



A Nightmare on Main Street

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Strategies for resolving
disputes in today's
housing bubble crisis.

Subdivision and Maintenance Bonds

As a result of the housing market collapse, real estate developers and redevelopers have experienced an industry-wide decline in home sales. Reduced demand, sweeping price reductions, increased inventory, and declining sales

have nearly halted new residential construction, leaving scores of housing developments across the country in various stages of incompleteness.

This housing downturn and the accompanying proliferation of the so-called “zombie subdivisions” has touched the surety industry. A general decline in residential construction spending has contributed to a rising storm of litigation involving subdivision and maintenance-bond claims. Given the explosion of these bond disputes in the state and the federal courts across the country, both attorneys and surety claim specialists should reconsider the unique obligations undertaken by a surety involved in subdivision and maintenance bonds, as well as some of the key, strategic defenses available to a surety when an obligee asserts a bond claim.

Subdivision- Performance Bonds— Key Defenses

A subdivision bond is a type of perform-

ance bond. It is a surety's guarantee that a builder or a developer will complete specified public improvements in an approved subdivision in accordance with the subdivision plan and a statutory scheme. Many states require subdivision bonds as a precondition to approving a subdivision plan, and developers must have them in place before beginning construction. Generally, a subdivision bond's purpose is to ensure that a developer builds public facilities such as streets, walkways, utilities, waste disposal systems, and other improvements important to large-scale residential development construction in accordance with local specifications.

When a developer fails to complete bonded improvements within the time period specified in the subdivision plan or applicable statutory scheme, the subdivision bond provides the obligee—typically a city, a county, or a municipal corporation—with recourse to the surety to fund completion of the improvements. Such recourse, however, does have limits, and the par-



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ties to subdivision bonds often dispute the scope of these bonds' guarantees.

Define a Surety's Financial Exposure—Indemnity or Penalty Bond?

Subdivision bonds generally fall into two categories: penalty bonds and indemnity bonds. On receiving a claim, to properly evaluate a surety's potential exposure, an attorney and

On receiving a claim

involving a subdivision bond, a surety claims specialist and legal counsel should canvass statutory law in the relevant jurisdiction to determine whether the legislature has enacted reprieves for subdivision developers.

a surety claims specialist need to understand the limit of a surety's obligation under a subdivision bond and the distinction between a penalty bond and an indemnity bond.

Specifically, a subdivision-penalty bond essentially is a surety's promise to pay the penal sum of the bond to the obligee in the event that the principal fails to complete the bonded improvements by a certain date. In contrast, under a subdivision-indemnity bond, a surety agrees to indemnify the obligee for actual losses suffered by the obligee up to the penal sum of the bond as a result of the principal's failure to complete the bonded improvements by a certain date. An indemnity bond limits an obligee's recovery to the costs associated with completing the improvements up to but not to exceed the penal sum. The language of a bond will dictate its status as an indemnity bond or a penalty bond.

Take Advantage of Specific Legislative Reprieves

In most instances, a subdivision surety

stands in the shoes of the developer and is entitled to all of the defenses available to the developer. Because subdivision bonds typically are the object of legislative creation, sureties should determine whether they can take advantage of emergency statutory controls designed to exonerate or to relieve developers during economic recessions.

On receiving a claim involving a subdivision bond, a surety claims specialist and legal counsel should canvass statutory law in the relevant jurisdiction to determine whether the legislature has enacted reprieves for subdivision developers. For example, in acknowledgment of the slow completion of subdivision developments as a result of the housing downturn, in 2009 the North Carolina legislature passed the Permit Extension Act, designed to afford developers additional time to complete subdivisions without requiring them to reapply for permits or other authorizations. See North Carolina Senate Bill 831 (Session Law 2009-406).

