

# Surety Bonding on Construction Projects: The Basics

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Consideration of whether a bond is appropriate in your construction project will require an analysis of how risks are to be allocated between the owner and the contractor. Generally, provision of a bond will protect the owner in the event that a contractor defaults on its obligations. While a bond may not be appropriate in every circumstance, this article will provide an overview of the basic types of bonds in the construction industry.



## What is a Surety Bond?

A surety bond is one method to share risk under a construction contract. Most commonly, an owner will require the general contractor to obtain a bond from a surety in the event that the contractor defaults on the contract. If the contractor fails to perform its obligations, the surety effectively assumes the obligation of the contractor. A surety will complete due diligence regarding the contractor before issuing a bond, and will typically look to the contractor's historic performance and financial capacities.

There are three parties to a surety relationship: 1) the surety, who is the guarantor which issues the bond; 2) the principal, generally the contractor or subcontractor, whose contractual obligations are guaranteed by the surety; and 3) the obligee, typically the owner, who is the beneficiary under the bond.

Bonds differ from policies of insurance in that an insurance policy is a relationship between only two parties - the insurer and the insured, and requires the insurer to undertake payment of money on the occurrence of a certain event. On the other hand, bonds involve three parties, and the surety under a bond has obligations collateral to that of the principal.

## Default under a Surety Bond

The surety and the principal have joint and several liability to fulfill the contractual obligations with the obligee, but, the surety's obligations are triggered only if the principal defaults in its obligations. There are several types of default which may include insolvency, abandonment of the construction project, failure to fulfill work stipulated in the contract and,

in some circumstances, serious delays to the project.

## Types of Bonds

There are four main types of bonds used in the construction industry in Manitoba:

1. Performance bonds;
2. Bid bonds;
3. Labour and Material payment bonds; and
4. Lien bonds.

### *Performance Bonds*

The intention of a performance bond is to protect the owner against the default of a contractor. The surety under a performance bond agrees that, if the contractor defaults in the performance of a specific contract, the surety will remedy the default. Issuance of a performance bond will be conditional on the financial health of the contractor and performance of past projects.

However, the surety will only step in to remedy the default if three conditions are met:

1. The contractor must be in default under the contract;
2. The owner must have provided notice of the default to the contractor (and most often provide the contractor a chance to remedy the default); and
3. The owner must have performed its obligations under the contract.

If the conditions are met, the owner can look to the bonding company to comply with its obligations under the bond. The surety then has the option of how to proceed in the face of the default. The surety can: (1) choose to remedy the outstanding default and keep the existing contractor working; (2) take over the work and complete the contract using its own forces; (3) re-tender the work and pay the successful bidder the amount to complete the work (up to the amount of the bond); or (4) pay the amount of the bond to the owner. This choice is to the surety's discretion; the owner cannot dictate how the surety chooses to proceed in remedying the default.

There are also circumstances in which a surety would not be responsible under the bond, including where there has been a material change to a bonded contract, such as an increase in the amount of the contract or a change in payment terms, without the consent of the surety. The surety can also decline to make a payment if a claim is not brought within one year. The terms of the bond will be essential in making a determination of whether the surety has become responsible for remedying a default.

There are also certain limitations to performance bonds. Each bond guarantees performance of only the specific project mentioned in the bond and only applies to claims that fall within the scope of work specified in the contract. Where there is a dispute between the owner and

the contractor regarding whether the contractor is in default, litigation may ensue to establish the default, before which the surety may refuse to take steps under the bond. The surety may also take time to investigate the default after receiving notice, defeating the purpose of ensuring timely project delivery.

### *Bid Bonds*

The primary purpose of a bid bond is to prevent frivolous or “low ball” bids on construction projects. A bid bond is typically provided by a contractor along with its bid on a project. If the owner awards the contract to the contractor, and the contractor fails to enter into the construction agreement with the owner, the bid bond is in place to pay a “penalty” to the owner. This amount will be stipulated in the bond and will often be a percentage of the bid amount.

### *Labour and Material Payment Bonds*

A labour and material payment bond is slightly different from other types of bonds as it does not *directly* benefit the owner of a construction project. Instead, this type of bond is used to benefit suppliers of labour, services and materials to the contractor on a project.

Where a general contractor fails to pay suppliers of services and/or materials on a specific project, then, subject to certain conditions being satisfied, the surety will pay the claims of any qualified claimants under the bond. In most instances, the amount of the bond itself will be limited to 50% of the contract value. Under the terms of a labour and material payment bond, the owner is a trustee of the payments owing to suppliers and subcontractors.

These types of bonds are most commonly found in construction projects where the owner is a governmental agency or authority, but they are also becoming more prevalent in the private sector. Ontario’s *Construction Act* requires contractors who enter into agreements with governments or municipalities to provide a labour and material payment bond as a part of the contract. The federal government will also include a requirement for a labour and material payment bond in a standard form.

To successfully make a claim under a labour and material payment bond, a subcontractor or supplier must fall within the definition of a claimant as set out in the bond. The claimant must also provide appropriate notice to the surety of its claim, and is often required to commence an action against the surety within one year following the date on which the general contractor ceased work on its contract with the owner.

Timing of making such claims is important. Care should be taken to review the time period allotted to bring a claim and what the bond specifies as to whom notice is to be provided. As the owner stands as a trustee of the funds owing to subcontractors, the owner has a duty to inform beneficiaries / subcontractors of the existence of the bond, failing which the owner can become liable for breach of trust.

## *Lien Bonds*

Lien legislation in Manitoba permits security to be posted in place of a lien claim that has been filed or registered, which allows title to the property in question to be cleared of the lien. The lien is then a charge against the security instead of the property. A lien bond acts as such security. The bond itself can be thought of as a promise from the surety that if there is a judgment made against the lien, and the debtor fails to pay, the surety will pay the amount of the judgment.

However, the use of lien bonds has fallen out of favour in recent years, following the Supreme Court of Canada's decision in *Stuart Olson Dominion Construction Ltd. v. Structal Heavy Steel*, 2015 SCC 43. In that decision, the Supreme Court held that provision of a lien bond did not discharge the contractor's trust obligations under *The Builders' Liens Act*. Although the general contractor provided a lien bond to discharge the lien, the Court held that it may still be found liable for breach of its trust obligations.

## **Key Takeaways**

Bonds play an important role in construction projects, particularly in the allocation of risk. However, bonds may only provide limited protection to an owner or, in the case of labour and material payment bonds, place additional obligations onto an owner as it relates to subcontractors and suppliers of the project. In assessing whether to have a type of bond on an upcoming project, a more thorough understanding of the protections and obligations that the bond provides is important. Carefully reading the language contained in the bond will be important to understand your rights and obligations in all circumstances.

If you are considering whether to make a claim under a bond on an existing project, be sure to read the wording of the bond to determine whether you are eligible to make a claim, and the time limits within which you must make a claim or start a court action. Failure to make a claim during the prescribed period can permit the surety to deny your claim.

**Sharyne Hamm's** practice is focused in the area of civil litigation, with a primary emphasis on construction litigation and dispute resolution.

If you have a construction law matter to discuss, contact Sharyne or any one of our other **construction law lawyers**.

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