

## **THE USE OF IMPROVEMENT DISTRICTS IN THE DEVELOPMENT OF SUBDIVISION PROJECTS**

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1. Introduction. Improvement districts represent a means by which land developers obtain infrastructure development financing with terms that are substantially better than those offered commercial banks.
2. What is an improvement district? An improvement district is a form of political governmental entity. As opposed to being controlled by elected city or county officials, the developer has the sole and exclusive control over all aspects of the improvement district's activities. The developer-appointed board of commissions reports to no other governmental entity. Three property owners within the district are appointed to the board. The district is formed by collecting the signatures of all property owners on a formation petition. Given the fact that the developer owns all of the property in most cases, only the developer's signature is required.
3. How does the developer benefit from improvement district financing? The developer realizes a number of substantial benefits.
  - a. First, the bonds sold by the district (also known as the infrastructure development loan) bear an interest rate that is less than that charged by commercial banks, has a fully 30 year amortization period, has a fixed interest rate, and is not subject to balloon maturities.
  - b. Second, no interest or principal payments are required during the first two years after closing. In a properly structured transaction, the developer never is required to make a debt service payment because the developer will have sold all lots to third parties.
  - c. Third, the developer is not required to repay the bond debt. The debt is paid by means of an annual pro-rated special real estate tax that is tied to the ownership of each lot. As lots are sold to third parties, then the special tax payment obligation is passed to and assumed by the lot purchaser without financial recourse back to the developer.
  - d. Fourth, because the developer is not obligated to repay specified infrastructure costs, these passed-on costs represent profit to the developer that is not otherwise realized if the developer directly pays these costs. In other words, the dollar amount of the bonds equates to additional profit to the developer that otherwise is not realized in a routine commercial bank financing.
  - e. Fifth, the developer can receive a development fee that is payable from bond proceeds in an amount equal to approximately 5% of the bond's total

principal sum. This allows the developer to accelerate its profits from the project.

- f. Sixth, in a commercial bank financing, the bank requires a release fee from each lot that equals, say, 85% of the lot sales proceeds. The developer's profits are deferred until the end of the project. With improvement district financing, this deferral is not realized and the developer begins realizing full profit upon its first lot sale.

4. Historic Problems with Improvement Districts. During the early '80s districts experienced a number of financial defaults. These defaults were the result of the over-construction of lot inventory by the developer, the inclusion of an annual special tax that was excessive and not acceptable to the marketplace, the failure of developers to expeditiously construct and complete its infrastructure, the failure of developers to properly market lots to builders. These failures have given us new insights into the proper way to structure district bond issues.

- a. First, only build two year's worth of inventory.
- b. Second, don't overburden your lots with excessive annual taxes. Know your market and determine the maximum annual tax required in order for the tax to not negatively impact sales.
- c. Third, endeavor to obtain builder lot purchase contracts either before bond closing or immediately thereafter.

5. Case Study—Sewer. Some developers opt to finance their sewer system infrastructure costs through the issuance of improvement district bonds. We suggest that the developer structure its transaction as follows:

- a. Sewer Cost Assumption. For the purpose of this case study, we assume that per-lot sewer cost is \$5,000 per lot.
- b. Tap Fee. As with many cities, the improvement district may desire to charge each lot purchaser (not the developer) a "tap fee" or "impact fee" equal to \$1,500. This sum is used to immediately pay-down each lot's \$5,000 principal allocation. This is only an option, and is not required, in which case the Annual Recurring Special Tax (see below) would be increased.
- c. Monthly Service Fee. Each lot, thereafter pays to the district a monthly recurring fee of, say \$50. This sum pays operational and maintenance expenses.
- d. Annual Recurring Special Tax. Each lot is additionally assessed annually a special tax in an amount sufficient to amortize the remaining \$3,500 over a thirty year period of time at tax exempt rates. This tax is included in each property owners PITI monthly payment. It is important that this tax be kept to a level so as to not negatively impact marketing.
- e. Developer Benefit. The developer realizes as additional profit the sum of \$5,000 (the sewer cost) multiplied by the number of lots originally developed. Assuming a 200 lot subdivision, the developer realizes an

extra \$1,000,000 in profit by doing nothing other than using an improvement district as a finance source and selling lots with a nominal per-month sewer usage fee.

For additional information, contact Heartsill Ragon III at the phone number or email address referenced above.