Coates' Canons Blog: Subdivision Performance Guarantees

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So the county granted initial approval for a large residential subdivision. Now, after completing some (but not all) of the roads and infrastructure, the developer wants final plat approval so she can close on the first round of lot sales. This may be practical—the cash flow from early lots may support the subsequent infrastructure—but it relies upon a developer's promise to follow through with adequate remaining improvements. What if the improvements are not built to standard? What if the economy tumbles and the developer goes bankrupt? What becomes of those expensive infrastructure needs?

One option is to require from the developer a performance guarantee with financial assurance that ensures subdivision improvements are completed as promised in a timely manner. If a developer fails to complete the guaranteed improvements, then the local government may call upon the funds of the financial assurance to complete the improvements. This blog considers the authority for performance guarantees, practical considerations for terms, and questions for administration and enforcement.

Authority

City and county subdivision regulations may require specific infrastructure improvements in conjunction with subdivision approval. Such improvements commonly include installation of adequate water and sewer, construction and dedication of subdivision streets that meet town or NCDOT standards, and provision of parks and recreation space. Moreover, the statutes authorize subdivision ordinances to require "construction of community service facilities," a broad category that can encompass stormwater facilities, sedimentation and erosion controls, sidewalks and trails, and more. For more on authorized subdivision exactions, see this blog. Depending on the jurisdiction and the type of development, such improvements may be dedicated to the public or maintained as private.

"To assure compliance with these and other ordinance requirements, the ordinance may provide for performance guarantees to assure successful completion of required improvements." (NCGS § 160A-372; 153A-331). If such guarantee is required the developer must be allowed to choose from a range of assurance types. These may include a performance bond, a bank-issued letter of credit, funds held in escrow, or other financial assurances. A performance guarantee could assure improvements regardless of whether they will be dedicated to the public or remain private.

These financial assurances commonly cover construction *performance*—guaranteeing funds if the developer fails to complete the agreed-to improvements. Some jurisdictions also impose a *maintenance* guarantee to cover the time from completed construction (and release of the performance guarantee) until the road or other infrastructure has been

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accepted by the appropriate entity (*e.g.*, municipality, water authority, or NCDOT).

In order to balance between enabling development and reducing risk of default, some jurisdictions require that a certain percentage of improvements (75 percent of required infrastructure by cost, for example) be complete before a developer may use a performance guarantee.

Local governments are not limited to performance guarantees. Other enforcement tools are also available to ensure compliance with subdivision requirements. One option is to say no—to refuse final plat approval until all infrastructure is complete. That gives certainty of completion, but may hinder development and few jurisdictions use this option anymore. Another option is to issue approvals for phases such that all of the improvements for one phase must be complete before final plat approval for that particular phase. Additionally, cities and counties may withhold building permits, seek injunctive relief, or bring other actions to ensure compliance with the subdivision ordinance. NCGS § 160A-375 and § 153A-334. Even if a local government allowed a performance guarantee to lapse, the other remedies may still be available. Town of Pinebluff v. Marts, 195 N.C. App. 659, 673 S.E.2d 740 (2009).

In addition to the authority of local governments requiring improvements and performance guarantees, it is worth noting the statutory authority for developers prior to final plat approval to enter into contracts to sell lots. NCGS § 160A-375 and § 153A-334 outline the disclosures and limitations related to such contracts, including among other things, that closing on the contract cannot occur until after final plat approval.

Terms

Courts enforce the authorized and agreed-upon terms of the performance guarantee, so getting the terms right in the ordinance and any contracts is critical. "Under North Carolina law . . . 'a public performance bond is a contract, governed by the law of contracts. Parties entering into public performance bond are free to contract for any terms they so desire.' Therefore, the contractual terms of the Bonds are controlling . . . ." Cnty. of Brunswick v. Lexon Ins. Co., 425 F. App'x 190, 192 (4th Cir. 2011) (unpublished)(quoting Town of Pineville v. Atkinson/Dyer/Watson, Architects P.A., 114 N.C. App. 497, 442 S.E.2d 73, 74 (1994)). Here are some topics and terms to consider.

