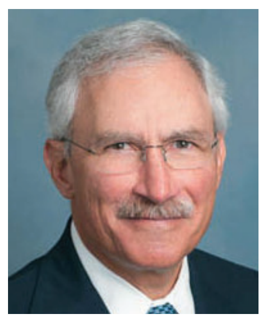
Feature

Six Considerations in Underwriting Subdivision Bonds (Part 1 of 2)



BY ARMEN SHAHINIAN AND BETH J. ROTENBERG

LAND DEVELOPMENT LAWS, which regulate land use and subdivision growth, are commonplace in most states, counties, and local municipalities (Public Agency). These laws and regulations (Statutory Scheme) allow the Public Agency to control the design and improvements of subdivision developments to assure consistency with local public health and environmental standards, and to coordinate subdivision planning (lot size, configuration, street patterns, and utility easements), as well as overall community planning. Most importantly, the Statutory Scheme ensures that the developer properly installs streets, sewers, lighting, sidewalks, and drains prior to their dedication to the Public Agency and its taking over their maintenance. Ultimately, the Statutory Scheme is designed to prevent the subdivision from becoming an undue burden on the community and local taxpayers. In the course of this two-part series, we will examine the basis for and the scope of subdivision bonds, as well as six important considerations in underwriting these types of bonds.

The subdivision agreement and the subdivision bond

Obtaining approval from the Public Agency, whether through a subdivision map, permit, or otherwise, is often the initial step a developer must take in developing a parcel of real property. Prior to the development of unimproved land, the Public Agency, as part of the Statutory Scheme, often requires a developer to enter into a Developers Agreement (Subdivision Agreement). The Subdivision Agreement will generally require the developer to construct improvements required by the Public Agency as part of the Statutory Scheme and will set forth the time within which the improvements must be completed. To ensure the faithful performance of the required subdivision improvements, including liability for changes or alterations in the work, before issuing a subdivision map or other required permit, the Public Agency may require the developer, as principal, to post security, usually in the form of a Subdivision, Developers or Plat Bond (Subdivision Bond) acceptable to the Public Agency, as obligee. The Statutory Scheme may specify the form and content of the Subdivision Bond, or additional or other financial assurance (that is, letters of credit, certificates of deposit, etc.) to be submitted.

While Subdivision Bonds uniformly provide assurances to the Public Agency if a developer defaults on its obligations under a Subdivision Agreement, there are differences in Subdivision Bond forms. Typically, Subdivision Bonds are indemnity bonds requiring performance or payment up to the bond penalty from a surety if a developer defaults on its obligations under the Subdivision Agreement. In some jurisdictions, Subdivision Bonds are treated as either pure forfeiture bonds or financial guarantee bonds, and some jurisdictions also require a Subdivision Payment Bond, guaranteeing payment to laborers, subcontractors, and material suppliers.

The amount of security required to secure performance of the obligation under a Subdivision Agreement is determined by the Public Agency, generally within a prescribed monetary range. For example, the portion of the security that guarantees faithful performance of the completion of the improvements under the Subdivision Agreement (that is, the Subdivision Performance Bond) is generally calculated as a percentage of the total estimated cost of the improvements to be installed; such costs are frequently determined by an engineer on staff or retained by the Public Agency. In some instances, however, the developer may prepare the estimate of costs to construct the public improvements. The Subdivision Payment Bond, which secures payment to the contractor, subcontractors, laborers, and materialmen, is generally required in an amount not less than 50 percent and no more than one hundred percent of the total estimated cost of the improvements. In addition to the base cost of the improvements, the security often covers costs and reasonable expenses, including attorneys' fees that the Public Agency may incur in successfully enforcing the secured obligation.

Underwriting considerations

Often the ability of the surety to avoid future claims on Subdivision Bonds starts with the underwriting process. Avoiding exposure to loss on Subdivision Bonds requires monitoring and communication with the developer-principal, not only at the underwriting stage, but also throughout the course of the project.

