

Construction Performance Guarantees

A financial performance guarantee is a monetary commitment on the part of a construction contractor to complete a development in a satisfactory manner or, when a specific activity ends, remove a potentially hazardous or undesirable situation. Financial guarantees are also frequently required after improvements have been completed for a fixed period of time – usually a minimum of a year – to ensure that the improvements were constructed in a satisfactory manner. Such guarantees are often called “bonds”, but a bond is actually one specific form of guarantee. The generic term for financial performance guarantees is “surety”.

Why Require Surety?

Sometimes projects are never fully completed. This includes required remediation and clean-up. Non-completion may occur due to financial, legal, or market issues outside of a developer’s control. There also may be problems with improvements not being installed correctly or landscaping or site stabilization measures not surviving. Or the contractor may go out of business. Construction is a risk-filled enterprise, and even capable and well-established contractors can fail. According to BizMiner, a business research organization, over 20 percent of the general contractors, heavy construction contractors, and special trade contractors operating in 2007 were out of business in 2009. Despite an underwriter’s rigorous prequalification process and a municipality’s best judgment about the abilities of a contractor, sometimes contractor default is unavoidable.

It is important, therefore, that a municipality not be left with a financial liability to either



Surety helps protect public investments and minimize taxpayer liabilities.

correct a problem or complete the installation of roads, sewers, drainage facilities, or other public infrastructure.

Unfortunately, municipalities occasionally have the mistaken notion that surety requirements are not “developer friendly”. As a result, far too many roads and related improvements deteriorate prematurely because they were installed improperly. This aggravates property owners and drives up maintenance and repair costs for taxpayers. Reputable contractors – whether incorporated as a business or not – understand that surety protects their liability and reputations. They will perform adequately and get their surety money back in a reasonable amount of time.

The actual use of surety by a municipality is almost always a tool of last resort after repeated attempts have failed to get the responsible developer or owner to complete activities or correct problems. Often, when threatened with the use of the posted surety, a developer will complete the required improvements since default would certainly make it difficult for the developer to obtain surety for other jobs in the future.

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When is Surety Used?

Typically, financial performance guarantees are used in the following circumstances:

For land disturbance activities, including site clearing, grading, and erosion control related to a development project. Surety is often required to ensure that a site is properly stabilized (i.e., graded and seeded). If a site has been cleared and the land disturbed – and then abandoned or erosion and sediment control measures not installed or maintained – the impacts on down-slope properties can be severe, as can the impacts on drainage systems, sensitive environmental areas, water bodies, and public roads. In populated areas, and for resource extraction activities (i.e., timber, surface mining, hydrofracking), where the site may pose a public safety risk, items such as fencing will often be included in the surety requirement.

Public improvements within subdivisions. Often, subdivision development occurs in phases. Not all public improvements are installed before construction (and even occupancy) of houses or offices begins. By allowing building construction, much less occupancy, before all public improvements are complete, the municipality risks having to step in and complete the improvements should the developer fail to do so. Adequate surety protects the municipality and new building owner from such risk.

Maintenance (work quality) guarantees. Surety is frequently required to ensure that work was done in an adequate manner. It generally takes a full year to determine that

facilities (roads in particular) were installed properly. Having adequate surety to ensure that work can be corrected or redone, if necessary, is important – particularly if the facility is built on private land and will be dedicated to the municipality and become the responsibility of taxpayers.

Improvements within an existing public right-of-way or easement (i.e., installation of driveways, utility connections, or drainage improvements). An individual site development project, such as building a home or commercial structure, typically requires installation of a driveway from a public road, as well as hook-ups to public utilities in the right-of-way or within an easement and possibly drainage improvements. On large construction projects, trucks may damage public roads or bridges. A municipality may want financial surety to ensure that the public facility is not damaged and is completely restored after the work is completed.

Removal Guarantees. With the proliferation of telecommunications towers and commercial wind turbines (and, perhaps in the future, natural gas extraction operations), the requirement for surety to ensure the removal of such facilities if they are not used as intended, for whatever reason, has become a normal permit condition in many municipalities. These types of facilities, while serving a legitimate public purpose, have an ongoing impact on the community. Therefore, resources should be available to ensure that they can be removed, at the owner's expense, if they are abandoned or decommissioned for a specified period of time.