At least one federal court already has examined the breadth of the Permit Extension Act. In 2009, the County of Rutherford, North Carolina, filed a lawsuit in the Western District of North Carolina seeking to compel a surety to complete its principal's subdivision obligations or pay the penal sum of the subdivision bonds. See *Rutherford Co. v. Bond Safeguard Ins. Co.*, 2009 WL 6543659 (W.D.N.C. 2009). The surety sought to have the court dismiss the county's complaint, contending that the Permit Extension Act guaranteed its principal additional time to complete the bonded improvements, thereby rendering the county's claim against the bonds premature. Although the court denied the surety's motion without prejudice, it did hold that when the Permit Extension Act is [a]sserted as a defense to [a] plaintiff's claims of breach of contract rather than a bar to prosecution, [the surety] could reasonably argue that it has not yet breached the bonds because it has until December 31, 2010 to complete the work, insofar as it stands in the shoes of the principal.

The court further concluded that the county could respond to this defense by proving that the developer, in whose shoes the surety stood, would not be entitled to the extensions provided by the act as a result of failing to comply with the act.

Beware the "Sweetheart Deal"

When presented with a subdivision-performance bond claim, sureties are well advised to look out for the "sweetheart deal." This is typically characterized as a self-dealing contract between a municipality and a successor developer. The arrangement typically rises when an obligee attempts to fund a successor-developer subdivision agreement after the primary developer defaults using bond proceeds and creating an unintentional windfall for the successor developer or the municipality, or even an illegal forfeiture.

If a successor developer assumes all of the obligations under the original subdivision plan and accepts the benefits provided by the surety's subdivision bond, for example, funded improvements, the surety may recoup its losses from the successor developer invoking its common law right of equitable subrogation. As a subrogee to a municipality, a surety arguably has the right to stand in the shoes of the municipality and demand payment for the public improvements or reimbursement for its losses attributable to constructing the public improvements. A surety also may have a common law right of indemnity against a successor developer that assumes all of an original developer's obligations under the subdivision plan, including the bonding and indemnity obligations. A surety might also pursue a successor developer under an equitable theory of recovery such as unjust enrichment.

Under a subdivision-performance bond a surety may not retain performance obligations if meeting the obligations would result in an unintended windfall to the obligee. A Florida federal court implicitly accepted this "successor-developer defense" in *Westchester Fire Ins. Co. v. City of Brooksville*, 731 F. Supp. 2d 1298 (M.D. Fla. 2010), when a municipality attempted to lay claim to bond proceeds before making efforts to complete an abandoned subdivision. While the subdivision bond, issued in accordance with a local ordinance requiring that the bond guarantee access to certain public utilities before people purchased the homes, did not expressly require the city to complete the improvements, the court nonetheless realized that permitting the municipality to collect under such circumstances would result in an unreason-

able windfall to the obligee. Specifically, the court commented that

[n]o salutary purpose is achieved by requiring [the surety] to pay \$5.3 million to the City's general fund. The surety incurs no obligations under the bonds because [the developer] abandoned Phase Two before commencement and the successor developer will not develop the plot in the near future. Requiring the surety to pay under the present circumstances is both unreasonable and conflicts with the purpose of the City's ordinance requiring the posting of a performance bond. Furthermore, the City has suffered no damage and is not obligated to construct the Phase Two improvements.

Courts in various jurisdictions have permitted municipalities to use bond proceeds to reimburse successor developers for completing public improvements. *See, e.g., City of Sacramento v. Trans Pacific Indus.*, 98 Cal. App. 3d 389, 159 Cal. Rptr. 514 (Cal. App. Ct. 1979); *City of Merced v. Am. Motorists Ins. Co.*, 126 Cal. App. 4th 1316, 24 Cal. Rptr. 3d 788 (Cal. App. Ct. 2005). Thus, surety claims specialists and attorneys are well advised to determine the intent of an obligee, a lender, or a successive developer before responding to a subdivision-bond claim to avail the surety of potential successor-developer defenses or avenues of recovery.

Identify and Weed Out Improper Claimants

In evaluating a claim to a subdivision-performance bond, it is important to identify the obligee and to determine whether the plaintiff properly can make a claim to the bond. Indeed, courts routinely have restricted a surety's obligations to third parties asserting claims to a subdivision bond.

