Enforcement of Economic Development Agreements

Examining the Relative Effectiveness of Alternate Enforcement Methodologies

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The Problem Statement

If a city gives tax abatement to a company to incentivize its development, and the company fails to meet its development goals, the economic development agreement usually requires recapture of those abated taxes.

Unfortunately, if the company has gone belly up, there's nothing to recapture. And if the company hasn't (yet) gone belly-up, then city council will be faced with the unenviable task of enforcing the agreement and potentially driving the company (the rest of the way) out of business.

In this situation, the company is likely to argue that they have provided some or all of the promised economic impact, and thus should be entitled to retain the benefit of some or all of the incentives originally provided. Some statutes providing for economic development incentive programs require such recapture provisions to be included in the economic development agreement. Others do not.

The purpose of this paper is to advocate for flexible incentive programs to attract economic development to local jurisdictions without unnecessarily punitive recapture of benefits.

Economic development incentives requiring traditional recapture:

1. *Local Property Tax Abatement.*

Chapter 312 of the Tax Code, known as the Property Redevelopment and Tax Abatement Act, provides the best known and most frequently requested tax tool for economic development agreements. Under the Act, taxing units may abate a portion of the ad valorem taxes due on both personal and real property, for a period not to exceed 10 years, on the condition that the owner of the property make specific improvements or repairs to the property.[1] Such abatements are subject to self-imposed[2] and state limitations.[3]

a. *Mandatory Recapture required for failure to provide improvements.*

Tax abatement agreements for both Cities and Counties must state the specific improvements or repairs to be made to the property,[4] and must contain a recapture provision providing for "recapturing property tax revenue lost as a result of the agreement if the owner of

[1] Tex. Tax Code Ann. § 312.204.

[2] Tex. Tax Code Ann. § 312.002(a). ("A taxing unit may not enter into a tax abatement agreement under this chapter … unless the governing body has established guidelines and criteria governing tax abatement agreements by the taxing unit.")

[3] Tex. Tax Code Ann. § 312.204 (governing municipal tax abatement agreements); Tex. Tax Code Ann. § 312.402 (governing county tax abatement agreements); Tex. Tax Code Ann. § 312.206 (governing tax abatement agreements by other taxing units after execution of a municipal tax abatement agreement).

[4] Tex. Tax Code Ann. § 312.205(a)(1).

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the property fails to make the improvements or repairs as provided by the agreement."[5]

b. Permissive recapture.

The act additionally provides that a taxing unit may include in a tax abatement agreement a provision providing for the recapture of all or a portion of property tax revenue lost as a result of the agreement and payment of a penalty or interest, or both, on that recaptured property tax revenue if:

> i. the owner of the property fails to create all or a portion of the number of new jobs provided by the agreement,
>
> ii. the appraised value of the property subject to the agreement does not attain a value specified in the agreement, or
>
> iii. the owner fails to meet any other performance criteria provided by the agreement.[6]

2. Sales Tax Development Corporations.

The Development Corporation Act,[7] adopted in 2007 as the codification of the prior Development Corporation Act of 1979,[8] sets forth the provisions for Type A and Type B corporations (previously known as 4A and 4B corporations). The codified act defines certain categories of "projects"[9] that may be undertaken by development corporations, and the "costs"[10] of the Projects. Under the codified act, Type A and Type B corporations are permitted to pay the "costs" of "projects." [11]

a. Direct Expenditures Permitted.

Neither a Type A nor a Type B corporation is authorized to make "gifts or donations" of tax proceeds,[12] but in some cases, Type A and Type B Corporations are permitted to make direct

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[5] Tex. Tax Code Ann. § 312.205(a)(4).
[6] Tex. Tax Code Ann. § 312.205(b)(6).
[7] Tex. Loc. Gov't Code Ann. §§ 501.001 et seq.
[8] Tex. Rev. Civ. Stat. Ann. art. 5190.6 (Vernon 1987 & Supp. 2001).
[9] Tex. Loc. Gov't Code Ann. §§ 501.101-.107; Tex. Loc. Gov't Code Ann. §§ 505.151-.159.
[10] Tex. Loc. Gov't Code Ann. § 501.152.
[11] Tex. Loc. Gov't Code Ann. §§ 504.301-.305, 505.032
[12] *Compare* Tex. Att'y Gen. Op. No. JC-118 at 8 ("neither section 4B nor any other provision of the Act authorizes a development corporation to make a gift or donation of section 4B tax proceeds.") *with* Tex. Att'y Gen. Op. JC-0109 ("Although article 5190.6 prohibits a city from granting a development corporation public money or free services, the Act does not preclude a city from providing funds or services to a development corporation in exchange for consideration from the development corporation, within certain limitations.")

