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This article discusses the circumstances under which a subdivision bond surety is excused from performance or is required to complete performance when its principal abandons a project.

Deconstructing Subdivision Bonds

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As many of you know, the West is leading the country in housing failures and foreclosures. While Nevada is leading, California and Arizona are running second and third. There are scores of undeveloped subdivisions and subdivisions in default. Many, if not all, of the developers were responsible to provide financial responsibility to local public bodies for completion of the subdivisions. The financial responsibility required was predominately in the form of letters of credit or surety bonds. The bonds were issued to include infrastructure work, road work, water work, and even landscaping. Some projects have several bonds associated with them. While there are developmental similarities between each subdivision project, there is one commonplace dissimilarity: the bond form.

The problem with having several defaulted subdivision cases is that not a single bond form is the same. This leads to problems in more than one respect. The first is locating a resource that explains the bond language. The ordinances or rules creating them bear short shrift to explaining how the bonds are to work and what key words or phrases mean. For example, some of the bonds have a “call” provision with no explanation as to what the word “call” means, what the obligee’s duties are in “calling” the bond, and what the surety’s obligations are when, and if, the bond is “called.” While some of the bonds are entitled “performance bonds,” the bond forms do not define what “performance” means. Some of the bond language is more akin to an indemnity bond or a penalty bond than a performance bond. The type of bond form, along with the surety’s liability, is discussed by the Supreme Court of Virginia in Board of Supervisors Fairfax County, et al. v. Ecology One, Inc.¹ Here, the county sued

a residential housing developer and the surety to recover a judgment as a result of the developer’s breach of its development agreement to construct streets and drainage facilities. That agreement was entered into pursuant to a county ordinance and state statute concerning subdivisions and approval of plats. The bond form provided: “Both Principal and Surety desire to guarantee to the Obligee, performance of the agreement [between developer and the county].”² The developer abandoned the project. It defaulted on its construction loans, and the lender conducted a foreclosure sale, taking over the property.

At that time, eight lots were improved in various stage of construction, nine were unimproved, four houses had been completed but the streets were surfaced only with gravel, and the drainage facilities were practically nonexistent. The county assigned to the lender any money it received in its action against the principal and the surety not to exceed the amount actually spent by the lender to complete the work in accordance with the development agreement. The primary defense of the surety was that the assignment to the lender was invalid. Citing case law from New Jersey and Illinois, the court held that the assignment was valid because the assignment secured work covered by the bond, and the lender performed the work that was guaranteed by the bond. The county, however, claimed that the bond was an indemnity or penalty bond because it referenced a “penal” sum and wanted the balance of the bond paid as liquidated damages. This argument was rejected relying on the state enabling statute, the county ordinance, and the bond itself which called for a sufficient bond conditioned upon the construction of the

¹ 219 Va. 29, 245 S.E.2d 425 (1978).

² *Id.* at 429.

public improvements. The surety's liability was limited to the cost of completion up to the penal sum.

It is not unusual for the obligee to be a public body. Some of the bonds naming contractors as principals have co-obligees, adding a lender and/or the developer. Co-obligees often disagree over treatment: pay or complete? It is not uncommon for the obligee to not exactly know what it is supposed to do to make a claim and what to expect from the surety. When the surety investigates the project and finds that the developer/principal has failed to build even the initial infrastructure of the project and has abandoned the development, you may have what was litigated in Westchester Fire Insurance Co. v. City of Brooksville.³ There, the principal filed bankruptcy shortly after beginning construction of phase 2 of the subdivision. While it removed trees and cleared land, it neither began neither constructing improvements nor building any homes. Once the public body made a demand for performance, the surety filed a declaratory judgment action to determine the rights and obligations of the parties. The city, as obligee, neither attempted to construct the improvements nor solicit bids to establish the expected cost of construction. The city demanded payment of the face value of the bonds from the surety, promising to construct the bonded improvements as soon as it received the money from the surety. The court, however, held that because no homeowners existed for whom the city had to assure the availability of the infrastructure improvements, to impose the obligation to pay the face value of the bonds would result in a windfall for the city. Because this bond was construed by the court's review of the city ordinance as a performance bond, not as

a penalty bond (where the obligee recovers the face value of the bond regardless of damage incurred) nor an indemnity bond (where the face value of the bond establishes the obligee's maximum recovery, but the obligee may only recover for actual damages), there was found no purpose by requiring the surety to pay the face value of the bonds. The city had no obligation to complete, and it suffered no damage; the only real beneficiary was the new owner. Westchester insulates a surety from liability if its principal abandons the project, when there is no existing construction, no plan for construction, and no obligation of the public body to construct. A bright line test. There are a few other bright line tests.