How much? Subdivision ordinances commonly require that the applicant provide a work plan and cost estimate signed and sealed by a licensed engineer, land surveyor, or landscape architect. The ordinance, then, may require a stated percentage of that estimate. Jurisdictions may require some amount above the estimate (125 percent, for example) to address the risk of increased costs over time. Financial assurance for a maintenance guarantee may be much lower; 15 percent of total construction cost, for example. Some ordinances include an additional fee and/or percentage to cover basic administrative costs and any legal fees related to calling the financial assurance.

Term and Extension. The performance guarantee will, necessarily, have a deadline for performance. Reasonable extensions may be appropriate where the developer is making good faith efforts. It may be appropriate at the time of extension or other regular milestones to allow adjustment to the financial commitment. The financial assurance for a performance guarantee may be reduced to reflect completed improvements. In contrast, the financial assurance for a maintenance guarantee may be increased to reflect the rising likelihood of maintenance needs.

Note that federal and North Carolina courts have found that the Permit Extension Act of 2009 did not modify bond companies' obligations to pay subdivision performance bonds upon default by the developer. *See* Cnty. of Brunswick v. Lexon Ins. Co., 425 F. App'x 190, 192 (4th Cir. 2011); Synovus Bank v. Cnty. of Henderson, 729 S.E.2d 731 (N.C. Ct. App. 2012), *review withdrawn*, 366 N.C. 411, 735 S.E.2d 176 (2012).

Triggers for Default. It is plain that the local government should have rights to call the financial assurance if the developer fails to complete the improvements by the deadline. But, at what point is the developer in default and what are the mechanics to call upon the financial assurance? Does the local government have an obligation to notify the developer or the financial institution? The performance guarantee and financial instrument should have clearly-defined criteria for default and a process for calling the funds. For a performance bond, the terms *may* call for an opportunity for the surety to complete the improvements. If so, then the local government will need to provide appropriate notice of default and an opportunity to satisfy the obligation. Cnty. of Brunswick v. Lexon Ins. Co., 710 F. Supp. 2d 520 (E.D.N.C. 2010) aff'd, 425 F. App'x 190 (4th Cir. 2011).

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Local governments may be wise to include additional triggers to call the assurance, such as failure of the developer to renew an expiring financial instrument, developer insolvency or bankruptcy, or foreclosure on the property. Some additional terms will smooth the enforcement process. The agreement may grant rights for appropriate public bodies (the municipality, the county, NCDOT, or their contractors) to enter the property and complete construction of the improvements. Some local governments even include terms to authorize release of funds to an applicable property owners association to oversee the remaining construction. Practically this may be a useful tool, but the rights and obligations of the association would need to be clearly contracted. Moreover, there is an underlying question of authority to assign financial assurances to a third party as discussed below.

Criteria to Release. Prior to release of any performance guarantee, the local government needs confirmation that the improvements are complete and built to the required standards. Jurisdictions may require a letter from a licensed professional (engineer, surveyor, landscape architect) certifying completion. Following the certification, local government staff will inspect the improvements for confirmation.

Some jurisdictions have drafted form performance guarantees to make sure appropriate terms are specified. The model language for public construction performance bonds, provided at NCGS § 44A-33 may be instructive, but will not cover the distinct issues of subdivision performance guarantees.

Administration and Enforcement

Even if the terms of a performance guarantee are clear and comprehensive, the practical administration and enforcement deserve some consideration.

Who is administering? Performance agreements require careful administration. Development milestones will come and go, guarantees will approach expiration, and a local government official will occasionally need to call a financial assurance. Who is responsible? The attorney who approved the agreement, the finance department, inspections, public works, or planning? Clear roles and responsibility could save millions of dollars for the local government.

What if the financial assurance is more than the cost of improvements? Well, it depends on the terms of the contract. Some ordinances specify that excess funds must be returned to the developer. A general performance bond (or indemnity bond) will cover the cost of completing the improvements. A penal bond, in contrast, will pay the full stated amount, regardless of the actual cost of improvements. The NC Court of Appeals considered this issue in a recent decision. Although the surety argued that the actual cost of improvements would be less than the bond amount, the contractual terms of the bond stated that the sum was a penal sum. Thus, upon nonperformance the county was owed the full amount of the bond. As the court stated, “The plain meaning of ‘penal sum’ is an amount awarded to a beneficiary as a penalty if some obligation is not performed. The term ‘penal sum’ suggests the entire $6,000,000.00 was due once Seven Falls failed in the performance of the duties enumerated in the performance bond.” Synovus Bank v. Cnty. of Henderson, 729 S.E.2d 731 (N.C. Ct. App. 2012), *review withdrawn*, 366 N.C. 411, 735 S.E.2d 176 (2012). If, however, the developer never commenced the development, the local government may not have a claim against the financial assurance. Westchester Fire Ins. Co. v. City of Brooksville, 731 F. Supp. 2d 1298 (M.D. Fla. 2010) aff’d, 465 F. App’x 851 (11th Cir. 2012).