Generally, the bond obligee is the only entity with standing to assert a claim against a surety to recover from a subdivision bond. For example, in 2010, an Illinois federal court held that unpaid subcontractors did not have standing to assert claims for payment on a subdivision-performance bond. *City of Yorkville v. Ocean Atlantic Service Corp.*, 2010 WL 3385461 (N.D. Ill. 2010). The plaintiffs, styled as "use plaintiffs" in their complaint, were not parties to the surety agreement and sought recovery from the bond, arguing a third-party

beneficiary theory. The plaintiffs argued that, because a provision in the bond contemplated filing a mechanic's liens as an event permitting the City of Yorkville as the only named obligee of the bond to find the developer in default, the city intended to treat the subcontractors as intended beneficiaries under the bond terms. The court disagreed, observing that under Illinois law the intent to confer contractual benefits to third parties must be clear and direct. Moreover, the express language of the bond only secured the completion of the improvements; it did not guarantee payment for all labor and materials used in constructing improvements.

A similar result was achieved in *Rutherford County v. Bond Safeguard Ins. Co.*, 2009 WL 6543659 (W.D.N.C. 2009), in which a federal court endorsed a finding by a magistrate judge that the parties to a subdivision-performance bond did not bestow third-party beneficiary rights on the subdivision property owner's association. The court refused to construe the bond liberally by distinguishing the common law subdivision bond at issue from statutory subcontractor-payment bonds, which, under Florida law, courts have broadly construed for the purpose of achieving the statute's legislative purpose. Likewise, in *County of Brunswick v. Lexon Ins. Co.*, 710 F. Supp. 2d 520 (E.D.N.C. 2010), the court dismissed an attempted impleader action by new owners of a defaulted subdivision project on the basis that the new owners did not have an obligation to the surety. The new owners purchased the property at a foreclosure sale, and they were neither parties to the subdivision bonds nor the underlying development agreement for the subdivision. Accordingly, because the surety and the new owners did not have a contractual relationship, the new owners could not recover from the surety from the subdivision bond.

Frustration of Purpose

The frustration of purpose is another defense that a surety has when construction of a subdivision either never began, when the plan was reduced, or when the plan was altered. Frustration of purpose is a common law defense that a surety may raise to avoid having to perform in the future under a subdivision-performance bond when

an unforeseen event frustrates a contracting party's purpose for originally making the agreement. The Restatement (Second) Contracts defines the defense as follows:

Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which

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the contract was made, his remaining duties to render performance are discharged, unless the language or circumstances indicate the contrary.

See Restatement (Second) of Contracts §265 (1981).

In a subdivision-bond context, a surety successfully exercised this defense in *County of Yuba v. Central Valley National Bank, Inc.*, 20 Cal. App. 3d 109, 97 Cal. Rptr. 369 (Cal. App. Ct. 1971). The court determined that a letter of credit was intended to provide security for the full completion of a public improvement. Due to a population shift, the developer never started the subdivision improvements and decided to abandon the development altogether. Applying the frustration of purpose defense, the court denied the county's claim on the credit instrument, finding that "construction of streets would serve no useful purpose in the absence of such a subdivision and that none of the parties intended streets to be constructed except as part of construction of such a subdivision."

The defense also was raised successfully in *Habitat Trust for Wildlife, Inc. v. City of Rancho Cucamonga*, 175 Cal. App. 4th 1306, 96 Cal. Rptr. 3d 813 (Cal. App. Ct. 2009), when a bonded developer contracted with a nonprofit environmental advocacy group. Under the contract, the developer agreed to convey land to a trust to miti-



gate environmental impacts caused by the project development. At the time of execution, both parties believed that the trust was a qualified conservation entity (QCE) and that the city would approve the transfer of land to it. The city, however, did not approve the trust as a QCE, and the developer sought exoneration from its contractual liability, arguing that its performance

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would require the developer to convey land and funds to the trust without complying with the city's conditions to construct the development. The California Appeal Court affirmed the summary judgment in the developer's favor, agreeing that the essential purpose of the agreement was to satisfy the environmental mitigation condition.