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expenditures to or on behalf of a business enterprise to pay the costs of a project.[13] In many economic development incentive negotiations, the payment of these direct incentives is a central element in convincing the business enterprise to locate or expand in the city. It could be argued that direct-expenditure incentives are the most tangible, immediate impact for negotiating the incentives.

b. Performance Agreement Required.

When providing direct expenditures, however, the corporation must enter into a performance agreement with the business enterprise.[14] The performance agreement must specify, among other things, "the terms under which repayment must be made if the business enterprise does not meet the performance requirements specified in the agreement."[15] Attorney General opinions interpreting the predecessor to the current statute have additionally required that expenditures be "pursuant to a contractual or other arrangement sufficient to ensure that the funds are used for the purposes authorized."[16]

c. Repayment Schedule Provides Flexibility.

A close reading of this section, and the dearth of interpretive materials, suggests that the "terms" of repayment are subject to flexible drafting.[17] It remains to be seen whether courts would uphold contractual provisions providing for structured repayments based upon depreciation schedules or offset by the indirect consideration calculated through economic impact analysis.

d. Remember the Voters!

Both Type A and Type B corporations require that the sales tax be imposed through the ballot box.[18] As in all cases where voters approve a tax or project, the proceeds of the tax or bond are "'earmarked' with the character of a trust fund which may not be diverted to another purpose or project."[19] The position statements, resolutions, and ballot language may require the addition of further enforcement mechanisms into any Type A or Type B economic development agreement.

[13] *See e.g.* Tex. Loc. Gov't Code Ann. § 501.101 ("In this subtitle, 'project' includes … expenditures … required or suitable for the development, retention or expansion of … manufacturing and industrial facilities.").

[14] Tex. Loc. Gov't Code Ann. § 501.158

[15] Tex. Loc. Gov't Code Ann. § 501.158

[16] Tex. Att'y Gen. Op. No. JC-118 at 9 ("Expenditures for even project costs must be pursuant to a contractual or other arrangement sufficient to ensure that the funds are used for the purposes authorized.")

[17] *Contrast* Tex. Loc. Gov't Code Ann. § 501.158 ("…specify the terms under which repayment must be made …") *with* Tex. Tax Code Ann. § 312.205(a)(4) ("…provide for recapturing property tax revenue lost as a result of the agreement…").

[18] Tex. Loc. Gov't Code Ann. §§ 504.251, 505.251

[19] *Gallagher Headquarters Ranch Dev., Ltd. v. City of San Antonio*, 269 S.W.3d 628, 634 (Tex. App. 2008), *citing* Op. Tex. Att'y Gen. No. GA–0156, 2004 WL 367365, at *6 (2004) (*citing Black v. Strength*, 112 Tex. 188, 246 S.W. 79 (1922), *and Fletcher v. Ely*, 53 S.W.2d 817, 818 (Tex.Civ.App.-Amarillo 1932, writ ref'd))

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A Tale of Two City Incentive Programs.

