expiry dates and non-renewal notices; and

- Promptly review security instruments in the event of an agreement or permit default or anticipated default.

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