Residential Developer Default From A City's Perspective

Prepared by:
Jacob W. Reby
Lewis, Rice & Fingersh, L.C.
600 Washington Avenue, Suite 2500
St. Louis, MO 63101

Residential developer default has become commonplace and presents challenges not only to Lenders, but also to the Cities that house these partially completed "Zombie" subdivisions and condo developments. Understanding the City's perspective on residential developer default will better enable foreclosing lenders and prospective homebuilders to better deal with these difficult situations

A recent Missouri lawsuit titled City of O'Fallon, Mo. v. FDIC provides a great factual situation for this discussion. Premier Bank held escrow accounts for the benefit of the City of O'Fallon for several developers building subdivisions within the City.[1] These developers ultimately defaulted on their bank loans, leaving partially completed subdivisions which contained little or no infrastructure.[2] When the dust finally settled, the City was left with angry residents and an incomplete infrastructure. The City eventually spent more than $1 million to repair, replace and complete infrastructure improvements.[3] After attempts to collect from Premier Bank's escrow accounts, the City was still owed nearly a half million dollars.[4] Complicating this situation, the FDIC closed Premier Bank's doors in October of 2010.[5] The City of O'Fallon, Missouri has now filed a lawsuit against the FDIC to collect nearly a half million dollars from a failed Bank that was holding the City's escrow funds.[6]

The O'Fallon situation represents a City's worst case scenario. The more typical situation, while usually not as costly to the City, can nonetheless be extremely complicated and confusing. In Missouri, for example, Cities get involved with residential developers because Missouri state law requires Cities to get security for the construction of public improvements necessary for the basic enjoyment of property, such as water, sewers, roads, and utilities.[7] When the City approves a developer's subdivision plan, the developer needs to provide security in the form of a letter of credit, cash, or a bond. The security represents the City's estimate of the total amount of money necessary to complete all of the public improvements. Most Cities err on the high side to be safe. Usually, the City would like to see all of the public improvements completed first in the development process. In fact, in the St. Louis area most Cities will not approve completion, accept public dedication of the improvements, or return the security until the entire subdivision development is completed.

In the event of a homebuilder's default, the construction Lender will step into the shoes of the homebuilder and will likely look for a new developer to buy the Lender's position. Neither the City nor the Lender wants to be personally responsible for continuing the development of the subdivision. The typical situation is as follows: the City has substantial amount of money from the developer or the developer's Lender in

[1] Complaint at 2, *City of O'Fallon, Mo. v. FDIC*, (W.D. Mo. filed May 20, 2011) (No. 2:11-cv-04138-NKL)
[2] *Id*.
[3] *Id*. at 3
[4] *Id*.
[5] *Id*. at 2
[6] *Id*. at 3
[7] Mo. Ann. Stat. § 64.060 (West 2011)

escrow for public improvements, which need to be completed. The Lender, which just wants its money back, owns or is about to own a piece of property that neither the Lender nor the City wants to deal with. This brings up a variety of conflicts and issues.

From a City Attorney's viewpoint, the City has money that the Lender wants, and the only way for the Lender to get that money is for the Lender or a new developer to complete the subdivision. This gives the City leverage and presents interesting problems for the Lender. First and foremost, if the Lender decides to take on the task of developing the subdivision, the City will likely require the Lender to post security from a different bank in addition to the security already provided (so the Lender/owner is not guarantying its own obligation to complete improvements). While it is possible for a City to allow a Lender to post its own security, it is unlikely. If this does happen, the Lender will likely form a separate L.L.C. to handle the development. In most instances, however, the Lender, as well as the City, does not want to be in the position of being the general contractor. Because the Lender has no expertise in subdivision development, it is likely that the Lender must find a substitute developer to take the defaulting developer's place, which can be a time consuming process. The City's Public Works Department will be paying close attention to the security; if it is a letter of credit, the letter of credit's expiration date. If there is a risk of expiration, the City will likely draw on the letter of credit or make sure it is renewed to allow the Lender additional time to find a substitute developer. If drawn, the City can use that money however it needs in order to complete necessary public type improvements. What if some of the remaining infrastructure work is to be done on property outside of the subject development or outside the city limits?

If the City has a performance bond, it will have to try to demand performance from the bonding company or otherwise draw on the bond. This is often difficult and time consuming. Many Cities do not have the staff or expertise to pursue a bond claim. If the Lender obtains a substitute developer, the City still does not have to turn over the security. The City may hold onto the security until it obtains verification that the public improvement work is completed to the City's satisfaction. Even upon completion, if there is a dispute as to whom the money should be paid, the City may still keep the money until the dispute is resolved.

In addition to these difficulties, there are other challenges for the City. One situation that can cause problems is where a substitute developer, due to market demands, decides to reduce the size of the undeveloped homes. The homeowners of the completed houses (who are now voters) will revolt because the drop in home sizes for the neighboring homes means a drop in value for their existing homes. However, if the completed subdivision meets the City's Subdivision Code, the City must approve the new developer's request for building permits. The square footage of the proposed house is usually not a relevant factor in the approval process. As a solution, a City could suggest that the new developer of a partially completed subdivision make the fronts of the proposed houses look the same as existing houses while reducing the depth of the houses, so that they appear from the street as though all the houses are the same size. Some Cities have binding or non-binding architectural review boards which address

consistency among the homes, ensuring there are not mansions next to smaller houses or vice-versa. However, these review boards tend to have very little or no standards.

Another potentially problematic situation arises when the City is called upon by the homeowners to enforce the subdivision indenture. The City will likely claim that the subdivision indenture represents a private contractual relationship, that it is not a party to the indenture, and therefore has no right to enforce the indenture. The homeowners may have other options available to enforce the indenture, but the City will not want to get involved. If at the beginning of the development process the City reviews a subdivision indenture at all, it is typically just to make sure that the trustees are responsible for maintenance and that they have the right to make assessments to pay for the maintenance.

The most common problem arises when the partially completed subdivision becomes overgrown with grass or weeds. The City's only way to remedy this condition is through a claim of public nuisance. The City may attempt to force the Lender to cut the weeds, but in many cases the Lender will not do landscape maintenance. The City will typically cut the weeds or cure the nuisance and place a lien on the property. In larger areas, the City can hire a property management company to maintain the area while the City continues to put liens on the property.

Although homebuilder default may appear to be a no win situation for a Lender, there are some practice tips for smoother sailing with the City. Communication is essential to a smooth resolution. The Lender and the City need to be on the same page. The more each side does to understand what the other side is doing, the better off both sides are. Both sides ultimately want to find a substitute developer, who will complete the subdivision and make the development a success. In order to accomplish this, both Lender and City must have open lines of communication to reach the common goal.

Cooperation is equally important. The Lender should try to avoid a position where it is fighting City Hall. This situation almost never ends well for the Lender. Politically speaking, it looks like the City is essentially fighting to make sure its citizens are taken care of, while the Big Bad Bank is fighting to get its money back. In a lawsuit a Judge will likely perceive the situation this way as well. The City has control over the escrow money and will hold onto it until the work is completed to the City's satisfaction. Therefore, the Lender must cooperate to avoid acting as a homebuilder, to get some of its money back and to escape this financial mess in a timely manner.

In summary, the Lender and its attorneys should remember that communication and cooperation with the City is essential to reaching a satisfactory conclusion for all parties in this difficult situation.