A new owner/developer may not bring a bond claim. In Morro Palisades Co. v. Hartford,⁴ the court held that where a subdivider agreed within a reasonable time to improve the streets and roads in a tract of land relating to the approved subdivision map, and posted with the county a bond to ensure faithful performance of the work, the county presumably was entitled to receive the roadwork, which the subdivider agreed to perform, and was entitled on a theory of breach of contract to the sum equal to the cost of the uncompleted portion of the work. However, Palisades involved a new owner, who was not an obligee on the bond. The court dismissed the case because the new developer could not make a claim against the bond.

Private lot owners have no standing to make a claim against the bond. In Norton v. First Federal Savings,⁵ the court held that the plaintiff lot owners were not entitled to recover damages against the surety caused by delays in completion of off-site

³ 731 F.Supp.2d 1298 (M.D. Fla. 2010).

⁴ 52 Cal.2d 397, 340 P.2d 628 (S. Ct. 1959).

⁵ 128 Ariz. 176, 624 P.2d 854 (1981).

improvements due to an assignment agreement between surety and seller, in that the surety did not assume the seller's promise to plaintiffs to complete the improvements on a specific date. The court, however, stated that a subdivision bond obligation could be satisfied by the principal developer constructing the subdivision or "payment to the city of the predicted cost for construction for the city's use in completing the improvements."⁶

An approved site plan is required. The court in River Vale Planning Board v. E.R. Office Interiors, Inc.⁷ held that the installation of improvements contemplated by the bonded development agreement required, as a condition precedent, an approved site plan. The improvements were required only if the developer proceeded with the project contemplated by the site application and approval process—once the application was abandoned, there was no need for the developer to proceed, no burden was placed on the municipality, therefore the municipality, as obligee, could not enforce the bond against the surety.

Construction of the improvement was required to charge a bank's instrument of credit posted to guarantee subdivision construction. In County of Yuba v. Central Valley National Bank,⁸ a developer abandoned the project before construction. The lender issued an instrument of credit to secure the faithful performance of improvements to a subdivision, but the contractor was unable to obtain financing and no construction or development of the land was ever begun. The county then made

claims against the bank on the instrument of credit. The court held that the purpose for requiring the security for the work was to ensure performance of the subdivider's obligation to place streets in the proper condition for public use. No purpose was served by construing the security instrument to relate to construction of streets where the development of neither the subdivision nor the streets had ever commenced. The court suggested that at least partial improvement of the land and commencement of construction of the streets is required as a prerequisite to the emergence of the obligations owed by the lender to the county.⁹ The record disclosed no damage to the county, and to allow the county to recover would constitute an illegal forfeiture.¹⁰ Although the rationale of this case involved an instrument of credit, this rationale could support a defense for the surety when the subdivision bond is a performance or indemnity bond. The County of Yuba case also raises the issue over whether the same defense rationale would apply if partial performance of the underlying development agreement had been performed before abandonment and there exists the potential to complete the subdivision.

The answer should be yes if the obligee has suffered no damage, there is a new developer, and the subdivision plan is changed. In The City of Peekskill v. Continental Insurance Co.,¹¹ a municipality sued a surety to collect the proceeds on a public improvement performance bond. Here the court held that the contractor procuring the bond did not perform a sufficient amount of the contract to require completion of the public improvements covered by the bond. Changes to the site approval plan and a substitution of developers, done without the knowledge and

⁶ *Id.* at 858.

⁷ 241 N.J. Super. 391, 575 A.2d 55, 59-60 (N.J. S. App. Div. 1990).

