

feature

# Bonding the Rapidly Growing and Changing P3 MARKET in the U.S.

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BY FRANK M. RAPOPORT AND JERRY P. BRODSKY

**SUBCONTRACTORS AND SUPPLIERS RELY ON THE PAYMENT BOND IN CASE THE GENERAL CONTRACTOR DOES NOT OR CANNOT PAY THEM. THEY CANNOT LIEN PUBLIC PROPERTY FOR PAYMENT, SO THE PAYMENT BOND PROVIDES THEM THEIR ONLY PROTECTION.**

**PUBLIC-PRIVATE PARTNERSHIP (P3)** projects have finally emerged in the U.S. infrastructure market. Contractors and their sureties must be poised and committed to profile their willingness and capabilities to embrace this new model of project delivery. Those minimizing this inevitable shift will be left out of upcoming deal flow from mayors, governors, and county officials. Asset classes moving rapidly to the P3 market include K-12 schools, higher institution dorms and life science centers, municipal and state buildings, water and wastewater, transit and mixed-use transportation oriented development. Witness pending and closed deals involving Long Beach Civic Center; La Guardia Central terminal and parking structure; West Chester, Phoenix, Denver, and San Juan Airports; Howard County and Long Beach Courthouses, and a slew of road and bridge deals including I-595, I-66, Presidio Parkway, Ohio River Bridges, and Goethals Bridge. All of these and other projects represent \$50 billion in P3 activity.

This article will explore the benefits of P3 projects and why P3 projects will increase dramatically. More specifically, this article will address the role of surety bonds on P3 projects, new bond forms attendant to P3 projects, and how to maneuver the risk issues relevant to P3 projects.

## **Why P3 is Now Mainstream**

Unsustainable state and municipal debt levels have brought P3 projects to the forefront. The P3 technical innovation, quality construction, on-time delivery, and operational benefits have created its growing acceptance and are transforming how public infrastructure is delivered. Recently, we have seen evidence

that the partnerships between public agencies and private enterprise are critical to a state's planned infrastructure development. So much so that a governor vetoed a bill he believed put P3 projects in jeopardy.

In the summer of 2016, Colorado Governor John Hickenlooper vetoed SB14-197, an anti-P3 law, and stated, "We firmly believe that government should always strive to be transparent and accountable." He added in his veto message, "Unfortunately, SB 14-197 is not just a transparency

bill; it also inappropriately constrains the business terms of future P3 agreements." The governor instead signed an executive order that will improve transparency, accountability, and openness; while avoiding aspects of the proposed bill that would have discouraged private sector participation in future P3 agreements. The leadership demonstrated by Governor Hickenlooper, through his veto, and more importantly, by his executive order, showed a clear path to achieve what must be undertaken in order

to balance the public interest while allowing the innovation and quality delivery that the private sector can bring. Governors rarely veto bills so this action is noteworthy as a precursor of the further emergence of P3 projects.

Key leaders across the nation are realizing that P3 opportunities encourage private sector investment in their states and provide long-term solutions for delivering core infrastructure and creating new economic development opportunities.

These government officials are realizing that P3 projects help protect taxpayers through complimentary incentives. P3 projects gain skin in the game of private financing with financiers who risk their money to get the project off the ground. P3 projects also account for the full cost of operating and maintaining the project over many decades, not just the initial construction. Additionally, P3 projects give the government more control, not less, by holding those private partners liable for problems like delays, cost overruns, and deferred maintenance.

P3 projects are very different from the way most public infrastructure projects are built today. In most cases, today's projects are designed by the government and awarded to the proverbial lowest bidder. The lowest bidder has no say or motivation suggesting a better innovative solution and plays no role in how quickly the asset falls into disrepair. Indeed, there is little or no attention paid to what the project will cost the taxpayer over its useful life, much less where its maintenance funding will come from. And there are few protections for the taxpayer when costs rise, delays creep or political infighting prevents spending money to cure maintenance. The results leads to public buildings that aren't maintained, roads with too many potholes, and water systems that leak and waste water, as the pipes are over 100 years old. P3 projects offer a better way:

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P3 model typically occur only when a project is completed. Therefore, the private partner is highly motivated to complete a project on time and on budget so that it can begin revenue generation or reduce the accrual of its debt financing. In the very few instances where a P3 private partner failed to deliver an asset as stipulated, the taxpayer was not penalized and the private partner absorbed the financial loss.

