Subdivision Improvement Guarantees:
What Are Your Options?

By Jim Scheer

While each option for guaranteeing subdivision improvements has its advantages and disadvantages, subdivision bonds are the instrument of choice for most of today's developers.

In most jurisdictions, developers must assure local governments that they will complete all required subdivision improvements within a specified period of time and at no cost to the community. To that end, they typically turn to one of three distinctly different financial instruments – letters of credit, trust instruments, and subdivision bonds -- to provide the necessary guarantees. This article describes these three instruments as well as the advantages and disadvantages of each. (Of course, a fourth method of guaranteeing subdivision improvements is to use cash – that is, to deposit cash with the local government. For minor items, say those costing $5,000, a cash deposit is the easiest and least costly method.

Letters of Credit

Bank letters of credit are the most commonly used type of guarantee for subdivision improvements. Once the final cost of the improvements has been estimated, the affected municipality determines the amount of the letter of credit guarantee. Amounts vary by municipality but typically equal 125 percent of the estimated cost of the planned improvements.

With the amount determined, the developer approaches the bank with pertinent details, including the type and cost of the improvements, the names of subcontractors performing the work, and the time of construction. In the case of a negotiated land and improvement loan, the bank also delves into the financial aspect of loan repayment. When does the developer expect to start selling? What is the developer's sales price? What is the developer's cost? When does the developer expect final sales to be completed? Does the loan fit in with the developer's line of credit? These factors all determine a bank's willingness to finance subdivision and its improvements.

For a developer using a letter of credit, the bank must by law include the amount of the letter of credit as part of the developer's bank line. Of course, if a developer is obtaining an acquisition and development (A&D) loan from the same source, the letter of credit may be shown as a set-aside portion of the A&D loan.

Trust Instruments

While trust instrument guarantees can take several forms, the procedures used to determine the amount of the guarantee are the same as those for letters of credit or subdivision bonds. A trust is typically set up at the developer's bank and funded with the developer's liquid assets. It is a three-party agreement among the bank, the affected municipality, and the developer. The agreement enumerates the obligations of all parties and grants the municipality authority to withdraw funds from the trust if the developer fails to complete within the agreed upon time all subdivision improvements according to plans and specifications approved by the municipality. In some cases, the municipality

allows the developer to withdraw funds as long as the withdrawals pay for improvement costs and the balance in the trust account is sufficient to complete the remaining improvements.

Developers are increasingly turning to bonds as the preferred instrument for guaranteeing subdivision improvements. Just like any good banking relationship, bonding relationships must be nurtured and built on mutual trust.

Subdivision Bonds

Again, the amount of the subdivision bond is dictated by the affected municipality after a review of the projected costs as estimated by the developer's engineer. Typically, insurance companies write subdivision bonds. The language on the bond must be approved by the municipality. Like trust instruments, the bonds are three-party agreements. The principal on the bond is the subdivider, the obligee is the municipality requesting the guarantee, and the surety or insurance company is the guarantor. The bond simply guarantees the agreement executed between the developer and the municipality for the installation of improvements. The corporate assets of the insurance company guarantee the obligation. If the developer fails to install the improvements according to the approval plans and specifications within the allotted time, the insurance company must complete all improvements upon the municipality's request. In recent years, more and more insurance companies have learned that issuing subdivision bonds is profitable business for them.

Advantages and Disadvantages

Most municipalities accept all three forms of guarantee. Each subdivider must determine the best instrument for the needs of his or her operation. To do so, the developer must examine the advantages and disadvantages associated with each type of guarantee.

The cost of a letter of credit typically runs from 0.75 percent to 2 percent per annum of the amount of the required improvements. If the planned improvements require more than one year for completion, the letter of credit is normally reduced at the end of the first year. Some municipalities, however, do not permit a reduction; others allow a quarterly reduction based on the balance of the improvements to be completed at that time. If a developer is contractually bound to a maintenance period, a reduced letter of credit remains in effect until expiration of the maintenance guarantee period.

Most banks are accustomed to issuing letters of credit that are not cost-prohibitive, and municipalities routinely accept them; banks, however, look less favorably on issuing letters of credit because such instruments are counted as liabilities. One disadvantage to a developer is that a letter of credit ties up the developer's line of bank credit, which could potentially be used for more profitable ventures. A municipality can easily call a letter of credit. Further, if a developer's bank fails to issue a renewal for the letter of credit, the municipality automatically calls the letter. While municipalities like the ease of calling a letter of credit, either of these events precipitates a crisis for the developer. Finally, negotiating reductions in the amounts of letters of credit can be a cumbersome process.

Not all municipalities accept trust instrument guarantees. Assuming that a developer 's money funds the trust, the only cost accruing to the developer is the legal fees for drafting an acceptable agreement; trust interest earnings flow to the developer. A carefully drawn

agreement prevents the municipality from arbitrarily withdrawing the funds. However, unless a developer is financially strong and has no other use for the money that funds the trust, the opportunity cost is high. Cash remains tied up for extended periods.

Bonds are now the instruments of choice for many developers of all sizes. The cost of subdivision bonds is equal to or less than the cost of letters of credit. Municipalities accept the bonds, which are not charged against the developer's bank credit. The bonds are simple to administer, and municipalities cannot "cash" them in until they prove their loss. In this regard, municipalities often prefer a bond because they do not have to exercise a fiduciary responsibility as is required when cashing in a letter of credit. The bonding company employs trained claim personnel who act as both referee and guarantor. In addition, bonding companies normally do not take an assignment of a developer's assets as collateral. Their indemnity agreement is the developer's sole pledge to hold them harmless.

In some jurisdictions that use bonding, the developer must obtain both a completion bond to ensure that the work will be performed and a labor and material bond (at perhaps 50 percent of the amount of the completion bond) to ensure that the developer will pay his or her contractors. Because a municipality looks at letters of credit as cash that could be used to pay any contractors as needed, it does not require companion bonds. However, if a companion payment bond is required, it can be incorporated as part of the subdivision bond.

Developers are increasingly turning to bonds as the preferred instrument for guaranteeing subdivision improvements, just like any good banking relationship, bonding relationships must be nurtured and built on mutual trust. Not every developer shows a profit every year. In those down periods, it is the strong relationships that keep banks lending and bonding companies bonding.

Jim Scheer is president of Scheer's Incorporated, of La Grange, Illinois, which provides bonds and insurance for the construction industry.

As appeared in Land Development/Winter 1995.