IS YOUR SECURITY WORTH THE PAPER IT'S WRITTEN ON?

BONDS, LETTERS OF CREDIT, AND OTHER FORMS OF SECURITY

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I. INTRODUCTION

Questions frequently arise regarding forms of security that are available for consideration by local governments. This paper will analyze the two most common forms of security -- the letter of credit and the bond -- what they are, how they work, and how they are different, as well as canvassing some other forms of credit that are less often considered. In construction tenders, the tender security is generally taken either as a bond or a letter of credit, while the performance security is almost always by way of bond. For subdivision servicing agreements and development permits, the vast majority of security taken is by way of letter of credit.

Whenever a municipality is evaluating alternative security arrangements, it should consider:

- the sufficiency of the security (is the amount of security sufficient to secure the performance of the obligation or correct the default?)
- the liquidity of the security (how easy is it to turn the security into cash? Does the security require a lawsuit to realize the cash?)

While the most liquid form of security is a cash security, that is not always the method available to a municipality in a particular transaction.

Using the assumption that the audience for this paper is local government staff, this paper will refer to the party who has the benefit of holding the security as the municipality, and will refer to the party dealing with the municipality who is obliged to grant some type of security as the contractor.

II. AUTHORITY TO REQUIRE SECURITY FOR PERFORMANCE OF OBLIGATIONS

Local governments in British Columbia may require security from persons for the performance of obligations under the following authority:

A. Contract

1. Natural person powers (municipalities only) S. 8(1) of the *Community Charter*.
2. Corporate powers (regional districts only) S. 176 of the *Local Government Act*.

B. Statutory Service and General Regulatory Powers

1. Section 15 of the *Community Charter* for municipalities all regulatory and service powers, whether in the *Community Charter* or the *Local Government Act* (except Parts 26 and 27 of the *Local Government Act*).

2. For regional districts, service (not regulatory) powers only, S. 796.2(3) of the *Local Government Act*.

3. For regional districts, regulatory power S. 694.1 limited to two building permit powers only.

C. Part 26 and Part 27 of the Local Government Act Regulatory Powers (Management of Developmental and Heritage Conservation)

In respect of security, Parts 26 and 27 of the *Local Government Act* constitute a different regime. This is so for regional districts because S. 796.2 of the *Local Government Act* authorizing security generally for regional districts is limited (with exception of building permits) to non-regulatory authority.

In respect of municipalities, S. 15 of the *Community Charter* which authorizes terms and conditions generally (including security) in respect of regulatory matters, limits such authority to circumstances where the municipality:

> … provides[s] for a system of licences, permits or approvals …

Since the permit and approval systems in Parts 26 and 27 are directly established by the Province pursuant to the *Local Government Act*, S. 15 of the *Community Charter* has no application.

In Part 26, security is required:

1. in respect of Development Permits, Development Variance Permits, Temporary Commercial/Industrial Permits and Tree Cutting Permits pursuant to S. 925 of the *Local Government Act*;

2. in respect of subdivision, works and services pursuant to S. 940 of the *Local Government Act*;

3. in respect of Heritage Alteration Permits pursuant to S. 973 of the *Local Government Act*.

D. Rules Relating to the Use and Holding of Security

1. In non-statutory contractual circumstances, where a municipality is acting under S. 8(1) [natural person powers], and where a regional district is acting under S. 176 (corporate powers), the terms on which a security is held, used and expended vary with the contractual terms negotiated.

S. 24 of the *Law and Equity Act* R.S.B.C. 1996 c. 253 provides the courts with jurisdiction to relieve against all forms of penalty and forfeiture. Thus in contracts, one should avoid the terms "forfeiture" and "penalty". Stick with the term "security" and the wording that allows the municipality to "use and expend" the security. It is a consequential conclusion of this approach that the security be spent undertaking the obligations for which it was taken and that any other expenditure would be *de jure* a forfeiture or penalty.

