



CITY OF DURHAM | NORTH CAROLINA

Date: April 8, 2011

To: Thomas J. Bonfield, City Manager

Through: Theodore L. Voorhees, Deputy City Manager

From: Ed Venable, Manager of Engineering and Stormwater
Robert Joyner, Assistant Manager

Subject: Agenda Item – Report on Failed and Struggling Developments

Executive Summary

Following the 2008 downturn in the economy, some developers have failed or are struggling to complete the street, sidewalk and stormwater infrastructure in their developments. A “Failed Development” is one where there is no responsible entity remaining to complete required utility, right of way and/or stormwater infrastructure improvements and Public Works has begun the process to determine how best to facilitate the completion of the work. A “Struggling Development” still has a responsible entity with whom Public Works is negotiating to either complete the work or to secure available financial assurances to allow others to complete the work, including, potentially the City. Public Works is tracking these Failed and Struggling Developments and working with the remaining banking, insurance, and developer entities to move these projects forward.

Recommendation

The Department of Public Works recommends that the City Council receive the report about Failed and Struggling Developments; proceed with completion of the work for the Failed and Struggling Developments in accordance with the process recommended in the report, and, when necessary, bring individual Failed Developments requiring a special assessment back to the City Council for approval at the appropriate time.

Background

The Public Works Department oversees the inspections of public infrastructure improvements that new developments are required to construct. These public infrastructure improvements include the water lines, sewer lines, streets, sidewalks and stormwater facilities. Ideally all public infrastructure improvements are constructed prior to issuance of a Certificate of Occupancy for a home. Typically the water and sewer lines are completed early in a project’s life. Last to be completed are the stormwater devices, the final layer of asphalt, and sidewalks. Often a developer expects to sell lots to generate funds to be able to complete the public infrastructure. The City of Durham’s processes have accommodated this expectation by allowing various improvements to be

“phased” or otherwise completed toward the end of a project, but prior to the issuance of the last Certificate of Occupancy. It has also been the City’s practice to require the final layer of asphalt to be placed after most construction is completed so as to avoid subjecting the asphalt to damage from construction vehicles and equipment. This results in smoother riding roads. Public Works requires that public infrastructure that is not completed be financially backed by some form of construction security. The construction security is a financial instrument, such as a performance bond, letter of credit or certificate of deposit, held until the work is complete and then released. This is the typical Public Works process that has been employed to allow Certificates of Occupancy to be issued early in a project to help the project establish a cash flow.

Construction securities take several forms that are unique in their properties and in the way in which they are used. The type of construction security issued may impact how a development progresses through the process to complete a project, should it have to be called on by the City. Until this economic downturn, Public Works rarely had to call on a construction security. The types of construction security forms are commonly known as:

- Performance Bond – A written guarantee made by a third party (an insurance or bonding company) promising performance of certain work described in the bond up to a set dollar amount. These are typically used for large monetary amounts and may sometimes be limited to a term and may include a renewal provision.
- Letter of Credit – An irrevocable commercial letter of credit issued by a financial institution that names the City as a beneficiary in the event the project fails to construct improvements named. These are typically used for smaller monetary amounts.
- City of Durham Security Deposit – A cash deposit made by the developer and held by the City to secure the completion of the project. The deposit is returned to the developer upon satisfactory completion of public infrastructures within the development. These are typically used for smaller monetary amounts.
- Certificate of Deposit – A secured account held by a financial institution that pays interest on the secured account to the developer and that names the City as a beneficiary in the event the project fails to construct improvements named. These are typically used for smaller monetary amounts.

Since late 2008, the economy has drastically changed the manner in which the construction and housing industries operate. These changes have resulted in a country-wide decline in new home sales and overall commercial developments. In addition to this, banking and financial markets, which provided financial assistance to developers, builders, and owners, have undergone changes that have resulted in an environment that is inherently unstable.

This instability has created situations in which some developers are no longer able to sustain developments and are forced to close their businesses or restructure their

companies. To our knowledge, the City has never been confronted with a situation like this one in which multiple developers have defaulted and failed to complete projects.

Over the past two years the Development Review Group of the Department of Public Works has been dealing with bankrupt and restructured developments to make sure that public infrastructure and other required improvements are completed. The group has been instrumental in negotiations with financial institutions, insurance companies, restructured developments, and purchased bankrupt developments with the goal of ensuring the completion of public infrastructure improvements through either completion of the construction or payment of the available construction security.

Issues/Analysis

The City is currently dealing with a number of developments that the Department has placed into four categories of financial distress. It is important to note that each identified development has its unique circumstances and the tools that may be available to help guide one development to completion may not be available to the same degree in another development. Depending on a developer's solvency, a project may move from one category to another. For the sake of this report, the total number of developments in a given category is current as of the creation of this document. Detail on each of the developments is found in Attachment A. The categories are as follows:

- Category 1- Restructured Developments (15 total): Developer has restructured or a new developer has purchased the project. These projects have been completed or a new viable developer with appropriate construction securities in place is performing the work toward completion of the development.
- Category 2 – Monitored Developments (12 total): The Developer is still active in the project but progress is slow. Engineering Inspections and Development Review Group monitor the development's progress and work with the Developer to complete the project's infrastructure. Certificates of Occupancy may be held until the Developer has completed some of the improvements.
- Category 3 – Struggling Developments (17 total): Engineering Inspections and Development Review Group have called on the applicable construction security because the Developer has filed for bankruptcy or is unresponsive. The City provides the financial institution or insurance/bonding company a list of items that need to be installed or repaired for completion of the project and final acceptance. The financial institution or insurance/bonding company has the opportunity to seek cost estimates from contractors and determine if they will build the improvements or forfeit the security to the City. This tends to be a long process if the security is a performance bond. In the case of letters of credit, the principal sum is typically forwarded to the City within a matter of days of the City's demand. If the security is released to the City, then the Public Works Department intends to contract for project completion within the city's authority and with appropriate authorization from the City Council.