⁸ 20 Cal.App.3d 109, 97 Cal.Rptr. 369 (Cal. App. 1971).

⁹ *Id.* at 113.

¹⁰ *Id.* at 114.

¹¹ 999 F.Supp. 584, 586 (S.D.N.Y. 1988).

consent of the surety, relieved it of liability under the bond. In addition, the municipality did not suffer any damages, it made no payments toward the improvements, and the new developer agreed to complete the improvements. The change in the site plan and the change in the developer “discharged the surety.”¹² Even in the face of some work at a project site before the bond principal’s default, the surety may not be liable—the surety may be able to obtain a discharge—because of changes in the plan for the development and the intervention of a new developer.

Prince William County, Virginia brought an action against a subdivision developer and its surety under a subdivision agreement and related performance bond in Board of County Supervisors of Prince William County v. Sie-Gray Developers.¹³ Under Virginia law, the county was allowed to contract with another developer for the performance required of the principal and assign to that developer its rights under the performance bond; the damage recovery was limited to the reasonable cost of completion not to exceed the penal sum of the bond. This court also held that if the county proved that the cost of completion exceeded the penal sum, it could recover the full amount although the work had not been performed, in view of the “presumption that public officials will lawfully perform their duties.”¹⁴ The county did not have the right to assign its rights under the original performance bond to another developer for a purpose other than completion of the contemplated construction. The presumption was rebutted here because the new developer had sold its interest in the property, the county failed to establish the value of necessary easements needed to

complete the development, and therefore, since the county failed to establish consideration which the contracting parties attributed to the cost of completion, no recovery was allowed for the remaining sections of work because “a proper purpose” was not shown. The surety’s motion to strike these sections of the claim was sustained.

There are, however, several cases where the public body prevails against the surety after the principal abandons the project when partial work has been performed, even though the obligee allowed for changes to the development. In Board of Supervisors of Stafford County v. Safeco Insurance Co. of America,¹⁵ the County Board of Supervisors brought an action against Safeco Surety on its performance bonds following its principal’s default, failing to construct roads, water lines, and sewer lines for a county subdivision. The trial court dismissed the case in favor of the surety, but the Virginia Supreme Court reversed, holding that because the surety had approved the new development plan after the principal had abandoned the project, it was not necessary for the county to prove financial loss to recover against the surety. The facts showed that the only work done on the project was limited to on-site clearing and grading of the roads. No work was ever started on the installation of water or sewer lines. There was no dispute over the principal’s abandonment. Here the county notified Safeco that it was “calling the bonds” because the infrastructure work had not been completed as required. The county then rezoned and downsized the development. The court said that the county could recover the cost of completion of improvements. Because the county had established that the cost of completion exceeded the penal sums of the bonds, it had

¹² *Id.* at 586.

¹³ 230 Va. 24, 334 S.E.2d 542 (S.Ct. Va. 1985).

¹⁴ *Id.* at 547.

¹⁵ 226 Va. 329, 310 S.E.2d 445 (S. Ct. Va. 1983).

made a *prima facie* case. It was unnecessary for the county to prove a financial loss (that the performance bond is intended to guaranty completion of the improvement it covers), and as such, the county, as obligee, need not incur any expense or do any work on the improvements before collecting on the bond. Safeco argued that it would be a waste of money for the surety to pay for or install the work. However, the court held that this was not a determination for Safeco to make. The court also held that Safeco had voluntarily entered into the bonded relationship and was bound to that obligation. Under Virginia law and this bond, the court held that upon the failure of the principal to perform and notice from the county, Safeco could either perform at its own expense or pay the cost of performance up to the penal sum of the bond. The court granted a new trial to the county. You should read the dissent because it is much better reasoned than the holding opinion.

The surety must assert material deviation as an affirmative defense and satisfy its burden of proof. In Board of Supervisors of Fairfax County v. Southern Cross Coal Corporation,¹⁶ the dispositive question was whether the public body obligee, by completing the work after the principal had defaulted, had materially altered the surety's performance bond obligations so as to release the surety. During construction, the work had been completed in deviation of the original plans. The surety argued material change to support discharge. The Virginia Supreme Court concluded that the surety failed to satisfy its burden of producing evidence that the work could have been completed for a sum less than the amounts paid by the county board. The county board chose the least expensive alternative,

resulting in successful completion of the street project. The court enforced the jury's verdict against the surety.