2. In respect of statutory "service" a "regulatory power" (except Parts 26 and 27):

(a) Section 19 of the *Community Charter* applies to municipalities both in respect of service and regulation and requires that:

- the security to be by cash, irrevocable letter of credit, or some other form of security satisfactory to the council (or its delegate)
- interest becomes part of the security
- the security may only be used for the purpose for which it was provided
- any amount excess to purpose must be returned to the person who provided the security.

(b) with respect to Part 26 (S. 925) there is a wrinkle in the rule as to "return of the security". S. 925 provides for return to the "permit holder". This may be someone different than the person who provided the security. Conversely in Part 27, security taken for a heritage alteration permit follows the general rule and is to be returned to the person who provided the security;

(c) the only statutory rules relating to security taken by regional districts are found in S. 694.1 of the *Local Government Act*, but they only apply to building permits and approval to move a building under S. 694. Those rules are naturally indistinguishable from the rules in S. 19 of the *Community Charter* apply generally to municipalities with the one difference that the purposes for which the security may be used re limited to repair and replacement of:

- a highway (including sidewalks and boulevards)
- a public work or
- other regional district property that has been altered or damaged by an activity related to the subject matter of the [building] permit or the authorization (to move a building);

(d) there are no statutory rules laid out for regional district security in respect of other instances (in service bylaws like water, sewer, etc.). One assumes that the rules in

S. 19 of the *Community Charter* and S. 694.1 of the *Local Government Act* reflect the common law and that a court would read them into circumstances where a regional district may require security for services (S. 796.2(3)).

E. Requiring the Letter of Credit

We suggest the following provision for contracts or bylaws relating to the nature of the security required:

> A clean unconditional self-renewing and irrevocable letter of credit issued by a Canadian chartered bank or a credit union incorporated pursuant to the *Credit Union Incorporation Act* R.S.B.C. 1996, c. 82 or the former *Credit Union Act* of the Province of British Columbia, drawn in favour of the Corporation of the District of "XYZ" which letter of credit must be capable of being presented and drawn down at a branch of the issuer within the Municipality of "XYZ".

You should actually read the Letter of Credit when it is presented to you to make sure it is wholly and totally unconditional, is irrevocable, is self-renewing and is expressly to be honoured in Town at a branch of the issuer. Despite "unwritten policies" of the issuer, the general law is that a Letter of Credit will be honoured at the address of issuance.

III. LETTER OF CREDIT

A. What is a Letter of Credit?

A letter of credit is a formal written undertaking issued by a financial institution, usually a bank, to pay money to a designated person, in this case the municipality, upon receipt of a timely demand accompanied by delivery of certain documents specified in the letter of credit. The municipality can cash ('draw down on') the full value of the letter of credit, or portions of it, in accordance with the terms and conditions set out in the letter of credit.

Letters of credit are a specialized form of commercial credit, that date back to the 'letters of rights' that merchants used in twelfth century Europe when handling long-distance trade. The characteristic that gives them particular commercial utility and efficacy is the obligation of the bank to fulfill payment on demand. The bank that has issued a letter of credit does not need to inquire, when a beneficiary demands payment, about the performance of the side agreement which is the underlying reason for which the letter of credit was issued. The courts have long recognized that a letter of credit constitutes an absolute obligation upon the bank to pay, regardless of any dispute between the beneficiary and the contractor. (This is in contrast to a bond, where the issuer will, before any payment, consider the substance of the claim asserted by the beneficiary.)

There are two main forms of a letter of credit. The first is a "documentary" letter of credit which is used in commerce, where, as an example, the letter of credit is tendered as payment for goods, and the manufacturer who holds the letter of credit draws on it by presenting to the bank, thereby effecting payment from the purchaser to the manufacturer.

For municipalities, the more relevant type is a "stand-by" letter of credit, which is posted not for payment, but as a means of security. The letter of credit is prepared to secure the obligations of one party to another and is cashed only when the obliged party defaults. When it is properly drafted, a letter of credit permits the beneficiary to cash it without proving to the issuing bank that it has the right to do so, and so is as good as cash to the municipality for the amount on the face of the letter of credit. The insolvency of the contractor, as customer of the issuing bank, is completely immaterial to the enforceability of the credit against the issuing bank, which is another point in the favour of using a letter of credit.