**PROPER MAINTENANCE:** P3 private partners agree to maintain (not own) through a concession the public's assets to specified requirements through contractual agreement, often 30-50 years. If these requirements are not met, the private partner is not paid or incurs penalty payments. An added bonus is that P3 projects with a pre-negotiated fixed maintenance component may help the public sector avoid inflation-related pricing that would increase the cost of maintenance over the years.

**INNOVATION & PERFORMANCE:** Under the P3 model, the private

partner is accountable for all phases of project design, construction, and maintenance; and long-term profitability is dependent on operational efficiency. Therefore, private partners are incentivized to deliver an asset that is effective, efficient, and sustainable for several decades. There's far less chance that a P3-built and-managed asset will have design flaws, financial failures, or technology obsolescence. Innovative ideas might include more redundant mechanical systems in a vertical structure or advanced monitoring systems on roads.

Critics say that privately financed debt and equity is more expensive than public, or municipal, debt. This is a false comparison. Public debt is cheap because governments have the taxing authority to pay it back. Therefore, the taxpayer guarantees it—and pays for all the performance problems, too. Projects financed by cheap municipal debt lack the built-in P3 incentives to budget for the asset's maintenance over the long run.

Currently, 35 states, the District of Columbia, and Puerto Rico have some form of P3 legislation, although most are limited to transportation. Eleven allow P3s for vertical infrastructure, such as courthouses. Most of these laws require performance and payment bonds, in addition to letters of credit.

### The Value of Bonding and Dispute Review Boards on P3 Projects

Attending any construction project are differences/disputes between or among the parties, which are in need of resolution to keep the project momentum. Just as the public is protected due to the risk shifting to the P3 entity, the down-stream P3 team members need protection. Therefore, P3 team members must have access to remedies that encourage them to keep working and get paid while a difference or dispute is pending.

The performance bond is issued only to those contractors that, in the surety's estimation, can perform the



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## THE CONCESSIONAIRE AND DESIGN-BUILD TEAM ON A P3 PROJECT

When the concessionaire is the one that has the contract with the public owner, the concessionaire is the statutory “contractor.”

This means that the DB contractor is a “sub” under the statute, and if we follow the statutory definitions down the food chain, an entire tier of subcontractors and suppliers that usually have statutory bond protection do not.

work and pay all the subcontractors, suppliers, and workers on the job. The surety’s prequalification aims to prevent default. By issuing a bond, the surety provides the public contracting entity with assurance from an independent third party, backed by the surety’s own funds, that the contractor is capable of performing the construction contract.

Subcontractors and suppliers rely on the payment bond in case the general contractor does not or cannot pay them. They cannot lien public property for payment, so the payment bond provides them their only protection. Bonding supports economic empowerment, sustainability, and job creation for contractors and subcontractors.

In the event of a default, the surety can step in to complete the contract or hire a new contractor to complete the project, saving the taxpayers from extra costs to re-let the project and extra completion costs. Sureties also can extend the contractor credit during the project to help avoid a default in the first place. The performance bond assures the public owner that the construction contract will be completed. New forms encourage prompt resolution of disputes, which is critical in P3 even more so than in the traditional design-bid-build model; stopping work is not a viable option. The expedited dispute resolution bond form was used on the Pennsylvania Rapid Bridge Replacement Project and proposed on several others. This bond form mitigates failed completion risk by resolving, within a definitive and compressed time frame, the surety’s completion obligation in the

event of a design-build joint venture (DBJV) default. It does not mitigate delayed performance risk, which requires liquidity.

On Canadian P3 projects, sureties have issued a hybrid liquidity bond form. This bond form includes a liquidity component that provides a remedy if the DBJV fails to timely make liquidated damages (LD) payments and a traditional completion obligation if the obligee elects to request performance after a partial payment under the liquidity component. This liquidity bond form has been proposed on U.S. P3 projects but has yet to be issued for a U.S. P3 project. Watch for the surety industry to announce and further refine these new bond forms.

The expedited dispute resolution bond form normally uses a third-party mediation group, such as JAMS, to help resolve disputes. Dispute review boards (DRBs) are also contracted for among the parties at the inception of the project.

