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## SURETYSHIP

### SOME QUESTIONS AND ANSWERS ON THE NEW INDEMNITY AND SECURITY AGREEMENT

The new Indemnity and Security Agreement has now been in use for six months. Questions have been raised by both brokers and the persons who are called upon to sign the Agreement. We would like to answer some of the most frequently raised questions.

#### **1. Why a new Indemnity Agreement?**

As a result of the coming into force of the new Quebec Civil Code on January 1st 1994.

#### **2. Why did the new Code make it necessary to change existing indemnity agreements?**

For two main reasons:

- a. The new provisions of the Code require that contracts of this type be drafted in clear terms and
- b. The Code completely modifies the law on security, that is, guarantees (for example the law concerning what was previously referred to as assignment of debts).

#### **3. Why is the new Indemnity and Security Agreement longer than the previous agreement?**

For three main reasons (in order of importance):

- a. To respect the requirements regarding the comprehension of contracts as set out in the new Code, each provision of the new agreement has been treated in distinct paragraphs which, contrary to the former agreement, is easier to read;

- b. To respect the requirements of the new Code in matters of security (now referred to as "hypothecs"), the assignment of debts and of rights as set out in the old Code had to be replaced by their equivalents in the new Code;
- c. The new agreement must also cover the requirements of the other (common law) provinces which are different from the requirements in the Province of Quebec.

Most questions concern topics which are believed to be new provisions whereas these provisions are simply rewordings of the ones set out in the old agreement.

**4. *What are the hypothecs agreed to in the new Agreement?***

There are two:

- a. A **hypothec on claims** (formerly known as assignment of debts) to permit the surety to receive contract funds on the contracts which it must complete and
- b. A **hypothec on work in progress, materials and equipment** most notably on bonded contracts, to allow the surety to finish the work which it must complete.

**5. *Who grants these hypothecs?***

It is important to note that only the principal (who has required the issuance of bonds) is called upon to grant hypothecs under the new Indemnity and Security Agreement and **not all of the indemnitors**.

**6. *Why must we now register the Indemnity Agreement?***

First of all, it is not the Agreement which must be registered but rather the hypothecs set out in the Agreement. The reason is that, contrary to the provisions of the former Code, the new Code requires that most hypothecs (including those on all claims) be registered (we now say published or entered into the register), otherwise, they will not have any effect as regards third parties such as trustees in bankruptcy.

**7. *Why must an amount be indicated in the new Agreement?***

Simply because it is a requirement in the new Code (contrary to what was required by the previous Code).

**8. What is the meaning of that amount?**

It represents the value of the hypothecs granted in the Agreement, in other words, the value of the accounts receivable, the equipment and the work in progress on the bonded contracts in case of the principal's default.

This amount only affects the principal and not all of the indemnitors. It does not mean that the principal will necessarily be liable for this amount. This amount may sometimes appear high but it must be kept in mind that surety companies will not want to have new Agreements signed every time there is a change in the principal's circumstances, the registration of the hypothecs being valid for a period of ten years.

It must finally be remembered that the recovery of any amount will reduce the liability of the indemnitors for the same amount.

**9. Why do Quebec sureties register their Agreements whereas it is not a general practice in Ontario or in other common law provinces?**

Sureties in the other provinces have rights which are not available to sureties in Quebec. For example, under the *Construction Lien Act* in Ontario, owners (and sureties by legal subrogation) can deduct the cost of completing the work of the defaulting contractor, from the earned contract funds which have not been paid to the latter. There is no such provision in Quebec. To have an equivalent right, sureties in Quebec must enter into the appropriate register, a hypothec on claims. It remains that sureties in the other provinces will, depending on the circumstances, register their security interest under the applicable *Personal Property Security Act (P.P.S.A.)*.

**10. Do indemnitors under the Indemnity Agreement have an interest that hypothecs be granted by the principal ?**

Certainly. Every provision in the Indemnity Agreement which protects the surety also protects the indemnitors other than the principal by facilitating the completion of the work by the surety and in reducing its risk of loss, for which the indemnitors would be ultimately liable.

Let's consider the case where the bonded contractor goes into bankruptcy. As a result of having granted hypothecs to the surety, the accounts receivable on the project and the materials left on the site, will be available to the surety to complete the work. Otherwise, the accounts receivable, the equipment and the materials would go to the trustee in bankruptcy and the surety would suffer a greater loss which the indemnitors would have to reimburse.

**11. What happens when the principal's bank does not want the surety's hypothecs to have priority over its hypothecs?**

Depending on the circumstances, the surety could consent to an assignment of priority in favor of the bank's hypothecs, which would take nothing away from the bank but would allow the surety to maintain its position as regards other creditors of the principal as well as the trustee in case of bankruptcy.

It must finally be kept in mind that banks will register in the appropriate registers, the hypothecs granted by principals and assignments of priority

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