B. Autonomy of a Letter of Credit

A letter of credit is autonomous from the underlying contract or transaction to which it relates. For example, while a municipality and a contractor can agree that a particular letter of credit is required in the case of default by the contractor under a construction contract, the question of default under that contract is irrelevant to the issuing bank. The bank must honour the terms of the letter of credit itself. Consequently, any defence or reason for not performing a contract that a contractor may raise cannot prevent the municipality from drawing on the letter of credit. Within this understanding, the bank is not a guarantor or an indemnitor (as a surety is with a bond), but as a contracting party in the letter of credit relationship. This autonomy is what makes the letter of credit almost as good as cash, and therefore preferable to a bond for ease of use.

The only exception to this principal of autonomy is where there is fraud by the beneficiary and the issuing bank has notice of that fraud – such as misrepresentations made knowingly without an honest belief in its truth, or made recklessly or carelessly as to whether it be true or false. A demand for payment which clearly does not meet the conditions of the letter of credit may be found to be fraud on the letter of credit. However, in many circumstances it will be unclear whether the beneficiary's actions amount to fraud, or some lesser default which would not warrant the refusal by the bank to honour the letter of credit.

C. Terms for the Letter of Credit

The letter of credit will contain the terms upon which it may be cashed by the beneficiary. The security and liquidity of a letter of credit depend on the clarity of its terms. Since the sole consideration of the issuing bank before payment is whether the terms have been strictly complied with, municipal staff should closely scrutinize the terms offered in a particular letter of credit. The municipality will have to act in strict accordance with all conditions in order to be entitled to payment. Generally, all stand-by letters of credit should state the **time and place and the form of demand** for payment.

In order to ensure that a particular letter of credit can be used effectively and simply by a municipality, the highly desirable terms to be employed, from the municipality's point of view, are as follows:

(a) **Irrevocability**

The letter of credit should stipulate that it is irrevocable during its term, in order to prevent the issuing bank from revoking the letter of credit before its expiration date. The expiration date, or 'term', of a letter of credit is often set at "one calendar year after the date of issuance". After expiry of the term, the letter of credit is of no use. A revocable letter of credit gives no protection to the municipality as it can be revoked before a default (or reason for drawing upon it) occurs.

Further, the letter of credit should allow the local government to draw down on the letter of credit if it is about to expire.

(b) **Automatically Renewing**

An extension clause should be included within the letter of credit, such as the following:

"This letter of credit shall be deemed to be automatically extended without amendment from year to year from the present or any future expiration date hereof, unless at least thirty (30) days prior to the present or any future expiration date, the issuing bank notifies you [the beneficiary] in writing by prepaid mail that it elects not to consider this letter of credit to be renewable for any additional period."

(c) **Clean and Unconditional**

The letter of credit must be 'unconditional', in that the local government must be entitled to draw down on it, in whole or in part, upon written demand to the issuing bank. The letter of credit must also expressly require the issuing bank to honour a demand for payment without asking for any proof of any documents, or without making any inquiries as to entitlement. A letter of credit that does not require supplementary documentation to be presented at time of payment is called 'clean'. This allows the municipality to cash the letter of credit without submitting proof to the issuing bank that it is entitled to cash it as between the local government and the contractor, or that any preconditions have been satisfied by the municipality.

(d) **Incorporation of UCP600**

The International Chamber of Commerce began collecting and publishing some of the customs of letters of credit as 'rules' as a service to international banking and

trade nearly a century ago. These rules are continuously updated and the latest version from 2007 is known as the *Uniform Customs and Practices for Documentary Credits – UCP600*. UCP600 must be specifically invoked in the text of the letter of credit for these important customary rules to apply. The Canadian courts have, without exception, accepted references in letters of credit invoking UCP600 (or its precursors) to be effective to incorporate those rules as part of the contract of the letter of credit, binding upon all parties to it and persons claiming under it.