The DRB model consists of three members appointed at the beginning of a project. Some users on smaller projects are using dispute resolution advisors who function as single-person DRBs.

DRB members have extensive experience in construction projects and claim-resolution processes and often are selected for particular expertise in the type of project at hand. DRB members are required to be neutral, disclosing potential or actual conflicts of interest and committing to remain neutral and conflicts-free for the duration of the project. The DRB recommends the parties jointly select the three DRB

members to ensure confidence in the DRB’s expertise and neutrality.

After appointment, the DRB becomes familiar with the project and attends an “all hands” kickoff meeting to meet the players and start establishing a working relationship with the main parties. Thereafter, the DRB is kept abreast of project developments with regular paper updates or access to the project’s information-sharing website.

The DRB periodically returns to the project site for meetings with the parties to get project updates, discuss issues or challenges, identify emerging disputes and continue building relationships with the parties. This regular interaction with the parties and monitoring of project events focuses on preventing issues from becoming disputes.

DRB’s best practices also recommend that the DRB be available to give the parties advisory opinions. Advisory opinions typically are used for smaller, discrete disputes that the parties would like to resolve by agreement, but with advice from the DRB. The advisory opinion process is usually conducted at regular DRB site visits and is informal.

Other variants reviewed included a model used by the Texas Department of Transportation that may be best described as a “dispute adjudication board.” The Texas model operates as a formal arbitration process with a broad scope of review to address project disputes. This board hears disputes and issues written findings of fact, conclusions of law, and decisions. The process and procedures of this board are typically set forth in a separate dispute board agreement appended to the contract. See K. Dettman et al., *Dispute Resolution Board Foundation, Recommended Best Practices for Use of Dispute Review Boards (DRBs) on Public Private Partnership Projects in the U.S. and Canada*, July 21, 2015.

### P3 Risk Issues and the DRB Process

In the design-build (DB) phase of a P3 project, the critical participants

are the public owner, concessionaire, and the entire DB team, led by the DB contractor.

Two other critical participants during the DB phase include the following:

- OCEI (owner construction engineering and inspection) team— inspectors hired by the *public owner* for quality control and compliance monitoring; and
- CCEI (concessionaire construction engineering and inspection) team— inspectors hired by the *concessionaire* for a similar role.

Once the lenders have put up their money and with the operations and maintenance contractors waiting for their time, the DB team drives the project forward during the riskiest period of the P3 life cycle.

One way to look at risk on a P3 project is to look at the expenditure of the lenders' funds during the project cycle. If we were to plot the expenditure of money over the life cycle of a P3 project, the risk profile would show the lion's share of the money

spent (and risk incurred) is during the DB phase.

Given the fact that on most projects the DB contractor's role begins and ends with the DB phase, any contractor working on a P3 project should be aware of the heightened risks faced by the DB team during the P3 cycle.

As counsel for the contractor in the 4-year DB phase of I-595 Florida, we have learned that, in addition to all the traditional risks faced by the DB team on any large project, certain additional risks and issues arise as a result of a P3 project. They include:

- Risks that are created by differences between the funding plan for the project under the P3 model developed by the lenders, concessionaire, and public owner, and the actual design and construction plan that the DB team must perform;
- A heightened risk of having to perform work that is disputed; and
- Risk and uncertainty created when existing statutes that regulate public works are applied on a P3 project.

In the traditional design-bid-build model, the funds for construction are made available to the contractor based on the progress of the works. This is important because proper cash flow is, of course, absolutely vital to every construction project. What happens on many P3 projects is that the financial model, which is prepared and submitted as part of the proposal, is based on milestones that are not well coordinated with the planned progress of construction. This happens largely because the design on which the financial model is based is very preliminary and often significantly different than the actual construction plan.

One of the results of this dislocation is that funding for work performed early in the construction phase is either released significantly before the work is done, which has never been a real problem, or significantly after the work is scheduled to be performed. The latter situation is problematic because subcontractors are unwilling or unable to accept the "pay when paid" risk, and those

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## **NASBP CE BREAKOUT SESSION APRIL 29 AND 30: "JUMP ON THE P3 WAVE: THE VALUE OF BONDING IN THIS RAPIDLY GROWING MARKET"**

Be sure your firm is not left out of this rapidly growing and changing market. Gain a better understanding of public private partnerships (P3s) by attending the NASBP continuing education session, titled "Jump on the P3 Wave: The Value of Bonding in this Rapidly Growing Market," held during the NASBP Annual Meeting at The Phoenician Resort in Scottsdale, AZ, April 29 from 1 to 3 p.m. and April 30 from 12:15 p.m. to 2:15 p.m.

