Coates' Canons Blog: Cash Grants for Real Estate Developers without Competition for Jobs—A Constitutional Quandary

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A local real estate developer, Al Czervik, proposes to construct a mixed-use development with residential, office, and retail space. The city council likes the development plan because it is consistent with the council's vision for the area. Czervik, seeing incentives being offered to convince companies to locate in North Carolina rather than other states, misses the significance of the competition element of those incentives and thinks his development, too, should receive incentives. He requests a $1 million cash grant ($100,000 per year for 10 years) from the city to "make the project work." Czervik is unwilling to promise jobs, of course—because it is the tenants who will provide jobs, not his development—but he is confident that tenants with jobs will locate in the development and therefore he seeks a subsidy nonetheless. Czervik's request gets the attention of the city attorney, who is well aware that this request rests on very shaky legal ground (as explained in this blog post and this law review article). How might the city attorney frame the legal issues for city council members, who are initially receptive to Czervik's request?

Background: Constitutional and Statutory Considerations

We start with a foundational principle of the North Carolina constitution. Local governments are not permitted to make gifts of public money or assets "but in consideration of [*i.e.*, in exchange for] public services," according to Article 1, Section 32 of the North Carolina Constitution (for further legal analysis of that constitutional provision, also known as the exclusive emoluments clause, see a blog post on the topic by my colleague Frayda Bluestein). Further, the state constitution permits local governments to expend funds "for public purposes only." It wouldn't matter, for example, whether the General Assembly enacted a statute empowering local governments to make a cash gift to every private company with the letter "A" in its name—a local government would still be unable to make the gift expenditure unless it served a constitutional public purpose. The constitution is the supreme law of the land—it trumps statutes enacted by the General Assembly when those statutes conflict with it.

This is not to diminish the importance of statutes. Statutory authority is required for every action undertaken by a North Carolina local government. The North Carolina Constitution, Article VII, Section 1, makes local governments creatures of the state, declaring that the General Assembly "may give such powers and duties to counties, cities, and towns … as it may deem advisable." If a local government cannot identify a statute that authorizes the activity it wishes to undertake, then the local government cannot engage in that activity.

Returning to our scenario, in order for the local government to make an incentive payment to Czervik, there must be both (1) an authorizing statute for such a payment and (2) a constitutional public purpose for the payment. The remainder of this post reviews several possible statutes and applicable case law.

Economic Development

The statutory language of the Local Development Act of 1925, G.S. Chapter 158, Article 1, provides North Carolina local governments with extraordinary authority to engage in economic development activities. Although G.S. 158-7.1 is broadly written, it is the oldest of the development statutes reviewed in this post. It was enacted at a time when incentive payments were clearly impermissible under the constitution and there was no thought of making cash payments to private companies as an incentive. It wasn't until 1996, in *Maready v. City of Winston-Salem*, 342 N.C. 708 (1996), that the North Carolina Supreme Court decided for the first time that incentive payments, under certain conditions, could serve a constitutional public purpose. The question is whether Czervik's request fits the conditions described in the *Maready* case.

As discussed in this blog post about the *Maready* requirements, the primary motivation for the court to permit incentives was interstate competition—the court was particularly interested in allowing incentives that could attract companies which "might otherwise be lost to other states"—and all of the incentives approved by the court involved both substantial job creation and new tax revenue that paid back the incentives within 3-7 years. In addition, the court was satisfied that "strict procedural requirements" would prevent abuse of this new incentive authority. Indeed, the court laid out the following incentive approval procedures as "typical," even though none of them could be found within the statutory language of G.S. 158-7.1 at the time:

- An initial necessity determination is made that the incentive is required for a project to go forward (necessity is easily proven in a competitive situation, where a company "might otherwise be lost to other states").
- A written guideline or policy is applied to determine the maximum amount of incentive that can be given to the receiving company.
- Expenditures take the form of reimbursements, not unrestricted cash payments.
- Final approval is made at a public meeting, properly noticed.
- A written agreement governs implementation.

Lower courts have stated that they will uphold incentives that are "parallel" to the incentives approved in *Maready*. Unfortunately for Czervik, his development project cannot be called "parallel" to the *Maready* standard. He cannot promise job creation, which is the primary form of public benefit described in *Maready*, and just as important, he cannot demonstrate that an incentive is "necessary" for his project to go forward in the community. Indeed, most real estate development projects do not involve interstate competition and cannot demonstrate that a subsidy is "necessary." Without a showing of necessity—always elusive in the context of a real estate development project—an incentive payment becomes an unconstitutional gift, regardless of whether G.S. 158-7.1 appears to authorize the payment. Accordingly, absent promised job creation and a showing of necessity, Czervik's requested incentive cannot be paid under G.S. 158-7.1.