Verify Conditions Precedent to Performance

Before a surety's obligations under a bond mature, the obligee must comply with any "conditions precedent," meaning events that must occur before the duty to perform a promise in the agreement arises. Local statutes or regulations governing issuing and enforcing subdivision bonds also may contain condition precedents to surety performance. And courts may expressly find such conditions in the bonds, in the underlying contracts, or implied by operation of law.

In one leading case that evaluated this particular issue, *Town of Groton v. Marie Lane Homes, LLC*, 286 Conn. 280, 943 A.2d 949 (Conn. 2008), the municipality of Groton, Connecticut, approved a subdivision under the condition, contained in a state statute, that the developers complete construction within five years after accep-

tance of the subdivision plan. See Conn. Gen. Stat. § 8-26c.

Before the subdivision's approval expired, the developer granted mortgage interests in numerous lots within the subdivision to third parties. The developer failed to complete the improvements within the five-year deadline causing the subdivision approval to expire automatically by operation of law.

The relevant statutory authority governing subdivision approval required the municipality to "call" the developer's subdivision bond to the extent necessary to construct improvements to lots within the subdivision that had been "conveyed" before the subdivision's approval expired. After the subdivision's approval expired, various interests, including those holding mortgages, attempted to compel the town to exercise its duty under the statute and call the subdivision bond, arguing that their mortgage interests constituted a "conveyance" under the statute. The town and the surety sought a declaration that the municipality did not have a mandatory obligation to call the bond to complete the improvements because providing a mortgage interest did not constitute a "conveyance" under the statute. The town and the surety prevailed. The Connecticut Supreme Court affirmed the trial court decision, holding that granting a mortgage interest in subdivision lots did not constitute a "conveyance" within the meaning of the statute. Therefore, since conveyance did not happen, the town did not have a mandatory obligation to call the surety's subdivision bond.

Additionally, the failure of an implied condition may also excuse a surety from performing in certain circumstances. For instance, in *Westchester Fire Ins. Co. v. City of Brooksville*, 731 F. Supp. 2d 1298 (M.D. Fla. 2010), the court held that actual construction by the municipality following the developer's default was an implied condition precedent of the surety's bonded obligation.

Subdivision-Maintenance Bonds—Defenses

Unlike a blanket subdivision bond, which guarantees the construction and completion of all bonded subdivision improvements, a subdivision-maintenance bond offers guarantees against defective materials and workmanship within a specified

time period following completion of all bonded improvements and the acceptance of those improvements by the governmental authority. As with subdivision-performance bonds, procuring a maintenance bond is often a prerequisite to approval for subdivision development, although questions involving the relevant statutory authority mandating a bond's procurement may also apply in certain cases. For example, in *Itzen & Robertson, Inc. v. Board of Health of Borough of Oakland*, 92 N.J. Super. 241 (N.J. Super. Ct. App. Div. 1966), a court decided that a municipal ordinance that compelled the installer of a sewage disposal system to furnish a maintenance bond exceeded the permissible scope of the statute defining the powers of local boards of health.

To sustain a claim to a maintenance bond, the obligee must prove that a defect is covered by the specific warranty described in the maintenance bond. Unless stated otherwise in the bond, a surety's maintenance-bond liability typically is limited to defective materials or workmanship discovered after completion and acceptance of the improvements and does not cover defects from ordinary wear and tear.

Confirm That a Surety Received Sufficient Notice

Maintenance bonds usually contain notice requirements that trigger a surety's performance obligations. Thus, a municipality's failure to provide a surety with prompt notice of the alleged defect may constitute a breach relieving the surety of liability. Understanding the potential prejudice to a surety when it does not receive strict notice of a claim, courts generally have treated notice requirements within a bond or an underlying contract as conditions precedent to the surety's performance. See, e.g., *Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997) (finding that the general contractor failed to meet necessary condition for the surety's liability under the performance bond when the general contractor defaulted on the supply contract and instead sent letter to the surety only mentioning the subcontractor's performance delay); *accord Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 376 F.3d 96 (2d Cir. 2004) (finding the general contractor's let-

ters notifying the subcontractor and surety under the performance bond that it was exercising its rights under the subcontract agreement default provisions insufficient to declare default as required to trigger the surety's obligations under the bond when the letters evidenced the contractor's desire to continue its arrangements with the subcontractor and to keep the subcontract in force and that if contractor wanted to trigger the bond it needed to terminate its relationship with the subcontractor and offer the surety an opportunity to complete the project itself or hire others to do so).