Presenters Michele Pavlik of Chubb Surety, Mary Jean Pethick of Zurich Surety, and Frank M. Rapoport of Peckar & Abramson, P.C. will examine surety underwriting of P3s; will outline different types of bonds, terms, and obligees in the P3 space; and will explain the legislative landscape at state and federal levels. They will also review the history, structure, and usage of P3 projects. Plan to join us for this interactive session where the speakers will share examples of P3 projects with which they have been involved.

that are willing account for the risk in their pricing, which, in turn, makes the contractor less competitive. The dislocation creates, to say the least, cash flow management challenges to the DB contractor and financial strain on smaller, lower-tier subcontractors.

This financial strain is compounded by the fact that final payment is invariably tied to acceptance of the work by the concessionaire and public owner, which can result in extended exposure to warranty claims and delays in final payment.

The risk of having to continue performing during the pendency of disputes is by no means unique to P3 projects. What is unique is the heightened risk of having to perform disputed work at risk, which is the result of the "Olympics Mindset"—delay is not an option—among P3 participants. The DB contractor, aided by sound legal advice, quickly figured out that, in order to convince the subcontractors to accept the Olympics Mindset and agree to continue performing notwithstanding pending disputes without a major impact on pricing, there had to be an efficient and effective contemporaneous dispute resolution process.

The project already "came with DRBs" (included in the concession agreement for disputes between the

concessionaire and FDOT, with some contractor participation). However, there was no requirement or provision for DRBs for the DB team. So, we added that by providing a DRB for resolution of disputes between the concessionaire and the DB contractor and in key subcontracts. These DRBs were subject to most of the rules and regulations that govern the FDOT DRB, with one major difference: FDOT DRB decisions take months to come down; our DRBs are required (unless the parties agree otherwise) to issue resolution within 20 days after the hearing.

### **Lessons Learned**

The biggest lessons for us have been that P3 projects are subject to different economic and legal forces and must, therefore, be well understood in order to be successfully managed.

Some additional issues facing P3 projects include:

- Contrary to a traditional DB structure, in a P3 arrangement, design could be very nascent when buyout occurs.
- Because of the commitment to working through disputes and the financial toll that it takes, certain mom-and-pop subcontractors may not be suitable to participate in a P3 arrangement. The DB contractor needs to ensure solvency and other

financial factors when teaming with subcontractors. This increased risk of working through disputes may be reflected in pricing.

- The concessionaire stands in the shoes of the public entity; the DB contractor needs to ensure easements and verify any pending disputes between the public entity and utility.
- Encroachment onto private land is common. Managing those relationships is imperative when considering the progress of a project.
- Contrary to a traditional scenario, there are more eyes on the DB contractor. Government entities, traditional agencies, lenders, and others all have rights on P3 projects to monitor work. The evaluation of the concessionaire's performance can adversely impact a DB contractor who is otherwise performing. ●

*Frank M. Rapoport is a Senior Partner with the construction law firm of Peckar & Abramson, P.C., where he leads the firm's P3 practice. Rapoport concentrates his practice on construction, government contracts, infrastructure development, and public-private partnerships. He has negotiated and closed 18 P3 deals in the U.S. He is also Chief Strategy Advisor for Association for Improvement of American Infrastructure, a national advocacy group promoting P3 project delivery. He can be reached at [frapoport@pecklaw.com](mailto:frapoport@pecklaw.com) or 484.362.8481.*

*Jerry Brodsky is a Partner and Director of the Latin American Practice Group at Peckar & Abramson. He represents international and domestic general contractors, construction managers, sureties and others in the U.S. and throughout Latin America and the Caribbean in the preparation of contract documents, negotiation, mediation, arbitration, and litigation of construction contract claims, construction and design defect claims, insurance claims, surety bond claims, and related matters. He can be reached at [jbrodsky@pecklaw.com](mailto:jbrodsky@pecklaw.com) or 305.358.2600.*