Performance Guarantees

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A fundamental purpose of subdivision controls is to ensure that adequate infrastructure improvements will be provided to service anticipated development. This requires substantial cooperation between the developer and the planning commission in providing for the eventual construction of roadways, water and sewer systems, and other public improvements within or near a subdivision. *[Editor's Note: For an overview of subdivision regulations, see Martin Leitner & Elizabeth Garvin's "An Introduction to Subdivision Regulations," in PCJ #5].*

The principal mechanism for protecting public and private interests in this process is the performance guarantee. This article explores why performance guarantees are necessary, what forms they typically assume, and how they operate.

Background

The history of land subdivision reveals why performance guarantees became a necessary element of subdivision control. No meaningful controls over the creation of infrastructure existed either under the Land Ordinance of 1785 creating the original "division" of most of the country into sections to be sold from the public domain or in most of its successor statutes controlling surveying standards and deed registration after "subdivision."

The results were predictable: subdividers routinely failed to provide proper public improvements to lots platted by their subdivisions and the purchasers of individual lots often found themselves without recourse after typical "boom and bust" cycles in land speculation wiped out the developer. Municipalities usually had to provide any unfinished infrastructure under these circumstances at great expense, recouped through special assessments, debt financing or increased taxes.

In the 1920s, subdivision control enabling statutes aimed to remedy these problems by requiring the proper arrangement of roadways, water and sewer systems, and other public improvements and by providing mechanisms for developers to ensure their timely installation.

Contemporary statutes ordinarily do the same, although their provisions vary widely from state to state. Some specify the precise means by which installation of required improvements must be ensured, while others allow municipal planning commissions to determine how performance will be accomplished or guaranteed.

> THE SURETY PROMISES TO GUARANTEE THE COMPLETION OF THE IMPROVEMENTS FOR THE BENEFIT OF THE MUNICIPALITY

Planning commissions have usually fulfilled their obligations by either: (1) imposing a "condition precedent" upon subdivision approval, so that the approval is not final until all infrastructure improvements are completed; or (2) granting a tentative ("preliminary") subdivision approval that is revocable if all infrastructure is not completed within a specified time. These approaches, however, can pose a problem for a cash-poor developer relying on borrowed money, who may not be able to make improvements until lots are sold and income generated.

Performance guarantees offer a way around this problem that may work not only for the developer, but also for the municipality and the lot purchasers.

What follows is a brief explanation of the basic types of performance guarantees: surety or performance bonds; letters of credit; and escrows. Each type of performance guarantee has its own set of benefits and drawbacks, which should be considered.

Surety or Performance Bonds

The surety or performance bond is the most commonly used type of performance guarantee. It is a simple instrument based upon a promise by the developer and a surety company to pay a specified sum to the municipality. The bond terminates when the developer performs his obligation — installing the improvements. Failure to perform within a specified time allows the municipality to call the bond and use the proceeds to pay for the developer's unfulfilled obligations.

The surety promises to guarantee the completion of the improvements for the benefit of the municipality (at least to the face value of the bond). As a result, surety bonds can be quite expensive, and unavailable to some developers.

The consequences of a developer's default depends upon the language of the bond. Typically, the surety is allowed to complete the work either by advancing necessary funds to the defaulting developer or by hiring another contractor. The risk to the surety is that it may become liable for completion of all of the required improvements, regardless of the amount of the bond. The surety's most common response to this risk is to settle with the municipality upon a fixed amount and for the municipality to complete any remaining necessary improvements.

Sometimes a surety will simply pay damages up to the stated amount of the bond to the municipality and sue to recover from the developer. The municipality may sue as well to recover any difference between the cost of completing improvements and the face value of the bond paid by the surety.

In sum, the appropriateness of surety bonds as performance guarantees can be assessed by balancing their apparent simplicity and common use against their likely cost to the developer and risk of litigation to the surety and municipality.

Letters of Credit

An increasingly common alternative is the letter of credit. This type of performance guarantee is based on a transaction typically involving three distinct contractual relationships.

First, there must be an underlying agreement concerning installation of improvements between the developer and the municipality. Second, the developer and the bank enter into an agreement, ordinarily as a auxiliary component of the bank's development and construction loans to the developer. Third, the bank and the municipality enter into an agreement directly as a result of the letter of credit itself. It is this final agreement which distinguishes the letter of credit from other forms of performance guarantee because it obligates the bank directly to the municipality.

The bank will try to protect itself by requiring that a developer to whom it will issue loans and a letter of credit demonstrate financial qualifications sufficient to allow the bank to recoup the full amount pledged by the letter of credit.

The bank may also limit its exposure by drafting express conditions into the letter of credit limiting the circumstances under which the municipality may demand payment — such as to circumstances where the municipality can show that it has suffered actual damage. The bank may also prescribe the timing of its pledge to apply the funds to complete the improvements after default in order maximize the likelihood of a mutually satisfactory settlement.

It is certainly true that negotiating various terms such as these in a letter of credit can drive apart the interests of a bank and a municipality. However, it is important to recognize that there is, in fact, an underlying shared interest in the completion of the improvements. Only if improvements are completed to platted and conveyed lots can the bank recoup its investment and the municipality meet its obligations to its new residents, the lot purchasers. The strength of these shared interests may explain why letters of credit have become increasingly popular as performance guarantees.

Escrows (Cash or Property)

Two other closely related types of performance guarantees deserve mention, cash escrows and property escrows. The cash escrow requires that a developer deposit money with an escrow agent in an amount keyed to the estimated cost of required improvements. The funds are released back to the developer when the improvements are completed — or are released to the municipality if the required improvements are not finished within a specified time.

The problem with this arrangement is that it places the developer in no better position than he would find himself if he were required to complete all improvements before selling lots. He must "double fund" the improvements since the money must be held aside even as he expends similar sums to complete the improvements.

Some municipalities have tried to alleviate this problem by authorizing periodic releases of the escrowed money as portions of the subdivision improvements are completed. This certainly decreases the financial burden on the developer, but municipalities need to be cautious about the possibility of excessive releases at any point before all improvements are completed. It may be quite difficult to apportion costs accurately for any one increment of the improvements — and there will often be problems of labor and materials cost increases as the subdivision is being built.

Some municipalities have also experimented with accepting property escrows, although there are some notable difficulties in using this form of performance guarantee. Valuation poses the initial problem. Even stocks and bonds (which may be easily valued at the outset) are subject to market fluctuation. A developer's equipment may suffer from pre-existing, but unaccounted for, depreciation and certainly presents the risk of ongoing wear and tear.

Other real property owned by the developer might appear attractive to accept as escrow — but some of that property's value may be based on the developer's intentions for it, and disappear if the developer fails on the subdivision for which the escrow is held. The valuation problem is compounded by the difficulty that a municipality (not typically in the marketing business) may have in selling the escrowed securities, construction equipment, or real estate.

Summing Up:

All of the performance guarantees described here carry benefits and detriments. However, the important thing for developers, banks, and municipalities to keep in mind is that each device for ensuring completion of subdivision improvements becomes appropriate under different circumstances. Recognizing and interpreting these circumstances will allow developers, banks, and municipalities to maximize their shared objective in having adequate infrastructure improvements provided to service anticipated development. ◆

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