GIFT CLAUSE CLARITY

Will the Supreme Court decision on indirect benefits hinder economic development?

By REBECCA L. RHOADES

It's a question that cities have struggled with for years: Do the economic incentives that are offered to draw in companies benefit the entire community? According to a recent court ruling, that answer may be "no." It's a decision that could have sweeping implications on future development.

On February 8, the Arizona Supreme Court unanimously ruled in Schires v. Carlat that the City of Peoria violated the State Constitution's Gift Clause when it promised to pay a private university and its property owner in exchange for opening a campus in the city.

The Gift Clause, adopted in 1912, requires public expenditures to satisfy a two-pronged test: first, whether the challenged expenditure serves a public purpose and, second, whether the value received by the public exceeds the consideration. A contract law term, "consideration" refers to something of value given to someone in return for goods, services or some other promise. "It just means value," says attorney Cameron Artigue, partner at Gammage & Burnham. "Is there enough value coming out of this contract?"

Adds Grady Gammage Jr, founder of Gammage & Burnham, "The intent of the Gift Clause was to stop public corruption. You can't give away public property for free, and you can't take public money and loan it to a friend of yours."

The five-years-long legal fight hinged on Peoria granting $2.6 million in incentives to Indiana-based Huntington University and the school's landlord to establish a satellite campus in the city. Of that amount, $1.89 million would be paid over a three-year period as the university hit performance thresholds. The remainder, slightly more than $700,000, would go to the landlord for tenant improvements. A comprehensive analysis of the impacts of the deal, commissioned by the city, determined that the university would provide jobs for area residents as well as quality educational opportunities and would enhance the vitality of its surroundings.

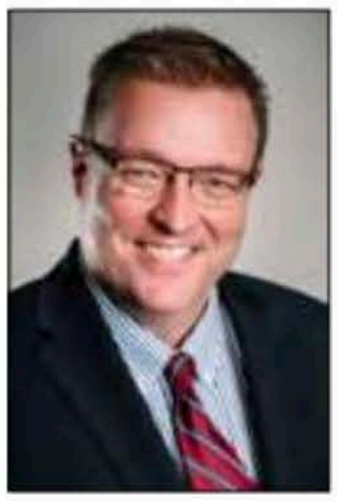
The court reconfirmed the long agreed body of law that economic development is a public purpose — meeting the requirements of the first test prong. However, in Schires, it ruled that the payments to the university and the landlord did not meet the adequacy of consideration prong because the benefits provided by the university were "indirect" and not "bargained for" as part of the promised performance, and therefore not of objective value when it came to determining adequacy of consideration. "Indirect benefits" are results that cannot be immediately measured, such as anticipated tax revenue and employment opportunities, and are not an enforceable promise to the public by the other party. On the other hand, "direct benefits" include goods and services provided by the business to the city, as well as the improvement of public property.

"Indirect benefits are the entire reason cities do these deals — to increase their tax base, to make their city more vital, to incentivize development in a particular part of town," Gammage notes. "They are investments, not gifts."

The seeds for this litigation date back decades to 1984's Wistuber v. Paradise Valley Unified School District — in which consideration for a public payment was certain duties performed by a teacher's association president in lieu of teaching — that set forth the two-prong test for Gift Clause compliance. "Wistuber was the seminal case. It was very deferential to city councils and was the law of the state until 2010," says attorney Jay Kramer, partner at Fennemore Craig.

That all changed in 2010, with the decision in the Turken v. Gordon case,


Cameron Artigue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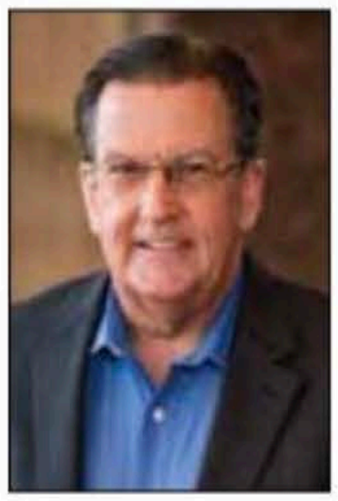
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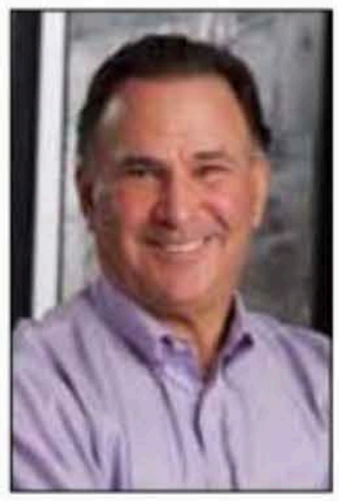
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also known as the "CityNorth" case, in which the Supreme Court took a more narrow position as to what consideration is appropriate for Gift Clause purposes. The case involved the development of a 144-acre mixed-use complex in Desert Ridge. To entice CityNorth to build, the City of Phoenix entered into an agreement whereby the developer would provide more than 3,000 parking spaces, including 200 park-and-ride spaces, that would be free to the public for 45 years. In return, it would pay CityNorth up to $97.4 million in sales tax over a period of 11 years.

