Surety Bonds Offer Protection for P3 Risks

BY STEPHANIE ROBICHAUX

Last year, the American Society of Civil Engineers gave the country’s infrastructure system a D+ overall grade point average. However, the need for infrastructure improvement far exceeds the available funds. The estimated investment needed to restore America’s infrastructure by 2020 is $3.6 trillion.

State and federal baseline spending has experienced large cuts since the Great Recession in 2008. While some state budgets are returning to pre-recession levels, most states still are operating on a fiscally conservative course.

With this potential infrastructure crisis at hand, financing through public-private partnerships (P3s) is more attractive than ever to public entities. While procurement methods for construction continue to evolve in the United States—including the increased use of P3s—construction risks remain the same. Surety bonds provide the best protection for owners, contractors, subcontractors and taxpayers.

Surety Bonds to the Rescue
Crucial to the success of a P3 construction project is a surety bond, which offers unmatched value through contract completion and payment assurance.

During the prequalification process, the surety examines the contractor’s work expertise, character, ability to work in the region where the project is located, current work in progress, and overall management skills, as well as its capital and record of paying its obligations. By issuing a bond, the surety, as an independent third party, provides assurance to the public entity, taxpayers and subcontractors that the contractor is capable of performing the construction contract, including paying its obligations. This assurance is backed by the surety’s own funds.

Another primary benefit of the bond is that the surety responds if the contractor runs into trouble. One of the most common phone calls sureties receive is a Friday afternoon request for help making payroll. Many times, default is averted because of the surety company’s expertise in seeing projects through to completion.

When a contractor gets into trouble, the surety may provide personnel, such as engineers, construction management specialists and accountants, with experience and expertise in handling crisis situations. Or, it may pay subcontractors and suppliers to keep the job moving forward and keep parties familiar with the project involved. It also may offer financial assistance to the contractor to reverse cash flow problems.

Protection for Subcontractors
Should the contractor default, the payment bond guarantees that covered subcontractors, suppliers and laborers will get paid. Generally, mechanics liens cannot be asserted against public property, and P3s are likely to be no exception. Subcontractors, suppliers and laborers on these projects must rely on the general contractor’s payment bond for protection. Many subcontractors and suppliers on public works projects are small contractors that have fewer resources to absorb non-payment.

Typically, subcontractors and suppliers extend large amounts of credit before submitting an invoice to the project’s prime contractor. They may have paid workers and suppliers and estimated taxes before knowing if payment is forthcoming for completed work. If the general contractor does not pay them as required, the subcontractors’ cash flow and overall financial condition could be significantly impacted.

Without the protection of a payment bond, businesses raise prices to account for these substantially increased risks, a cost ultimately borne by the taxpayer.

If the risk is deemed too great, the most skilled and successful subcontractors and suppliers may have to forego participation, particularly if the business climate provides less risky opportunities.

For all these reasons, bonds on P3s should be required by law. The United States is the only country that requires 100 percent bonding to protect virtually all public works projects. This policy, which was put into place more than 100 years ago, is contained in the federal Miller Act and the state Little Miller Acts, which require bonding on public works projects to guarantee payment for completion of the contract and payment of
subcontractors and suppliers. These public policies have assured the successful completion of America’s infrastructure and other construction projects. They also have protected businesses for decades, regardless of who provides the revenue stream for these projects.

**Protection for Taxpayer Dollars**
Because the private partner on a P3 project is always repaid for its funding, public money pays for the P3 project in the long run. Arguably, the risk to the public entity is increased in a P3 because it is responsible to the taxpayers to deliver a public service or facility, but the public entity does not choose or control the construction contractor, and could suffer financial loss if the private partner defaults.

If the contractor fails or defaults when the construction portion of the P3 is not yet complete, the public entity may have to take control of the project. Without a surety bond that includes the public entity as an obligee, the public entity would have to fund, manage and possibly re-let the construction part of the project. Requiring performance bonds on the construction portion of a P3 will protect the public entity and its taxpayers in the event the contractor defaults.

As P3s become a more common means to meet U.S. infrastructure needs, it is critical that surety bonds are required on these projects, just as they are on any other public works project.

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