1. The Starlight Reimbursement Agreement

In 2007, Starlight Inc.[20] approached the city for economic development incentives related to the rehabilitation of a vacant grocery store. Starlight would invest five million dollars to renovate the derelict building as high-tech office space, and open an inbound call center employing 383 full time employees. In exchange for this investment, the company received two incentives, a tax abatement from the city, which phased-in ad valorem taxes over a six-year period, and a $300,000 reimbursement of equipment costs from the city's Type B Corporation. The tax abatement agreement required the company to invest a minimum of $4M and employ at least 10 full time employees, as required by the city's guidelines and criteria. The Type B corporation's reimbursement was tied to employment figures. The relevant provision read:

> "Conditioned on the COMPANY's performance of all of its duties pursuant to this agreement,[21] VSTDC agrees to pay for part of the cost of the installation of the aforesaid EQUIPMENT. To ensure that the EQUIPMENT is utilized for the creation of economic development in Victoria, Texas, the amounts payable for the aforementioned EQUIPMENT are payable only as a reimbursable percentage of payroll over 48 months. The amount payable by VSTDC will be 2% of the total gross payroll at the FACILITY for each employee of COMPANY employed in the operation of the telephone call center at the FACILITY during the 48-month period following the date the COMPANY first notifies the VSTDC that the 48-month reimbursement period is beginning, in a total reimbursable amount not to exceed $300,000."

In late 2009 as the country fell into the "Great Recession," Starlight announced that it would be closing the facility. By this time the company had fully renovated the building and reached peak employment. Nevertheless, by January 2010, Starlight had gone dark.

Under the terms of the Tax Abatement Agreement, if employment fell below 10 full time employees, the company was in default. The city began discussions with the company, and the company ultimately repaid all of the ad valorem taxes that had been abated.

The Type B Corporation's reimbursement, however, was not subject to recapture. Under that agreement, the company was required to invest $300,000 in equipment, and to hire 300 full time employees prior to October 1, 2008. The company had met both of those goals. Nevertheless, despite the lack of recapture, the company did not run off with the corporation's money in the bottom of a carpet bag. Due to the structure of the reimbursement as a percent of payroll through the term of the agreement, Starlight only received a small fraction of the

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[20] A fictional name for a true story.

[21] The company's duties under the agreement included the investment of at least $300,000 in equipment, and the creation of "at least 300 new full time positions of employment for the telephone call center at the FACILITY prior to October 1, 2008."

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equipment reimbursement.

In hindsight, the Starlight incentive program was a success. Starlight took a blighted building and made it into a usable facility. After Starlight's departure, a competitor took the building over, and it remains a productive facility today.

Contrast the Starlight program with Plasticorp, another recent incentive program gone awry.

2. *The Plasticorp Tax Abatement Agreement*

Plasticorp[22] entered into a tax abatement agreement with the city in 2006, under which it promised to invest $6.3M in the expansion of its plastics plant in the city and to increase its workforce to 290 employees. Plasticorp was provided a six-year tax phase-in, and agreed to maintain its larger workforce for the term of the agreement.

By the beginning of the Great Recession, Plasticorp had completed its expansion of the plant, and had increased its workforce well above the required 290 employees. Then, in late 2010, Plasticorp was forced to significantly reduce its workforce, dropping considerably below the required 290 employees.

In response to the city's notice of Plasticorp's default, the company argued that it had provided the economic impact foreseen by the agreement, and the benefits to the city even exceeded the promises made in the agreement. The company further argued that recapture of the abated taxes would put further pressure on the company's already-strained finances, and potentially drive it (the rest of the way) out of business.

Plasticorp's first argument had some merit. Subsequent to the execution of the tax abatement agreement, Plasticorp had made a second expansion to its facility, and increased its workforce significantly above the required number of employees. Consequently, if the city were to look at the number of man-hours worked at the facility during the course of the agreement, it would find that the average workforce remained above 290, even though the current workforce was below.

Plasticorp's second argument also carried weight with city council members, who did not want to be responsible for putting employees on the street during tight economic times.

Nevertheless, council voted to terminate the tax abatement agreement with Plasticorp and, as required by the Property Redevelopment and Tax Abatement Act, to recapture all of the taxes that had been abated.

3. *Which one is better?*

I'm happy to report that Plasticorp remains open for business. The consternation that council was forced to suffer, however, prompted me to compare the Plasticorp agreement, which was a straight-up tax abatement, to the Starlight agreements, which included a forward-looking

[22] Another fictitious name, of course.

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reimbursement program.

As a result of that analysis, I have a strong preference for reimbursement based incentive agreements, based on performance indicators. I also have tried, where possible, to base the performance agreements on Chapter 380 agreements with reimbursements of payments made to the city by the developer. We have seen some success with these programs, but ultimately, it may take the failure of one of these businesses to truly test the arrangement.