In 2002, the International Chamber of Commerce brought into force the *UCP Supplement for Electronic Presentation* ("eUCP"), to adapt to the new electronic banking environment which is phasing out paper-based methods of communication and documentation. eUCP is intended to be a supplement to, but not a substitution for, UCP600 as it provides new definitions for centuries-old terms, such as 'appears on its face', 'place for presentation', and 'sign', and for the process of electronic presentation and payment. So far, the use of eUCP seems to be mainly in documentary letters of credit.

(e) **Specify Place of Demand**

The letter of credit should specify the branch of the issuing bank at which demand for payment may be made. Ideally, the letter of credit should allow demand by the municipality at the closest branch to the municipal hall, to make it easier for municipal staff to make a timely demand. No BC municipality wants to be using a letter of credit specifying that the demand for payment needs to be presented at a branch in Toronto.

(f) **Issuing Bank**

A related consideration is the credibility of the institution issuing the letter of credit. A municipality should consider only accepting letters of credit issued by banks chartered under the *Bank Act* (Canada). In the case of another institution, the municipality should satisfy itself regarding that institution's creditworthiness. Court cases have considered the enforceability of letters of credit against issuers which are insolvent, which do not always end happily for those beneficiaries.

D. Terms for the Underlying Agreement

The municipality should ensure that the contract between the municipality and the contractor includes the following terms regarding the letter of credit:

- explicit agreement that the municipality can use the letter of credit to complete the obligations of the contractor. Generally, the security will not cover the entire cost of the contract, and the agreement should contain comprehensive provisions regarding performance on behalf of the contractor if in default, responsibility for additional costs,

allocation of risks, and liability if the municipality needs to step in and perform the obligation itself.

- indemnification from the contractor in favour of the municipality, as the letter of credit may not cover the full cost in case of default.

- requirement that the contractor renew the letter of credit at least two weeks before it expires, and provide written notice and proof of renewal of the original letter of credit to the municipality.

E. How to Draw Down a Letter of Credit

While a properly drafted letter of credit can be as good to a municipality as cash, the drawing down on a letter of credit imposes a financial burden on a contractor. Often a contractor will have posted security to the issuing bank in order to obtain that letter of credit. Consequently, the municipality should be prepared for any cashing of the letter of credit to have an immediate detrimental effect on the contractor's financial condition and possibly the ability of the contractor to complete its other responsibilities under the accompanying contract.

Generally (and practically) speaking, here are the steps to follow when drawing down a letter of credit.

- Read the letter of credit. Ensure that any preconditions have been met by the municipality and the term has not expired. The demand for payment must be prepared in strict compliance with the specifications listed in the letter of credit (e.g. if the original letter of credit needs to accompany the demand for payment, a photocopy of the letter of credit will not suffice).

- Generally, the demand for payment should be an original letter on municipal letterhead signed by the corporate officer of the municipality (unless another particular individual is specified in the letter of credit to sign the demand for payment). The demand should be dated, and it should reference the letter of credit by number, the issuing bank and branch, and the person to whom presentation should be made (if applicable). Usually, the original letter of credit needs to accompany the demand payment. The demand for payment should specify the requested method for the money to be paid over – electronic transfer to a municipal account, money order, official bank draft, etc. – if the letter of credit does not specify the actual form of payment. Such form of payment is irrevocable once made.

- The demand for payment must be presented to the issuing bank at the branch specified in the letter of credit during its posted banking hours.

- Consider telephoning the bank in advance to give details of the letter of credit that will be cashed. Follow up the telephone conversation with a fax or email which includes a copy of the letter of credit, a copy of the demand for payment letter, and the name of the

person and date of attendance for demand of payment. Some banks allow for presentation by courier, but not all do.