Fennemore Craig and Gammage & Burnham, among others, represented the city and developer in the case. While the Supreme Court found in favor of their clients, it held that, for the purpose of the Gift Clause, an amount paid to a developer cannot be grossly disproportionate to the consideration received by the city. "We won that case, and the developer was entitled to receive the tax incentives as agreed, but we lost the war, because Turken was the first time that the court held that indirect benefits would no longer be 'consideration,'" Kramer says.

Schires takes that a step further by holding that economic impacts, such as construction sales tax, retail sales tax, and other municipal tax revenue arising directly from the planned project, are anticipated indirect benefits that are valueless under the consideration prong. The court also held that it would no longer defer to public officials on the actual value of the transaction. "It has always been part of Arizona law that courts will give legislative bodies the benefit of the doubt," Artigue says. "In Schires, the Supreme Court said no more abuse of discretion, no more deference. Judges should now determine, in the first instance, whether adequate consideration exists."

So what happens next?

Tom Belsche, executive director of the Arizona League of Cities and Towns, notes, "Economic development happens in all cities and towns, and it plays a huge role in attracting new businesses. It's extremely important that we get some clarity on this area, or we risk falling behind to other states. We're in a very competitive market. We not only compete with our fellow states in the Intermountain Region, but we also compete globally for businesses. In order for Arizona's economy to remain strong, we have to find ways to do this that meets this new requirement."

Because the ruling is so new, cities and their legal teams are still struggling to understand all of the implications, but incentive agreements will always remain a viable economic development tool to attract and retain businesses. The Gift Clause is part of the Constitution, and the legislature would need to refer any change to be voted on by the public, something Gammage does not believe will happen.

In addition, it is important to note that the Schires case does not involve GPLETs, or government property lease excise taxes. Under the GPLET program, property owners deed over their land to the city for a period of no more than 25 years, during which time they pay no property tax. Schires is about general revenue or sales tax-based incentives.

"In the future, cities are going to have to be very explicit about the types of benefits they receive," Gammage explains. "For example, if they want to give $2 million to a college, they're going to have to get $2 million worth of tuition credits for their residents. The trickier question is what happens when you're dealing with a large factory? What are your benefits when jobs and tax revenue don't count?"

Artigue recalls a 20-year-old case in which the Supreme Court held that declining to collect tax revenue cannot violate the Gift Clause because the money is flowing in the opposite direction. "If you never collect the revenue, you steer clear of the gift," he says. "Whereas collecting the money and then paying it out is a problem." Artigue and his colleagues have been advising clients to guarantee that indirect benefits are made direct by incorporating them into the terms and conditions of the contract. "Don't just say, 'Hey, look at all the jobs that are being created. Isn't that great?' It should be brought into the contract as a performance threshold so that an incentive is earned by the private party hitting that criterion."

Kramer says that he has been talking to his clients about agreeing, when they contract with a municipality, to guarantee over a period of time a certain amount of tax revenue to the municipality even though that is an anathema to developers. "Under Turken, Schires and other Supreme Court cases, there is an argument that if the developer makes an enforceable promise to provide certain economic impacts, those impacts go from anticipated indirect benefits that are valueless to direct benefits that constitute consideration for Gift Clause purposes," he explains.

Artigue offers this advice: "Schires is the second real estate-oriented agreement to be litigated in the last 10 years, so it's a miniscule proportion of deals that wind up in court. There is, to use a topical phrase, a sort of herd immunity — a safety in the pack. If you can avoid making yourself an attractive target, you should be safe."