What if the financial assurance is less than the cost of improvements? Does the local government have to complete the infrastructure? The statutory purpose and authority of a performance guarantee is for the developer to insure the completion of required improvements related to a subdivision approval. A performance guarantee should not create an obligation upon the local government to expend funds beyond the guarantee. That said, local governments should have standards in place from the start to ensure that adequate guaranteed funds are available if needed.

What are the rights of third parties? It will depend on the facts of the case and the terms of the guarantee, but third-parties will need clear authority and distinct interests to have a claim. Funds from a subdivision financial assurance cannot be used to pay contractors for work already completed—the statutory authorization for performance guarantees does not include payment bonds. In re Versant Properties, LLC, 1:10CV98, 2011 WL 1131057 (W.D.N.C. Mar. 25, 2011)(not reported). A property owners association may have a recognizable interest, but it will depend on the facts. Consider the federal district court’s ruling in a recent North Carolina case. The court initially allowed an association to intervene as having interests adverse from the county based on the association’s intent to assert a claim of declaratory relief to ensure

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that any funds secured from the bonds would be used for infrastructure in the subdivision. However, when the association failed to make that claim, the court granted the defendant's motion to dismiss the association. The court looked at the terms of the ordinance and contract to find that the association lacked adversity in interest and lacked a claim of breach of contract as a third-party beneficiary, among other findings. Rutherford Cnty. v. Bond Safeguard Ins. Co., 1:09CV292, 2011 WL 809821 (W.D.N.C. Mar. 2, 2011).

A separate question is this: Does a local government have authority to assign rights from a performance guarantee? There is no express statutory authority to assign the rights to third parties, but it may be reasonably necessary and within the contracting rights of a local government. Consider a county that has called a subdivision performance bond for incomplete subdivision streets. If that money had been obtained as a fee-in-lieu of construction, the county would be required to transfer the funds to a municipality to develop the roads. NCGS § 153A-331(c). A similar transfer may be reasonably necessary and appropriate for funds called from a performance guarantee. And, as noted above, "[p]arties entering into public performance bond are free to contract for any terms they so desire." Cnty. of Brunswick, 425 F. App'x at 192.

If the financial assurance is called and used for construction, is that subject to bidding requirements? This is an interesting question and the answer will depend upon how the financial assurance is called and the construction contract is structured. Generally it is the expenditure of public funds on a contract for construction that triggers bidding. If the public entity calls the financial assurance and contracts for the construction, then it is subject to typical bidding requirements. If the public entity calls the financial assurance and then contracts with a private entity (such as a subsequent developer) to complete the improvements, that too is subject to bidding—it is a contact for construction using public funds. If the financial assurance was structured to go directly to the homeowners association, the association's contract for construction may not be subject to bidding requirements. If costs are less than $250,000 the local government may be able to avoid bidding requirements by structuring the transfer of funds as a reimbursement agreement under G.S. 160A-499 & -320 or G.S. 153A-451 & -280. My colleague Frayda Bluestein has explored related (but distinct) topics of private funds and public construction here.

Conclusion

Performance guarantees allow local governments to assure timely completion of required subdivision improvements. Courts enforce the terms of the contract, so it is critical to get proper provisions in place from the start. Moreover, the practical considerations of administration and enforcement will benefit from clear ordinance and contract standards.

Links

- canons.sog.unc.edu/wp-content/uploads/2014/02/Picture1.jpg
- canons.sog.unc.edu/?p=6985
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_153A/GS_153A-331.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_160A/GS_160A-375.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_153A/GS_153A-334.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_44A/GS_44A-33.html
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