IV. SURETY BOND

A. What is a Surety Bond?

Generally, a bond is a three-party agreement, where the first party (the "surety") guarantees that the second party (the "principal"; here, the contractor) will fulfill its obligations to a third party (the "obligee"; here, the municipality). In exchange for guaranteeing the principal's performance of its obligations, the surety charges the principal a premium, and would look to the principal for indemnification if the principal were to default on its obligation. The obligee, who requests the principal to provide the bond, has the benefit of the guarantee and the obligation. The bond creates a three-way agreement between the parties and incorporates the terms of the underlying contract.

Unlike letters of credit, bonds do not stand on their own; they are based on the terms of an underlying agreement. The terms of the bond will be a blend of the bond itself, the underlying agreement, and applicable statute and common law. A bond is a contract of guarantee, not a contract of insurance. Any loss on a bond is ultimately the principal's loss. This is because, pursuant to an indemnity, the surety will look to the principal for recovery of any loss. The surety is entitled at Common Law, even if there is no written indemnity agreement, to be indemnified by the principal.

Obtaining a bond can be difficult for a contractor, as a bonding company before agreeing to be a surety must be satisfied of the contractor's ability to fulfill its contractual obligations in the underlying agreement. A surety will undertake extensive research to assess the financial stability, background, and character of a contractor, and history of its business.

B. Terms and Conditions

A surety is only liable on a bond if the principal defaults in respect of the undertakings contained in the underlying contract between the principal (contractor) and the obligee (municipality). Bonding companies generally have standard forms of each type of bond, and a municipality will have little success in negotiating changes to their standard forms. There are a number of important terms in every bond:

- The surety is firmly bound to the obligee for a specified amount.
- The bond specifically provides that the surety will not be liable for a greater sum than the specified amount of the bond.
- The underlying agreement is specifically referenced, including its date and the specifics of its contents, along with all specifications and drawings, and are specifically incorporated by reference into the bond.

- The bond is only in force and effect until such time as the contractor completes performance of the underlying agreement, upon which time the bond is null and void.

- It is a term of the bond that the municipality must perform all of its obligations under the underlying agreement, in order to claim under the bond.

- The bond specifies an expiration date prior to which any suit under the bond must be instituted by the municipality.

- To be effective and enforceable, a bond must be signed by all the parties, including the surety, and must be delivered to the municipality.

Where there is a default by the contractor the following rules apply:

- The surety is liable only for actual damages sustained by the municipality, except that the face amount of the bond represents the maximum liability of the surety, regardless of actual damages sustained by the municipality

- To the extent that the municipality suffers greater damages than the face amount of the bond, the municipality's recourse will be against the defaulting principal, and not the surety. As the municipality is entitled under the bond to recover actual losses from the surety, the municipality must take steps to minimize any losses it suffers due to the default of the contractor.

- There is no obligation on the municipality to exhaust all other sources or recovery before claiming on the bond.

C. Material Changes to Underlying Contract

A bond refers to a specific underlying contract. The municipality cannot increase the risk for the surety without the surety's consent. Therefore, if there is a material change to the contract without the surety's consent, the surety will be released from its obligations under the bond, unless the change is unsubstantial or benefits the surety. It is essential as an obligee to keep the surety company informed, and seek its consent for any changes to the underlying contract.

D. Types of Surety Bonds and How They Work

In construction tendering, the three most common forms of bonds are as follows:

- Bid Bonds guarantee that, if a contractor is awarded a construction contract under tender, and the contractor refuses to enter into the construction contract in accordance with the terms of that tender, the surety will pay the difference in value between the successful tender and the next lower tender, up to the penalty limit of the bid bond.

  Standard tender documents usually require a contractor to submit a bid bond, to ensure that contractors submit bids in good faith. If the winning tenderer fails to enter into a

formal contract or provide the required security for the final contract after receipt of notice of award, the tenderer will have defaulted and the municipality is in a position to make a claim on the surety. In that case, the surety must compensate the municipality according to the terms of the bid bond, subject to any defences it may have (such as an obvious mistake in the contractor's bid).