- Category 4 – Failed Developments (8 total): The City has collected the construction security for the project. Currently the City is finalizing punch lists and estimating costs to complete projects in this category. This report recommends options and alternatives on next steps to be taken for these Failed Developments. Cost estimates for the work is provided in Attachment B.

Of chief concern are developments in Category 4. These developments often lack sufficient construction security funding to complete the work required for acceptance. Construction security amounts were established with prices current at the time of construction, but as developments languished the base price of labor and materials has increased in some cases. Many developments have degraded over time due to the developer's neglect, and in some cases the degradation has been substantial. The cost to repair unanticipated degradation increases the cost to complete such developments considerably. Construction security amounts were initially established as reasonable security measures to ensure compliance, not as a total project completion funding source. Public Works had rarely collected a construction security until this recent economic downturn. Accordingly, in most cases the construction security is insufficient and consideration of other ways to inject funds into the project is required.

Alternatives

Given the insufficient funds to complete the current Category 4 developments, the Public Works Department is submitting for consideration the following alternatives to complete the work. Public Works Department recommends alternative 3.

Alternative 1

The property owners are responsible for the infrastructure improvements and would be left responsible for completing these improvements as would a developer with no financial assistance from the City of Durham. This is not recommended because it is impractical and would lead to further degradation of the development, its homes, and its infrastructure.

Alternative 2

Public Works obtains construction security funds and completes the work to the maximum extent possible with the available resources from the project construction securities. The improvements will be completed in priority order:

- 1 Street
- 2 Stormwater Devices
- 3 Sidewalks
- 4 Other

Any uncompleted work would remain uncompleted once funds are depleted by Public Works. The property owners would be left responsible for the completing the remaining work and improvements as would a developer with no further assistance from the City of Durham. While better than Alternative 1, this is not recommended because it is still impractical to leave developments incomplete and would lead to further degradation of the development, its homes, and its infrastructure.

Alternative 3

Public Works proceeds with securing the available construction security funds for the development. The work to be completed will be investigated and a list of quantities prepared. Based on the quantities, an estimate for completion of all remaining work will be prepared. An evaluation will then be made to determine what work is critical and what can be considered non-critical. A meeting with the affected property owners (including homeowners) would be conducted to review the situation and the difference in cost between the available security funds and the total project would be discussed. Through the use of the assessment process available under the City Charter or the North Carolina General Statutes, the City of Durham would assess the property owners for the cost of the constructed critical work less any available construction security collected by the City. Subject to the identification of a funding source, a contribution of some City funds (perhaps up to 10%) could be provided as a contribution to the success of the project. Either a petition or the use of the Charter Enabling Act Authority would be used thus resulting in each project coming back to the City Council for approval. This is the recommended approach.

Alternative 4

Public Works will proceed with securing the construction security funds from the sureties. The work to be completed will be investigated and a list of quantities prepared. Based on the quantities an estimate for completion of all remaining work to be completed will be prepared. The City will provide supplemental funding to complete all the work. Due to funding limitations and the lack of financial participation by the affected property owners, this is not the recommended alternative.

In the case of Alternatives 2 through 4, it is assumed that the City has, or can obtain, the necessary authority and/or easements to enter private property in the case of stormwater facilities and/or sewer and water utilities. In each of the above alternatives, the City may be willing to forgo some improvements, such as sidewalks for example. This non-critical work could then be completed at a later date, possibly through a petition process. Once Public Works completes the initial critical work, an evaluation is performed to quantify the remaining infrastructure deficiencies. The scope of the remaining work is then defined into categories to identify what should be done, and what is a “nice to have” element that can be temporarily deferred or permanently forgiven. An example of a forgiven construction element may be a sidewalk, which would then become a part of the Durham Walks Pedestrian Plan for future construction. Public Works could then estimate the cost of the work that has been selected for completion. A meeting can then be arranged with the property owners to share this information. The City can assess for completion of the work within the project, and could decide to contribute funds to the project, contribute design and management of the project, or contribute nothing to the project. As an example, the City may agree to contribute up to 10% of the cost of the improvements and agree to manage the process. With each project, as Public Works moves through the process, a report can be brought to City Council at the point where Public Works is ready to meet with the property owners concerning the work and discuss

the required assessment to cover the additional costs beyond the available construction securities.

A monthly status update review meeting will be conducted by Public Works jointly with the City Manager's Office and the City Attorney's Office until all outstanding projects are resolved.

Financial Impact

Public Works has invested a tremendous amount of staff time into tracking, monitoring, and negotiating the construction securities of the four categories of developments. The staff time invested is an indirect financial impact, and is estimated to increase or decrease in proportion to number of developments being classified in one of the four aforementioned categories.

In addition, there may be direct financial costs depending on the direction City Council gives the Public Works Department regarding how to proceed. Among the suggestions for bringing the developments into compliance is an option that the City provides a portion of, or all, the remaining funds required to complete any unfunded work. This approach has the potential to add a financial burden to the City. The list of financially distressed projects is expected to grow somewhat over time. At this time only the category 4 projects have a direct fiscal impact, and those costs are listed in Attachment B.

Of the Category 4 projects the total cost of the work is estimated at \$723,713. The amount of construction security funds available is \$268,000. The difference between the two is a funding gap of \$455,713. The recommendation for the City to contribute up to 10% of the cost to close the funding gap between the available construction security funds and the estimated cost of improvements for current Category 4 developments would create a financial exposure of less than \$50,000.

SDBE Summary

The SDBE Summary is not applicable for this item.