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Public Private Partnerships: Payment Security Concerns

Could your company be working on a public construction project without the payment assurances you thought it had under state or federal law? With the increased use of public-private partnerships (P3s), this question is a real concern for construction subcontractors and suppliers that rely on statutory payment assurances such as payment bonds and mechanic's liens.

P3 projects, historically used for traditional transportation infrastructure projects like turnpikes, are increasingly being used for social infrastructure such as college dorms and hospitals. P3s are long-term contractual agreements between a public entity and a private partner in which the private partner, in exchange for compensation, invests its own assets and delivers a public service or facility. Governments are turning to P3s because infrastructure needs far exceed the funding available in the budgets raised through taxes or that can be accessed with revenue bonds or borrowing. Typically, the public entity will authorize the private entity to design and build and, frequently, operate and maintain the resulting public work. P3 agreements attract the private capital for needed projects now, and the private party is paid back though some stream of public revenue that the public entity grants, such as the right to collect tolls, which in turn provides profits to the private partner's investors.

Subcontractors and suppliers bidding and working on P3 projects should carefully review and understand the contract's payment assurances and not assume that state or federal law will provide them.

For construction subcontractors and suppliers, one major concern with P3s is that established payment assurances under existing law may not apply. Mechanic's lien laws generally do not apply to construction on public land, and federal, state or local governments most often own the land on which P3 projects are built. Statutory payment bonds are required in all states for contracts awarded by public owners based on a public design and with public funding. Under a P3, however, the private partner—frequently called a concessionaire—contracts with the public entity, and the private partner then retains the construction contractor to

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complete the construction phase of the P3. Under normal circumstances, the concessionaire is required to follow all procurement laws, including providing payment and performance bonds, but legislation is being enacted specifically for these projects.

P3s are relatively new to the United States and 34 states currently have a variety of laws authorizing the use of P3s for various types of public projects. Some state laws are silent about payment assurances, assuming that all state procurement laws would be applicable to P3s. A few state laws specifically allow alternatives to payment bonds, such as parent company guarantees or equity partner guarantees, which could make it difficult, if not impossible, for subcontractors and suppliers to successfully pursue a claim. Other laws authorize the public entity to determine the amount and form of the payment assurance, meaning that the amount could be zero and the form could provide illusory protections. Still other states have enacted multiple laws, some of which provide payment assurances and some of which do not.

Subcontractors and suppliers bidding and working on P3 projects should carefully review and understand the contract's payment assurances and not assume that state or federal law will provide them. Payment protections may not exist unless they are specified in the authorizing legislation relating to P3s or included as a provision in the solicitation and award documents relating to a specific P3 project.

A lack of payment protections shifts very substantial risks to subcontractors and suppliers. 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. Such substantially increased risk cannot be accepted without ascribing a cost by the prudent business. Such cost is 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 business opportunities.

Performance bonds also provide important benefits for subcontractors and suppliers on projects. Owners, subcontractors and suppliers all lose the benefit of the surety's prequalification of the general contractor if a performance bond is not required. The surety's underwriting of a bond is crucial to the success of construction projects. The surety provides a bond only to contractors that, in the surety's opinion, are capable of performing the work. The surety examines the contractor's capacity to perform the work, character, ability to work in the region where the project is located, current work in progress and overall management as well as its capital and record of paying its obligations. By issuing a bond, the surety provides the owner, investors, taxpayers, subcontractors and suppliers with assurance from an independent third party, backed by the surety's own funds, that the contractor is capable of performing the construction contract. While the surety's underwriting of a bond aims to prevent default and nonpayment in the first place, if the contractor runs into trouble on the project or defaults, the surety provides the resources and funds to ensure contract completion and payment of subcontractors and suppliers.

Although federal and some state laws currently may be inadequate in providing payment security for subcontractors on P3s, their growing use may change that. Organizations representing construction subcontractors and suppliers, including the National Association of Credit Management (NACM) and the American Subcontractors Association (ASA), and the surety industry, including the Surety & Fidelity Association of America (SFAA), the American Insurance Association (AIA) and the National Association of Surety Bond Producers (NASBP) are collaborating to pursue federal and state legislation to extend the public policy benefits of laws that require prime contractors on public construction contracts to provide payment and performance bonds.

The best way to provide payment assurances for construction subcontractors and suppliers on P3s is to require by statute that the P3 agreement will require the private partner to bond the construction phase of the P3 as would be required under the federal Miller Act and state Little Miller Acts. That is why it is not only important to forcefully advocate for such a provision when Congress or a state legislature is initially shaping its legislation to create authority for P3s generally, but also to get involved on the local level in the process of developing requirements for a specific P3 project. It is also imperative to amend existing laws that lack payment protections for subcontractors and suppliers or afford inadequate payment protections.

In states where the current authorizing statutes for the conduct of a P3 project are silent regarding payment protections for subcontractors and suppliers, the collaborating national associations and local partners will seek a contractual provision to extend the payment protections of the state's Little Miler Act by a provision that appears in the contract solicitation and the resulting contract.

The collaborating national associations and local partners already have had a significant impact on policymakers. For example, in 2013, California, Florida, Illinois, Maryland and North Carolina enacted laws that assured that subcontractors and suppliers have payment assurances on P3 projects. In 2014, additional state legislatures are considering bills that would extend payment protections to P3 projects. Virginia and Indiana have been the most active states in allowing P3 projects and have done so with little or no bonding. These are high priority states in which existing P3 laws may be amended in the near future.

As with all projects, subcontractors and suppliers on P3 projects should assess the source and quality of payment assurances. Before signing a contract, the subcontractors and suppliers should request a copy of all bonds and verify their authenticity. SFAA's *Bond Obligee Guide's* list of surety companies and contact information (http://www.surety.org/?page=VerifyYourBond) can help. Subcontractors and suppliers can also determine if a surety is admitted in the jurisdiction of the project by checking with the state insurance department, which can be found on the National Association of Insurance Commissioners' website (http://www.naic.org/state_web_map.htm). Finally, the Department of Treasury's Circular 570 (http://fms.treas.gov/c570/c570_a-z.html) contains a list of approved sureties for federal projects.

Government entities in the United States have understood the importance of surety bonds and have required bonds for over a century to provide performance and payment assurance for the nation's infrastructure projects. Although new procurement methods have evolved—including the increased use of P3s in the US—construction risks remain the same, making surety bonds just as relevant and important today. Bonding is a tool that protects taxpayer and investor dollars and supports economic empowerment, sustainability, job creation and legacy wealth for contractors and subcontractors, and the surety industry remains ready to provide bonding for all types of construction delivery mechanisms, including P3 projects.

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