A municipality that wants to make a claim must notify the surety in writing. The bond itself sometimes sets out certain conditions of the claim, such as preparing a formal contract in accordance with the precise terms of the tendering documents and presenting it to the contractor for acceptance.

- Performance Bonds guarantee that the contractor will perform all of its obligations under the underlying contract. If the contractor fails to perform all of its obligations, then the surety's obligations arise, provided that the municipality has performed all its own obligations under that contract. The surety will be obliged to either remedy the default, complete the contract, or put bids for completion to the municipality.

For a municipality to claim under a performance bond, the principal must be in default under the contract and there must have been a proper declaration of default by the obligee. Case law provides that "default" only refers to those defaults that are of so serious a nature that the obligee deems it proper to make a declaration of default and call upon the surety to perform its obligations under the bond. The municipality must notify the surety in writing of the default. A surety will be liable under its bond only if all expressed requirements in the bond are met, including the municipality having met its own obligations under the contract and meeting time limits for making a claim. The surety is entitled to a reasonable period of time to investigate the alleged default. The municipality should ensure that it fully provides the surety with an opportunity to perform the contract or remedy the default. The municipality cannot perform the contract itself and assume that it will be entitled to collect payment from resulting losses from the surety.

To reiterate, bonds almost always require the municipality, as obligee, to perform all of its obligations under the contract before calling on the bond. Therefore, a municipality should exercise caution in deviating from the contract, even in response to a suspected breach by the contractor. Any failure to perform on the part of the municipality exposes it to a refusal to indemnify by the surety. Other denials of claim and surety's defences include:

- the bond is not executed properly or never delivered to the obligee;
- failure to notify the surety of the principal's default in a timely way or failure to give the surety an opportunity to follow one of the options available to it under the bond;

- · material change to the principal's work under the contract without the surety's consent;
- · payments made contrary to the payment schedule in the contract; and
- · extension of completion date without the surety's consent.

▪ Labour and Material Payment Bonds provide for the payment of subcontractors and material suppliers if the principal does not make payments as required by the underlying contract.

Unlike a payment bond, a performance bond may not be called upon by anyone other than the local government, as there is no privity of contract between the surety and the subcontractors and suppliers to the contractor. In order to give assurance to these persons, the contractor is generally required to obtain a labour and material payment bond.

As with the previous bonds, the surety is only liable for the limit on the bond, and the wording of the payment bond is important for determining the rights and responsibilities of the municipality and the obligee. However, labour and material payments bonds differ from other bonds in that the potential claimants, the subtrades and suppliers, are not parties to the bond. The standard wording of such payment bonds makes the obligee the trustee, on behalf of the claimants, of the rights against the surety that the payment bond provides, and permits the claimants to sue on the payment bond in the name of the obligee as trustee. The payment bond will contain time limits as to when claims can be made, and defines a method under which claims must be made. Claimants must show that the claimant has a direct contract with the general contractor, that the claimant has complied with the notice provision in the bond, and the amount that is properly due to the claimant.

E. Final thoughts on bonds

From the surety's point of view, the surety must consider the validity of claim by the municipality that the contractor is in default. Sureties generally support the contractor in defending any claim of breach of the underlying agreement, because to do otherwise puts the surety at risk of losing its right to be indemnified by the contractor. Sureties therefore have a great incentive to protect their own financial interest upon receiving a claim.

The protection that a bond provides to all parties comes from a combination of the bond, the underlying agreement, and the applicable law. Disputes involving bonds often arise from poor tendering practices (bid bonds) or poor contract documents (performance bonds). The parties should seek appropriate legal advice whenever there is doubt about tendering and contractual documents.

V. SOME NOTES ON OTHER FORMS OF SECURITY ARRANGEMENTS

It has been our experience that developers do ask municipalities to take alternate forms of security, in place of traditionally-accepted letters of credit and bonds. In the last year, these alternative forms of security have been offered with the developer complaint that the cost of borrowing, or of obtaining the letter of credit, is too high for the developer. The cost of borrowing is a business expense of the developer, which, to be frank, is not the municipality's problem.