Urban Redevelopment Areas

North Carolina's Urban Redevelopment Law (G.S. Chapter 160A, Article 22) authorizes a local government to exercise special statutory powers within a designated geographic area called a "redevelopment area." The designated area must be classified as blighted—meaning the growth of the area is impaired by the presence of dilapidated or obsolete buildings, overcrowding, or other unsafe conditions—or in danger of becoming blighted. See this blog post on urban redevelopment areas for more information on the establishment of redevelopment commissions, redevelopment plans, and redevelopment areas.

One of the powers that may be exercised in a redevelopment area is engaging in "programs of assistance and financing, including the making of loans, for rehabilitation, repair, construction, acquisition, or reconditioning of residential units and commercial and industrial facilities in a redevelopment area." In other words, a local government possesses authority to offer "programs of assistance and financing," presumably including grants, to developers who agree to construct or rehabilitate buildings in a redevelopment area. The exercise of redevelopment powers has been found to serve a public purpose (Redevelopment Comm'n of Greensboro v. Sec. Nat'l Bank, 252 N.C. 595 (1960)), and the *Maready* case relied

on redevelopment case law to support its decision to allow incentives for economic development.

The difference between financial assistance offered pursuant to the Urban Redevelopment Law and incentives offered under G.S. 158-7.1 is the form of public benefit obtained by the local government in return. In the context of urban redevelopment, the public benefit is derived not from job creation and increasing the tax base, but in attracting development to a blighted area consistent with the redevelopment plan. It is not clear whether the law permits a local government to provide a financial subsidy to a private developer within a designated redevelopment area. The constitutional question has not been tested, and regardless, there would need to be some showing that the subsidy was necessary to make the project feasible in the blighted area.

Czervik's development, however, is not located in a statutory redevelopment area, so the Urban Redevelopment Law is not applicable to his requested incentive payment.

Community Development and Affordable Housing

Local governments in North Carolina have long possessed statutory authority to assist private entities with construction of affordable housing for low and moderate income persons (G.S. Chapter 157) and to rehab private structures as part of a community development program for the benefit of low and moderate income persons (G.S. 153A-376, G.S. 160A-456). Case law has also found these activities to serve a constitutional public purpose. See, for example, *In re* Housing Bonds, 307 N.C. 52 (1980), regarding the public purpose of undertaking programs for the benefit of low and moderate income persons.

In the case of affordable housing and community development programs, the public benefit to be received in exchange for a payment is the rehabilitation or construction of structures for the benefit of low and moderate income persons. A conservative test for such assistance would examine whether the grant or other financial assistance would be permitted under requirements of the federal Community Development Block Grant (CDBG) program. In Czervik's case, there is no intent to benefit low and moderate income persons, so this authority does not apply to his request.

Municipal Service District for Downtown Revitalization

The final possible source of statutory authority for an incentive payment to Czervik is a municipal service district ("MSD") for downtown revitalization (G.S. Chapter 160A, Article 23), also known as a Business Improvement District, or "BID." An MSD for downtown revitalization is a special taxing district that municipalities (not counties) can establish to fund, among other services or functions, "downtown revitalization projects." My colleague Kara Millonzi describes the process for establishing such districts in her blog post on BIDs in North Carolina.

The statute authorizing MSDs for downtown revitalization, much like the statute for economic development, is broad in its scope. The statute describes downtown revitalization projects as services, functions, and developmental activities intended to further the economic well-being of the downtown area, and it offers a non-exclusive list of examples of downtown revitalization, such as "promoting business investment in the downtown area." The only explicit limits imposed by the statute, it appears, are the geographic boundaries of the district. Thus, the MSD statute presents a similar situation to G.S. 158-7.1, in which constitutional limitations may be more important than the statutory language.