1. **Become familiar with the statutory scheme.**

   What are the timing provisions for completion under the Statutory Scheme? For what public improvements is the developer specifically responsible? A surety may be liable where it voluntarily executes a Subdivision Bond of broader scope than that contemplated by the Statutory Scheme. For example, in *Mount Florence Group v. City of Peekskill*,[1] under the Statutory Scheme, the term of a Subdivision Bond could not be longer than three years, subject to extensions upon agreement of all parties. The Subdivision Bond at issue, however, had no specified term. The court held that the surety was bound by the more liberal language in the Subdivision Bond it executed. Accordingly, because the surety voluntarily agreed to execute a broader bond, claims against the Subdivision Bond could be made beyond the three year limitations period provided in the Statutory Scheme. As a further example, in *Board of County Supervisors of Prince William County v. Sie-Gray Developers, Inc.*,[2] the court held that, although the Statutory Scheme did not require the developer to make certain improvements to a state highway running along the subdivision as a condition of subdivision approval, where the developer agreed to widen the highway on its own, it (and the surety) were required to perform accordingly. In some jurisdictions, however, the courts will not enforce Subdivision Bonds that require installation of improvements beyond the scope of what the Public Agency is allowed by the statutory scheme to require as a condition to subdivision approval.[3] Thus, before executing the Subdivision Bond, it is important to know the exact requirements for the Subdivision Bond and the improvements under the Statutory Scheme, and to also include the statutory language, where appropriate, in the Subdivision Bond.

2. **Become familiar with construction costs and funding obligations.**

   The developer assumes responsibility to fund the costs of constructing or placing the subdivision improvements required by the Public Agency, and the Public Agency has no obligation to pay the developer for the cost of the subdivision improvements. From the surety's perspective, the requirement that the developer fund the subdivision improvements should be a critical part of its underwriting evaluation, and the following should be considered:

   A. Estimated costs of completion

   Has the developer properly estimated the costs necessary to complete the improvements? The Public Agency generally provides engineer's estimates for these expenses. The underwriter should attempt to ascertain the accuracy of the engineer's estimates and whether there are any major deviations between the engineer's estimates and the amount the developer has budgeted for completion.

   B. Funding of subdivision improvements

   Has the developer set aside sufficient funds to complete the subdivision improvements? Ascertaining the precise source of payment and the procedure to be followed in funding the subdivision improvements is an essential underwriting consideration. If a project is to be self-funded by the developer, the surety must be assured that the developer has committed sufficient funds to complete the required improvements. If a project is to be financed through a bank, the surety should request, and attempt to obtain, a Set Aside Agreement or other financial arrangement from the bank, which ensures that, as part of its commitment to fund the entire project, the bank has segregated sufficient funds to be used solely for the completion of the subdivision improvements.[4] In addition, the underwriter should consider continuing to monitor the financing of the project to ensure that the developer and the bank are complying with their obligations under the Set Aside Agreement (or other financial arrangement) to use the funds set aside to pay for the completion of the subdivision improvements. ●

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References:

1. 652 N.Y.S.2d 814 (App. Div. 1997).
2. 334 S.E.2d 542, 546 (Va. 1985).
3. New Jersey Shore Builders Ass'n v. Twp. of Marlboro, 591 A.2d 950 (N.J. Super. Ct. App. Div. 1999).
4. For additional information regarding the form of and issues which may arise in negotiating Set Aside Agreements, see Patricia J. Frobes, *Selected Issues in Secured Construction Lending*, in *REAL ESTATE FINANCING DOCUMENTATION STRATEGIES FOR CHANGING TIMES* 155, 157 (Am. Law Inst. 2007).

For a more comprehensive discussion of the issues raised in this article, see Susan M. Moore, et al., *Law of Developers or Subdivision Bonds*, in *THE LAW OF COMMERCIAL SURETY AND MISCELLANEOUS BONDS* 33 (Bruce C. King, et al. eds., 2d ed. 2012).

Be sure to read part two of this article in the Fall 2016 edition of *Surety Bond Quarterly,* which will discuss the importance of four additional considerations: monitoring work progress; monitoring the developer's financial status; communicating with the developer; and communicating with the financing bank.

Feature

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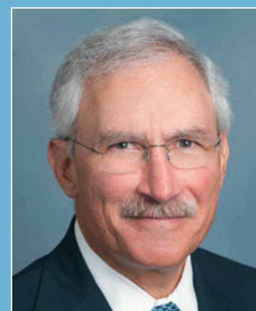
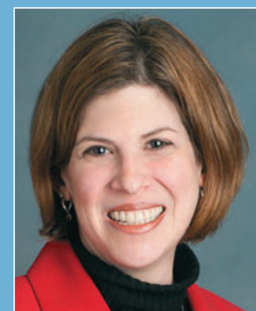