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Legal Status of Surety Requirements under NYS Law

Section 277 (9) of New York State Town Law gives towns, as part of their zoning powers, the authority to require a security from the property owner sufficient to cover the cost of the installation of infrastructure or improvements. Cities and villages are granted the same authority under the respective provisions of state City and Village law. Authorized forms of security include performance bonds; funds deposited in a certificate of deposit; an irrevocable letter of credit; obligations of the United States of America; or any obligations fully guaranteed as to interest and principal by the United States.

A Closer Look at the Authorized Forms of Surety

Bond. A bond is an insurance instrument and collectable from an insurance company. In general, these are not preferred by municipalities because collecting a bond can require suing the bond company.

Cash/Certified Check/Certificates of Deposit. A developer can provide cash surety to the municipality. When the improvements are completed in an acceptable manner, the cash is refunded to the developer. Cash is the easiest form of surety for a local government, but usually is neither desirable nor practical from the developer's standpoint for costly improvements. Cash is more useful if the surety amount is fairly small and the time it will be encumbered is relatively short.

Letter of Credit.

A letter of credit is a line of credit at a financial institution which the municipality can draw down upon demand.

Letters of credit are relatively easy and inexpensive for a developer to obtain. From a municipal standpoint, a letter of credit from a sound financial institution is a very useful form of surety.



Public Administration of Surety

There are several important steps in requiring and administering financial surety:

Requiring surety. Municipal laws (site plan review, erosion and sediment control, environmental protection, earth removal and grading, zoning, driveway installation, work in rights-of-way, etc.) should explicitly allow for surety requirements. For example, the Town of Canandaigua zoning ordinance states: "A Letter of Credit furnished for the installation of the required improvements shall be in the amount as determined by the design professional and reviewed by the Town Engineer as to form, sufficiency and manner of execution. The Letter of Credit shall be issued in favor of the Town of Canandaigua and shall assure the complete installation of the required improvements within such period, not longer than three years. The Letter of Credit shall be issued to the Town for an initial minimum period of one year."

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According to state law, the municipality must stipulate:

- When surety is required.
- Forms of surety acceptable to the municipality.
- The manner in which the covered improvements and the amount of surety will be monitored.
- Procedures for releasing the surety in whole or in part upon successful completion of required work.
- Procedures for determining what events would allow the municipality to take and use the surety.

Determining appropriate amounts. Detailed construction plans with cost estimates – sealed by a professional engineer or certified land surveyor – should be submitted. For landscaping components, an estimate or actual bid from a landscaping firm is often used. The estimates or bids should be reviewed for reasonableness by the municipality's staff or engineering consultant. The total surety amount should cover "worst case" scenarios. The amount of the surety will usually be higher than the developer's cost to allow for inflation, municipal administrative overhead, and contingencies.

Accepting the form of surety. The surety being offered should be reviewed by the municipal attorney or designated local official for form and compliance with state and local rules and regulations.

Administering and Monitoring Sureties. Internal processes should be established to file, protect, and track sureties that have been provided. The appropriate municipal officials may vary between communities but typically

the local treasurer, finance officer, building coordinator, and Planning Board may all be involved. At a minimum, the following controls are needed:

- Cash surety needs to be deposited in an escrow account and tracked.
- The originals of letters of credit, pass books, negotiable securities, and bonds must be stored in a place that is safe from theft, fire, flood, or other loss.
- A procedure for inspecting and documenting that work has been completed satisfactorily must be established.
- A procedure should be established for substituting a maintenance surety for the construction surety for an appropriate length of time after work has been completed – but allowing enough time to ensure that obvious defects in the work would appear.
- All surety should be constantly monitored for when it expires.
- For semi-permanent surety requirements, such as for removal of cell towers or wind turbines, an ongoing review and renewal of the surety is needed.
- Under state law, the proceeds of any surety are available to the municipality to meet its cost and expenses in completing the work as specified in the approved plan.

Resource

Contract Surety Bonds: Protecting Taxpayer Dollars. Surety & Fidelity Association of America and National Association of Surety Bond Producers, 2009.
www.sio.org/pdf/ContractSuretyBonds.pdf

- *Genesee Transportation Council - September 2010*
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