Receiving sufficient notice of an alleged deficiency is particularly important to triggering a surety's performance obligation under a maintenance bond, as a lingering and remedied defect in construction may increase the surety's financial exposure in the long run.

Observe Other Conditions Precedent

As with subdivision-performance bonds, an obligee's failure to comply with the procedural requirements for making a claim on a bond may preclude recovery in certain instances. In *Wright v. Town of La Grange*, 694 N.Y.S.2d 862 (N.Y. Sup. Ct. 1999), when developers of a subdivision requested release from a maintenance bond following the expiration of the repair period covered by the bond, the municipality's failure to notify the developers of certain drainage problems requiring correction within the time period covered by the bond prevented the municipality from insisting that the developers complete the repairs.

Define the Scope of Liability

In *Lower Salford Township v. International Fidelity Insurance Co.*, 2010 WL1741356 (E.D. Pa. 2010), a Pennsylvania municipality sought recovery to correct certain items in need of repair following the proj-

ect's inspection by the town engineer. The developer previously had made a maintenance agreement with the township that was the subject of the maintenance bond. The developer failed to make repairs as required under the bonded agreement. The maintenance bond's notice provision directed the municipality to notify the developer and surety in writing within 30 days of discovering defective work. The municipality, however, waited five months before writing to the surety and declaring the developer in default, and the surety, relying on the notice provision contained in the bond, sought to have the court dismiss the municipality's claim for failure to provide timely notice of the claim.

The court granted the surety's motion to dismiss but not for the reasons argued in its motion papers. Instead, the court determined that the plain language of the bond guaranteed against "defective materials and workmanship." Defects in workmanship, the court determined, meant that the developer would have had to perform the repairs required by the bond maintenance agreement first, and only after that, could the municipality claim that the work was defective. Based on this interpretation, the developer's act to make the repairs, followed by the municipality's discovery of defective workmanship would oblige the surety to perform. The court declined to treat a total failure to perform as a "defect" covered by the subdivision-maintenance bond.

As the court concluded in *Lower Salford Township*, a surety has responsibility for defects in improvements directly resulting using defective materials or performing faulty workmanship in completing contractual obligations.

Define the Contractual Limitation Period in the Bond

A maintenance bond, as a warranty, is

intended to cover the contractor's work for a fixed period of time. Consequently, recovery against the bond is permitted only where the defect arises during the period covered by the bond. See *Starett Bros. & Eken, Inc. v. Asher Fireproofing Co.*, 61 App. D.C. 182, 59 F.2d 358 (D.C. Cir. 1932). Moreover, the statute of limitations governing a surety's obligation to cure defective performance usually begins on date on which it had been accepted that the project had been completed. See *Fed. Ins. Co. v. Sw. Fla. Ret. Ctr., Inc.*, 707 So. 2d 1119 (Fla. 1998).

Be Wary of Alterations to the Bonded Obligation

A surety may become discharged from the obligation to make good for a principal when the contractual undertaking that the bond intended to cover becomes so materially altered that the bond covers a different obligation. A maintenance bond of a surety, therefore, may only need to accept responsibility for defects resulting from poor work quality or pour quality materials but not for defects due to other causes. In *R.F. Conway Co. v. City of Chicago*, 274 Ill. 369, 111 N.E. 703 (Ill. 1916), a contractor agreed to maintain street paving improvements for a period of five years after completing the work. The contractor did not have design obligations under the contract. Thus, when the municipality permitted the street to fall into abnormal disrepair, it had to restore it to its original condition before calling on the surety to repair it.

Conclusion

Subdivision-bond and maintenance-bond sureties have numerous defenses to explore when evaluating claims, the most typical of which the authors discussed in this article.