Allowing the subdivision to go into foreclosure is not enough of a material deviation to relieve the surety of liability. In County of Brunswick v. Lexon Insurance Company,¹⁷ the surety argued that the foreclosure of a property made it impossible for the surety to complete its bonded performance. Here the surety, even though demand was made, did not undertake its performance obligation; rather, it claimed performance was impossible. The demand was to either pay the penal sum or arrange for completion of the construction. The court did not blame the lender for the foreclosure, but blamed the principal. The court denied the surety's motion for summary judgment and granted the county's motion for summary judgment for the reduced amount of the bonds which was in excess of \$3.5 million. A costly bet to lose by a surety asserting the "do nothing" defense to a bond claim.

Can the surety claim discharge if the obligee makes an assignment? An obligee's rights may be assigned, but not if it is an abdication of its obligations. The New Jersey Appellate Court, in Clearwater Associates v. F.H. Bridge and Son Contractors,¹⁸ held that under New Jersey law, several years after abandonment by the principal, a municipality may assign its rights under a subdivision bond where the assignment is for the sole purpose of obtaining the performance guaranteed by the bond and upon showing that the improvements have been made. The court held that there is no reason why a "compensated surety" should be exonerated in circumstances where its liability to the municipal obligee is clear simply because the bargained-for improvements were completed

¹⁶ 238 Va. 91, 380 S.E.2d 636 (1989)

¹⁷ 710 F.Supp.2d 520 (E.D.N.C. 2010)

¹⁸ 144 N.J. Super. 223, 365 A.2d 200 (1976)

by someone else. However, if the rights assigned by the obligee were of the “entire claim” resulting in the abdication of the public body’s obligation to complete, the claim should be dismissed as the assignment is then unenforceable.

An obligee’s agreement to assign its collection proceeds against the surety to a new developer was permitted in City of Sacramento v. Trans Pacific Industries, Inc.¹⁹ There the California court of appeals affirmed the trial court’s judgment in favor of the city in its action against the developer and its surety for damages occasioned by the developer’s failure to construct public improvements as required by the subdivision agreement. The developer sold a portion of the subdivision on which it had failed to make the improvements, and the purchaser entered into an agreement with the city whereby it agreed to construct such improvements in exchange for the city’s promise of reimbursement from the recovery of bond proceeds in its pending lawsuit against the surety. The court of appeal affirmed the trial court’s judgment in favor of the city against the surety and held that the city’s right to damages arose when the developer failed to respond to its demand for completion of the improvements and that the obligee’s rights were not affected by its subsequent agreement with the new developer for the completion of the improvements. There was no showing of any unfulfilled condition precedent to the surety’s obligation to pay. A “palpable need” existed in favor for the public body because development had commenced and the rest was planned.

In Transduller Centre Limited Partnership v. USX Corporation,²⁰ the District Court of

Virginia, applying Virginia law, held that the county could assign its rights under the subdivision agreement and performance bond to another developer as a consideration for completing work guaranteed by the bond. The assignment was found enforceable under Virginia law. Partial completion did not bar recovery. The court did agree, however, that the surety’s liability was limited to the reduced bond amount—the bond had been reduced by the county beforehand.

In conclusion, these cases show that the subdivision bond surety stands a better chance of a discharge when the developer/principal defaults or abandons the project if: no lots have been sold—no vertical construction; the obligee has suffered no damages; no site or subdivision plan exists; or there is little or no possibility that the subdivision will be completed or the actual project has been materially altered. However, courts have found the “compensated” surety liable on a performance bond when completion of the subdivision is contemplated, even if the project was downsized, the obligee has incurred no damage, little or no work was performed before the principal’s abandonment, the development has been sold to a new developer, and the obligee under local law has assigned its rights under the bond.

¹⁹ 98 Cal.App.3d 389, 159 Cal.Rptr. 514 (1979)

²⁰ 761 F.Supp. 430 (E.D.Va. 1991)



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