More often, though, these alternate security forms are offered for municipal consideration after a bank or bonding company has determined that a particular contractor is not creditworthy. These financial organizations have the knowledge and experience to perform intensive due diligence on a contractor's financial position, which far exceed the investigations that municipal staff are capable of performing. We would caution staff to treat this message as a "red flag" about the contractor's financial health, which would make realizing the security on any of these alternate types of security arrangements even more uncertain. If a bank does not want to extend credit want to a particular contractor, why would you want to?

A. Mortgage

A mortgage is a transfer of an interest in real property from a debtor to a creditor for the purpose of securing the performance of an obligation or the payment of a debt, and that transfer is made subject to the condition (known as the equitable right of redemption) that upon the performance of the obligation or payment of the debt, the property will be transferred back to the debtor. This is a common method of securing payment, especially in the residential real estate context. In modern practice in British Columbia, title to the land is not actually transferred to the creditor at the time of registration of the mortgage documents. Instead, the mortgage security is registered at the Land Title Office as a charge against the title to the land, and the creditor remains the legal owner of the land. Despite this practice, the language of redemption still survives when discussing mortgages.

The ultimate remedy of a creditor is to take title to the property in satisfaction of the mortgage. However, in practice the creditor will nearly always recover its funds through a court-ordered sale of the real property in situations where the owner is not able to find replacement funds to satisfy the mortgage in time. Foreclosure is a process that is accomplished by notice, the granting of a time to redeem to the debtor (usually six months), and if the property is not redeemed, applying to the court for the sale of the property. Upon completion of the redemption period and the appropriate steps for sale, the judicial approval required for the transfer of the property is obtained at court. The court is asked to approve all steps in the process, including the purchase price, terms of sale, and even the commission payable to a real estate agent involved in the sale.

There are many laws, both statutory and judge-made, regulating the terms and conditions of mortgages, which are too numerous to detail here. There are, for example, rules regarding the maximum amount of interest that can be charged (both before and after an event of default), how long a debtor can remain in default before a creditor can take steps to foreclose, equitable

remedies of the debtor against quick foreclosure, and so on. The terms of any mortgage need to be drafted carefully.

There are several important issues that make taking security in the form of a mortgage less desirable to a municipality than a letter of credit or a bond.

The first problem, and it is an integral problem to the use of this type of security by municipalities, is whether or not the municipality has advanced money to the developer. **A mortgage is not enforceable unless the creditor has actually advanced money or value, or if the mortgage secures an obligation, that obligation must have a liquidated ascertainable value so that the debtor may be able to have certainty in the amount required to discharge the mortgage.** In the case of a residential mortgage, a bank extends credit that allows the debtor to purchase the home. In the municipal arena, it can be very difficult to identify just what type of consideration the municipality (as creditor) has extended to the debtor in order to require the granting of the mortgage. A municipality needs to carefully consider whether the context is a debt owing, or at least a liquidable obligation to the municipality, in order to use a mortgage as a security tool in that situation. Drafting this type of mortgage requires some special provisions and ought to be done on a one-off basis, and not pursuant to the standard form mortgage terms in this Province.

Secondly, the municipality will have to go to court to enforce its right to possession of the real property interest. Upon default of payment, the mortgagee cannot simply take title to the property from the debtor. Foreclosure and sale proceedings take time, even if uncontested, which is not ideal for a municipality that requires immediate cash for expenditures on unperformed contractor obligations. The foreclosure process itself costs money, so this needs to be factored into the interest rate and terms of the mortgage. If the municipality wants cash in hand from the realization of the security, that municipality will need to find a purchaser of the real estate interest in order to recoup the unpaid amount. Consider how likely the chance of a decline in land values in your area is, and how desirable and marketable the particular property is, in order to get value for security. If the contractor mismanages construction on the property or the contractor has other financial problems, the property may contain a partially completed building, which could be an additional liability for the municipality. Another probability if the mortgage is in default is the registration of liens against the property title, especially builders' liens and judgments for other creditors. Finally, if, on a court-ordered sale, the land sells for more than the mortgage and foreclosure costs, the municipality is not entitled to keep the excess, but must pay that excess to the contractor.

