PP019 – Surety Bonds & P3 Projects: Complete Protection Against Contractor Default

Introduction

As Public Private Partnerships (P3's) become more common as means of financing public construction and infrastructure, the challenge of protecting the public interest against the peril of contractor default becomes more complicated. Surety bonds provide complete protection for all partners against financial and political risk. In addition, they provide other benefits to the project such as contractor prequalification and dedicated protection for trades and suppliers. The surety industry has responded to need of P3 partners for protection against construction default with a number of innovative products designed to respond to the challenges of risk management on large infrastructure projects.

Background

In an increasingly competitive global environment, Public-private partnerships (P3’s) have become commonplace as a means of financing public construction, building infrastructure and delivering public services. In addition to maximizing efficiencies and innovations of private enterprise, P3’s can provide much needed capital to finance government programs and projects, thereby freeing public funds for core economic and social programs. In Canada, the P3 model of project delivery has been enthusiastically embraced by public jurisdictions across the country and indeed most provinces have now set up public agencies to coordinate P3 endeavours.

A critical risk management consideration for governments and project lenders is protection against the risk of contractor failure during the construction process. Given the magnitude of most P3 projects, failure of the construction group would be catastrophic both financially and politically and securing against this risk is the cornerstone of prudent risk management. Astoundingly, management of construction risk, despite the potential for calamitous consequences is often dealt with in a haphazard manner or overlooked entirely by potential P3 partners as they structure a workable project agreement.

It is not uncommon for project lenders to require the construction consortium to provide financial protection in the form of a "pay-on-demand" liquid instrument, typically in the form of a bank letter of credit. While these instruments offer the tantalizing convenience of cash-on-demand, they do not provide complete protection from the perils of contractor failure. Indeed, relying on them as the sole source of performance security can leave concessionaires, lenders and public agencies exposed to significant financial and political risks.

To ensure themselves of complete protection against contractor default, P3 partners should require performance and payment bonds to guarantee that the contractor will perform the obligations of the construction contract and pay subtrades and suppliers. Bonds will bring a number of important and perhaps unappreciated benefits to the partnership; benefits not provided by any other form of contract security.

1. Complete Performance Security

Liquid security will provide some financial protection for concessionaires and/or lenders should the construction group default leaving a monetary shortfall in its wake. However, from the perspective of the public side of the partnership which may have little or no direct financial stake in any given project, liquid security provides no protection against the political risk of an unfinished project.

Nor will liquid instruments provide the means to bring the project to completion should the lender and/or concessionaire decide to cut its losses and walk away. In fact, a call on the security can often trigger a series of events that will result in the dissolution of the consortium, leaving the contracting party with cash but no viable asset and the formidable challenge (not to mention expense) of seeing the project through to completion.

A performance bond by contrast provides, as its name suggests; performance. While surety bonds may not deliver cash-on-demand in the manner of a letter of credit, this is more than compensated for by the extent of the protection (performance and payment protection, each in the amount of 50% of contract value) and the delivery of a completed and viable project.

2. Prequalification

The surety prequalification process is very intensive and touches on every aspect of the construction firm's operations, work program, financial picture and experience. When a construction entity forms a relationship with a surety company, it is just that; a relationship. Surety firms don't bond a contractor on a stand-alone basis for a single project. Instead they provide an ongoing surety facility to that contractor for all projects bid and undertaken. This greatly heightens the standard of due diligence required. By extending a bond facility to a contracting firm, the surety is effectively assuming financial responsibility not only for the success of the bonded work program, but for the viability of the entire corporate entity behind the construction operation.

In practical terms, this "partnership" provides the surety with insights into all facets of the construction group's operations and structure; insights that may not be available to outside analysts and/or lenders who are conducting a project-specific review. What's more, this process is ongoing which can enable the surety to become aware of potential problems that could affect the progress of the current project well in advance of their impact.

Finally, as a partner with the contractor for its entire work program, the surety is in a unique position to influence the financial structure for any given project in a way that benefits all parties. For example, it is not uncommon for a surety to require the influx of additional capital as a condition of executing a bond on a major project.