BY ARMEN SHAHINIAN AND BETH J. ROTENBERG

Introduction

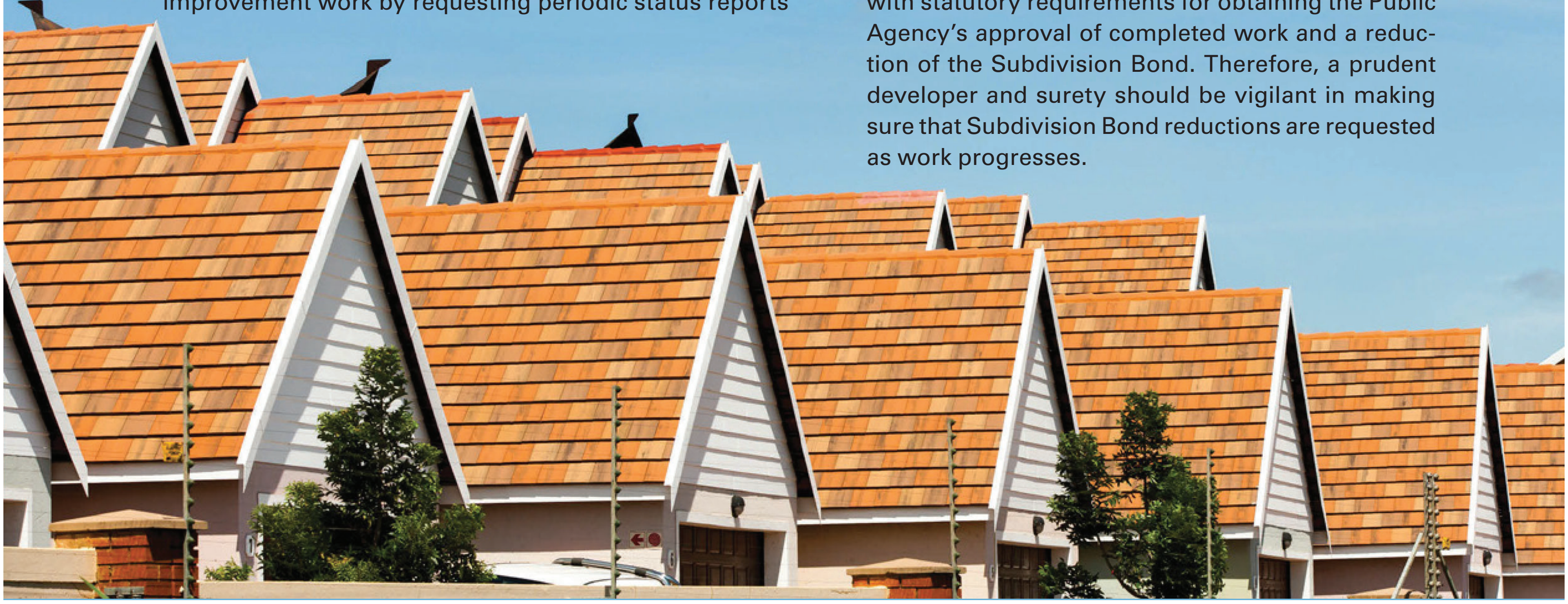
As we discussed in Part 1 of this article, which appeared in the summer issue of *Surety Bond Quarterly*, given the very specific nature of subdivision bonds, which are limited to the construction of subdivision improvements in accordance with a particular Statutory Scheme,[1] there are certain considerations to which surety bond producers and underwriters should pay particular attention when placing and underwriting these bonds. In Part 1, we examined the importance of (a) familiarity with the Statutory Scheme, and (b) familiarity with the developer's construction costs and funding obligations. The four remaining considerations are discussed below.

Underwriting Considerations Continued

1. **Obtain Project Schedule and Monitor Work Progress**

   The surety may wish to obtain a projected schedule of completion of the subdivision improvements from the developer; and monitor the progress of the subdivision improvement work by requesting periodic status reports from the developer. It may discuss any delays with the developer and obtain assurances that the project will be completed on a timely schedule.

   Monitoring the progress of the work is particularly important in order to limit any potential liability under the Subdivision Bond. Once a Subdivision Bond has been issued and delivered to the Public Agency, the surety may be held liable up to the full penal sum of the Subdivision Bond. However, the Statutory Scheme may provide a mechanism to obtain a reduction of the penal sum of the Subdivision Bond as construction of the required improvements is completed. Such reductions in the penal sum act as a partial release of the surety, and, therefore, limit the surety's potential liability should the developer be declared in default or otherwise fail to complete the remaining improvements. However, a reduction of the Subdivision Bond penalty is not automatic. The developer must comply with statutory requirements for obtaining the Public Agency's approval of completed work and a reduction of the Subdivision Bond. Therefore, a prudent developer and surety should be vigilant in making sure that Subdivision Bond reductions are requested as work progresses.



2. **Monitor the Developer's Financial Status**

If the developer is self-funding, the surety should closely monitor the developer's financial ability to complete the required improvements. If the developer has bank financing, the surety should communicate often with the bank to assure that the bank is properly disbursing funds as subdivision improvements are completed and that set aside funds are used solely for their intended purpose. Continuous monitoring of the developer's financial status and the progress of the required improvements is particularly important given that the surety's exposure on Subdivision Bonds may be extended for six to ten years (or longer) beyond the completion date initially contemplated in the Subdivision Agreement.