A related issue is whether a particular piece of real property is already mortgaged to a commercial bank or other lender. If a mortgage is already registered on title to a particular property, all the debtor would be able to offer to the municipality as security is a second mortgage (which is a mortgage on the owner's retained equitable right of redemption). A second mortgage is much less secure than a primary mortgage, and also more difficult to foreclose upon. We would not recommend a municipality taking security by way of a second mortgage in any event.

B. Guarantee

In brief, a guarantee is a promise made by one person (the "guarantor") to answer for the debt or default of another (the "principal"; here, the contractor) to a third person (the "creditor"; here, the municipality). The guarantor undertakes that the obligation to pay will be performed, in the sense that the guarantor will answer for the debt of the principal if the principal does not perform as required. The creditor can look to the guarantor as an alternate source of payment. This method motivates the guarantor to cause the debtor to make payment or facilitate the performance of its obligation. A guarantee may be limited or unlimited in amount, absolute or conditional, secured or unsecured.

This method of ensuring payment is only as good as the contractual promise of the guarantor, the guarantor's creditworthiness, and the guarantor's ability to be located when the principal has defaulted on the debt. In effect, the guarantee is no different at law than the principal's promise to perform the original obligation. A municipality should consider requiring that a third party guarantee itself be secured by a cash security, letter of credit, performance bond, or mortgage.

C. Promissory note

A bare promissory note (the quintessential "I.O.U."), while evidence of indebtedness, is only as good as the creditworthiness of the party that offers it. If properly drafted, it can be enforced in a court of law, but actually realizing payment from a promissory note is a significant hurdle. Without some form of pledge or further security, this is the same as the promise to perform the original obligation, and is not an effective form of security.

D. Escrow agreement

An escrow agreement is an arrangement where property is put into the hands of a third party (called the escrow agent) to be held until a certain contingency takes place or a condition is met. It requires two agreements to be entered into: the first between the two parties regarding the certain property to be placed in escrow, and the second between the two parties and the escrow agent where the escrow agent accepts the obligations put upon him or her. This process is much more commonly used in the United States than in Canada for real estate transactions.

An example of an escrow agreement would be where a third party was nominated to hold the duplicate indefeasible title to real property owned by the contractor. The municipality and the contractor would then set up agreements as to the terms and conditions as to when the duplicate titles would be handed to the escrow agent, what the escrow agent could and could not do with the duplicate titles, on what terms the escrow agent would give the duplicate titles back to the contractor (or the Land Title Office), and what would happen in the event of dispute.

E. A note on why a Lien is not Security

Occasionally, clients request that a lien be placed against land, as security or after a particular security has been shown to be insufficient. Most liens arise through the operation of statutes

(such as a builders' lien, or a lien for unpaid taxes under the *Community Charter*) and the rights and remedies of the parties are clearly laid out in those statutes. There is a common-law lien that gives the creditor the right to retain possession of property until the debt to which the lien relates is repaid. This type of lien relies entirely upon continuous possession and confers no power of sale on the creditor, so this is really just a defence to a debtor's claim to recovery of its property. Generally, liens are not a consensual form of security, so really are not applicable to the type of situations discussed here.

VI. SO, HOW DO THEY COMPARE?

Liquidity matrix	**Letter of Credit**	**Bond**	**Mortgage**	**Bare Guarantee**
Have to prove default or non-compliance of contractor to realize the security?	**No**	**Yes**	**Yes**	**Yes**
Affected by other creditors, bankruptcy, or insolvency of contractor?	**No**	**Yes**	**Yes**	**Yes**
If payment not forthcoming from contractor, is a lawsuit required?	**No**	**Maybe**	**Yes**	**Yes**