380 Agreements Provide the Flexibility.

In Chapter 380 of the Local Government Code, the state legislature may have provided the greatest impact per word of any chapter in the state economic development package.

1. A Broad Economic Development Program.

Spanning less than one page in West's publication of the Local Government Code, Chapter 380 nevertheless provides broad economic development authority to cities. Under Chapter 380, a municipality may create an "economic development program" under which it may make "loans and grants of public money" and provide "personnel and services of the municipality" to promote state or local economic development.[23]

a. Must Stimulate Business in the Municipality.

Chapter 380 requires that the purpose of the program be to "promote state and local economic development and to stimulate business and commercial activity in the municipality."[24] For this purpose, the municipality includes its extraterritorial jurisdiction. This provision does not appear to require that the funds be expended within the municipality, only that the impact of the expenditure be to stimulate business and commercial activity within the municipality. Consequently, a city might be able to determine through legislative findings that a program under chapter 380 expends public funds outside the municipality in a way that stimulates commercial activity within the municipality. For example, a large project in an unincorporated area near an isolated municipality may stimulate commercial activity within the municipality if the new workforce is likely to drive population expansion or if the large project is likely to generate spin-off commercial activity.

b. Ensuring Public Purpose.

The Attorney General has argued in his Economic Development Handbook that a chapter 380 agreement must ensure that a public purpose is met by the incentive through appropriate controls, such as recapture provisions. These requirements are not set out in the statute, nor are they referenced in any case law on this issue. Although Article 3, Section 52-a of the Texas constitution specifically provides that economic development is, in itself, a public purpose, the better part of valor may dictate caution in this regard. The Attorney General specifically states that a city should:

[23] Tex. Loc. Gov't Code Ann. § 380.001.
[24] *Id.*

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i. Enter into a binding contract that outlines what steps the business will take that justify the provision of public funding, such as the creation of jobs, expansion of the tax base, or enhancement of physical facilities.

ii. Include in the contract a recapture provision.

iii. Include in the agreement tangible means for measuring whether the industry has met its obligations under the contract.[25]

c. Are 380 Agreements Limited to Money?

Chapter 380's constitutional framework is provided by Article 3, Section 52-a of the Texas Constitution, which states that "the legislature may provide for the creation of programs and the making of loans and grants of public money ... for the public purposes of development and diversification of the economy of the state...." In a case unrelated to Chapter 380, the Attorney General has taken the position that Article 3, Section 52-a is limited to loans and grants of public money. Although the Dallas Court of Appeals initially disagreed with the Attorney General on that point, the opinion has been vacated, and the question remains unresolved.[26] Chapter 380 contains similar language to Article 3, Section 52-a, stating that a municipality may "establish and provide for the administration of one or more programs, including programs for making loans and grants of public money." (emphasis added). I would argue that this language permits programs that are broader than loans and grants of money, but I may need to be prepared to argue with the Attorney General on that point.

2. Two Successful Examples

Since the Starlight and Plasticorp contracts were terminated, we have executed three separate economic development agreements, all under Chapter 380. Each of them provided forward-looking reimbursements to the business, rather than tax abatements or up-front direct funding. A quick review of two of the projects will serve to illustrate the benefits provided by forward-looking reimbursements.

a. The Donnell Apartments

In 2011 the city was approached by a developer looking to construct upscale, market rate apartments in a blighted area of town near one of the hospital complexes. The project provided

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[25] *Economic Development Handbook 2008 at 181, citing* Op. Tex. Att'y Gen Nos. LO 94-037 (1994) at 3, LO 97-061 (1997) at 4, *and* GA-529 (2007) (acknowledging that none of these concern Chapter 380 agreements, but asserting that their reasoning arguably applies.).

[26] *Ex parte City of Irving*, 343 S.W.3d 850, 855 (Tex. App. 2011), *reh'g overruled* (June 29, 2011), *review granted, judgment vacated, and remanded by agreement* (Nov. 4, 2011) ("Additionally, section 52–a states that 'the legislature may provide for the creation of programs and the making of loans and grants of public money ... for the public purposes of development and diversification of the economy of the state....' Tex. Const. art. III, § 52–a (emphasis added). It does not state that the economic development program has to make loans or grants of public money, as the Attorney General contends.")