3. Dedicated Protection for Trades and Suppliers

A labour and material payment bond can be instrumental in minimizing costly delays in the event of a prime contractor default by providing payment assurances to the trade contractors. The payment protection afforded by the bond provides a strong incentive to subcontractors and suppliers to work with the bonding company in a cooperative manner toward a timely completion of the project. By keeping the original construction team in place, continuity is maintained and the disruption to the work is minimized.

This is in contrast to liquid instruments such as a letter of credit which do not provide a dedicated amount for the reimbursement of unpaid subcontractors and suppliers. While liquid security may deliver cash relatively quickly, the ultimate time frame for project completion will be extended significantly unless unpaid trade claims are settled at 100 cents on the dollar.

Preserving the continuity of the construction group has benefits beyond the assurances of a more timely completion. Keeping the original subtrade contracts in place will ensure that the validity any specialized warranties provided by these trades will be maintained going forward.

Finally, a payment bond will either solve or prevent serious legal problems that can beset a defaulted project such as construction liens and proper disbursement of trust amounts.

4. Adequacy of Protection

Letters of credit provide the contracting party and lenders with a fixed (and often limited) amount of cash to deal with the financial consequences of construction default. Depending on the terms of the project agreement and/or lenders agreement, this may or may not provide adequate financial protection to these parties.

The surety industry has responded to the unique risk management challenges posed by P3 contracts by bringing innovative products and approaches to the table. P3 partners now have a broad range of choices as they seek to find the right form of contract security for their project; choices that offer protection during both the construction/installation phase and the operation/maintenance phase.

The following is a list of surety options available to P3 partners, subject to the underwriting criteria of the issuing bonding company being met:

- Standard performance bonds as developed by the Canadian Construction Documents Committee (CCDC) which provide the basic level of performance protection including the completion of the construction work and coverage for certain default related costs.

- A variety of specially designed P3 performance bonds that have been developed by individual SAC member companies. The language contained in these bonds will vary from surety to surety, but most contain provisions that respond to the unique performance security needs of P3 projects. Among the options available:
    - A dedicated portion of the bond amount to be made available as an on-demand cash advance.
    - An accelerated response to a declaration of default which will minimize delays in default rectification and allow a surety's involvement prior to the default of the construction entity being formally established.
- Labour & Material Payment Bonds that provide payment assurance to subtrades and suppliers thereby ensuring continuity of the construction team as discussed earlier.
- Renewable "Multi-Year" performance and payment bonds to provide a protection package against default during the operations/maintenance phase.

In setting out its security requirements, the partnership may call for a combination of the available products to ensure complete protection over the life of the project. For example, the public agency may require a performance (standard or specialized) and payment bond combination to protect against default during the construction phase; followed by multi-year bonds to take effect once the construction obligations have been fulfilled and the operation/maintenance phase commences.

The Surety Association of Canada has encountered resistance on the part of some public bodies who are reluctant to "impose" security solutions on a proponent, particularly in cases where little or no public money is used to finance the initial construction. We suggest that this reluctance can prove to be very costly both politically and financially. Our response to these hesitant owners is simple: It may be their deal, but it’s your project.

Whatever approach is ultimately taken, it is critical that adequate provisions are in place to protect against the potentially ruinous consequences of contractor/concessionaire default. Surety bonds provide comprehensive protection to all parties of the P3 partnership.

Glossary of Terms

Obligee

An individual or organization in whose favour an obligation is created and to whom a bond is given.

Principal

The individual or organization that bears the primary responsibility for fulfilling the obligation under the written contract referenced in the bond and that has the duty to perform for the Obligee's benefit.

Surety

The party to a surety bond who answers to the Obligee for the Principal's default or failure to perform as required by the underlying contract, permit or law.

This paper is intended to serve as a general guideline to assist members and other readers in responding to the issues discussed. Nothing contained herein should be construed as legal advice and readers are cautioned to consult with legal counsel for such advice.

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