A Subdivision Agreement generally provides for completion within one to two years and allows for relatively easy extensions. The limitations period for suit on most Subdivision Bonds runs from the completion date in the Subdivision Agreement. This beginning date for the limitations period may be modified by any extensions granted by the Public Agency. The nature of a subdivision development and the changes in the housing marketplace often require the developer to seek one or several extensions of time for the completion of the improvements. Unless the public is threatened by a dangerous condition or some other health hazard, the Public Agency generally grants a requested extension. Most forms of Subdivision Bonds do not require that the Public Agency or the developer notify the surety of an extension. Thus, the surety's exposure on the Subdivision Bonds may be extended for a considerable period of time without its knowledge; and the longer the project takes, the less likely it may be that the developer has the funds to complete the improvements. Thus, continued vigilance is important in order to properly assess the surety's exposure on Subdivision Bonds. If the project is self-funded by the developer, the surety should assess the developer's continuing ability to install the improvements. Where the surety has legitimate concerns relative to the ability of the developer to pay for the costs of completion, the surety may consider requesting collateral as may be permitted under the principal's indemnity agreement.

A particularly difficult issue arises when the surety has obtained a Set Aside Agreement from a bank. If the project is extended, it is incumbent upon the developer and the surety to assure themselves that the Set Aside Agreement does not contain an expiration date. If there is such a date, the surety and the developer should request that the expiration date be extended simultaneously with any extensions of the project for an equal length of time. Thus, the surety must not only monitor the completion of the project but, it should also assure itself that the developer has funds or financing in place during any extensions.

3. **Communicate with the Developer**

The surety should periodically communicate with the developer to determine if there are any major changes in its development plans or financial condition that could impact its ability to timely complete the subdivision improvements. If a developer's financial condition changes or economic or marketplace conditions change, the developer may work with the Public Agency to assure that appropriate extensions are applied for and obtained and communicate with the bank to assure that it understands and agrees to maintain its financing and/or Set Aside Agreement during the extended time frame.

4. **Communicate with the Bank**

Similarly, the surety should maintain open lines of communication between itself, the developer, and the bank that issued the Set Aside Agreement, or provided other financing, to ensure that, if the developer is in default of its obligations under any bank financing arrangement, the bank will continue to work with the surety to ensure the completion of the subdivision improvements. For example, the Set Aside Agreement may also contain provisions requiring the bank, in the event of its foreclosure on the property as a result of the developer's default, to require any third-party purchaser to assume or take title to the property subject to the developer's subdivision improvement obligations. These negotiations may also deal with the bank's obligations under the Set Aside Agreement or other financial arrangement to make available to the surety the funds to complete the subdivision improvements.

Conclusion

Understanding and appreciating the unique aspects of Subdivision Bonds is imperative for properly underwriting these bonds and avoiding future claims. An awareness of the key provisions of the Statutory Scheme in play, and consistent monitoring and open communication among the surety, the bond producer, the developer-principal, and any bank that has provided financing to the developer with respect to the improvements, are the key components to properly evaluating any bonding request and ensuring the completion of the bonded subdivision improvements without loss to the surety.

Armen Shahinian is a surety, construction and bankruptcy litigator with the firm of Chiesa Shahinian & Giantomasi PC, with offices in New York, NY, and West Orange and Trenton, NJ. Shahinian is a Past Chair of the American Bar Association, TIPS Fidelity & Surety Law Committee; serves on the NASBP Attorney Advisory Council; and is a Member of the Board of Directors of the Surety Claims Institute and Editor-in-Chief of its Newsletter. He can be reached at ashahinian@csglaw.com or 973.530.2002 (or NY at 212.973.0572). Beth J. Rotenberg is an associate with the firm of Chiesa, Shahinian & Giantomasi PC., where she practices in the areas of fidelity and surety law, construction litigation, and bankruptcy and creditor's rights out of the firm's offices in New York, NY, and West Orange and Trenton, NJ. She can be reached at brotenberg@csglaw.com or 973.530.2118.

Reference:

In Part 1 of this article, we defined the "Statutory Scheme" as the body of land development laws and regulations that have been enacted by most states, counties, and local municipalities (Public Agency) to control the design and improvements of subdivision developments to assure consistency with local public health and environmental standards, and to coordinate subdivision planning (lot size, configuration, street patterns and utility easements), as well as overall community planning.

For a more comprehensive discussion of the issues raised here, see Susan M. Moore, et al., *Law of Developers or Subdivision Bonds,* in The Law of Commercial Surety and Miscellaneous Bonds 33 (Bruce C. King, et al. eds., 2d ed. 2012).