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the kind of infill that the city had been trying to encourage for years, and the city was willing to incentivize the project to ensure development. The Donnell Apartments[27] program involved a $19.2M investment in an apartment complex of at least 240 market-rate apartment units. The city required architectural approval and a quick construction schedule. In exchange, the city will provide direct reimbursement payments equal to the amount of ad valorem tax actually paid to the city in each of the first four tax years after completion of construction, with a total cap of $200,000 reimbursement.[28]

Under this program, the city enabled the construction of the apartment complex without initial capital outlay. The city is protected from overpayment through a termination provision that allows the city to terminate the agreement prior to any reimbursements if the developer fails to meet the terms of the agreement. Should the city terminate the agreement at that point, there will be no payments to recapture.

b. The Green Duck Hotel.

The second project that the city incentivized with a 380 agreement required more creativity. The city had recently conducted a survey to determine the need for additional hotel and conference space in the community, and the survey showed that the community could support additional conference space with seating for 250 people. The city was approached by a hotel developer who was developing a hotel of 120 rooms. The hotelier's franchisor required the development to have conference space, but less than the city needed. The city decided to incentivize the hotelier to expand the conference space beyond his franchise requirements, and the hotelier specifically requested a rebate of hotel occupancy taxes.

The Chapter 380 Agreement for that program required the developer to invest at least $11M in a hotel with a minimum of 120 rooms and conference space to seat 250 people.[29]

Payment will be made to the developer based on the amount of hotel occupancy tax the developer pays to the city in each of the first five years after the development completes construction, capped at a total reimbursement of approximately $240,000.

Because the developer specifically requested hotel occupancy tax reimbursement, the 380 agreement requires the developer to provide documentation on a quarterly basis that establishes "as a matter of law" that the developer is engaged in activities described in Section 351.101(a) of

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[27] Again, a fictitious name for a real project.

[28] "The Total Chapter 380 Payment shall be paid in four annual installments (the "Annual Chapter 380 Payment"). The Annual Chapter 380 Payments shall not exceed the actual amount of property taxes paid to the City as stated in the Property Tax Notice. In no case shall the annual Chapter 380 payments exceed fifty thousand dollars ($50,000)."

[29] "The Project shall consist of a privately financed hotel with a minimum of 120 rooms and a banquet/conference room that will accommodate at least 250 people, at the Developer Campus, with a banquet room of at least 4,000 square feet, an adjoining pre-function area of at least 800 square feet, with an adjoining boardroom style conference room for at least 12 people. The facility and accommodations provided by the Project shall be more upscale than ninety percent (90%) of the hotel rooms currently available within the City."

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the Texas Tax Code.[30]

This documentation requirement is additionally backstopped by a legislative finding by the city council that incentivizing the conference portion of the facility will "promote tourism and the hotel and convention industry" as required by the Tax Code.[31]

Conclusion

In each of these programs, the city is protected by the ability to terminate the contract if the project does not meet the developer's promises. But in each case, the promises should be met at the conclusion of construction. There is no ongoing employment requirement or other ongoing economic development obligation.

However the structure of these agreements could easily be applied to long term obligations like the employment requirements from the Plasticorp and Starlight projects. In such a case, the city must decide in the negotiation phase whether to accept that compliance for some portion of the term adequately compensates the city for an equitable portion of the incentive payments, or whether the city will require recapture of the total incentive.

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[30] "From the date of completion of construction through the termination of the Agreement, the Developer shall provide, on a quarterly basis and in conjunction with the Hotel Occupancy Tax Notice, documentation necessary to establish, as a matter of law, that the Developer has engaged in Activities described in Section 351.101(a)(1),(2),(3),(4),(5) and/or (6) of the Texas Tax Code."

[31] "Whereas the City finds that construction of the project will (1) provide additional economic benefits to the City, (2) be a catalyst for economic development benefiting the entire community, (3) promote local economic development, and (4) stimulate business and commercial activity in the City."

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