However, North Carolina courts have not yet had an opportunity to evaluate the downtown revitalization statute or the public purpose of cash grants offered pursuant to the statute. In addition, a review of case law across the nation offers no support for such grants—no cases were identified that supported the grant of public subsidies to private developers outside of the instances already mentioned above: economic development with competition for jobs, urban renewal of blighted areas, and projects primarily for the benefit of low and moderate income persons. To the contrary, the Arizona Supreme Court, en banc in 2010, held that cash payments to the developer of a mixed-use development—much like Czervik—were an unconstitutional gift because tax revenues alone were not valid consideration under that state's gift clause. *Turken v. Gordon*, 224 P.3d 158 (Ariz. 2010). The holding in Arizona, while possibly influential, is not controlling in North Carolina, so the question remains unresolved here.

Accordingly, there is legal risk associated with relying on North Carolina's MSD statute to make incentive payments to private developers. For those local governments that wish to take advantage of the ambiguity in North Carolina to offer such incentives anyway, it is recommended that they mitigate their risk somewhat in two ways: (1) follow the procedural

requirements described in *Maready* that were not explicitly required by G.S. 158-7.1, and (2) attempt to determine "necessity" as described below.

Maready Procedures Not Found in G.S. 158-7.1 and the Necessity Challenge

Recall from the earlier discussion of *Maready* that the court listed the following approval procedures for incentives, even though the listed procedures were not required by the authorizing statute, G.S. 158-7.1:

- Necessity determination.
- Applying a written guideline or policy to determine the maximum amount of incentive that can be given to the receiving company.
- Expenditures take the form of reimbursements, not unrestricted cash payments.
- Final approval is made at a public meeting, properly noticed.
- A written agreement governs implementation.

A local government seeking to provide incentives for Czervik's development through an established MSD would have no difficulty complying with these procedures, with one notable exception: the necessity determination.

It should be recognized at the outset that determining that a public subsidy is "necessary" for a private development, in the absence of a genuine competitive situation, is challenging. In our work with local governments through the Development Finance Initiative (DFI) here at the School of Government, our goal is to maximize the public benefits and achieve public interests while minimizing the public expense associated with any particular development project. To accomplish this goal, we conduct independent financial feasibility analysis of the development project and examine public involvement through a tiered approach, as an approximation of necessity, as follows:

1. **Public ownership**: Are there public infrastructure elements of the project that a local government could acquire directly from the developer through a public-private partnership for construction (G.S. 143A-128.1C, G.S. 160A-458.3) as described in a blog post by my colleague Norma Houston, or a reimbursement agreement (G.S. 153A-451, G.S. 160A-499), thus relieving the developer of some of the costs of development by buying a portion of the development for a "reasonable" price? Parking facilities, sidewalks, government offices, and parks and recreation space are common candidates for acquisition by the local government. See this blog post on DFI's project in Wilmington as an example. If feasibility is achieved, stop here, because a grant cannot be "necessary." By stopping before making a grant, a local government avoids the constitutional concern entirely because no subsidy is provided to a private entity.
2. **Unsubsidized loan**: Would feasibility be achieved through subordinated debt at a market rate of interest (approximately 5% higher than the interest rate of the primary loan) as described in this blog post on mezzanine debt and this post on the legal procedures for a loan? A loan is often sufficient to make a development project feasible, as explained in this blog post about the impact of a loan on a development project. If feasibility is achieved by an unsubsidized loan, stop here, because a grant cannot be "necessary." Here again, the legal risk associated with a grant is avoided entirely.
3. **Subsidized loan**: Would feasibility be achieved through subsidized subordinated debt, such as a lower-than-market interest rate or deferred interest and principal with a balloon payment upon sale? A subsidized loan is essentially a loan that sits alongside a grant—the grant portion buys down the interest rate or the payments on the loan as described in this blog post on legal procedures for a loan. Notice, however, that the legal risk associated with subsidizing a private entity through an MSD resurfaces, because this loan contains a grant or subsidy. If feasibility is achieved by this loan, stop here, because any further grant cannot be "necessary."
4. **Grant (or equity contribution)**: Finally, if none of the above measures achieves feasibility for the project, then a grant may be "necessary" to make the project go forward in the developer's proposed form. Note, however, that the constitutional concerns remain. Why must the development take the form proposed by the developer? Is the rate of return for investors in the project being subsidized by the public, and if so, is that rate of return justified? What public benefit will be achieved by the project, beyond increasing the tax base? To avoid making an unconstitutional gift, should the local government be entitled to returns on the same basis as other equity investors, at least until the grant is repaid?

Perhaps Czervik could receive assistance if his project is located in an established MSD. However, even if a local government follows the tiered approach to determining "necessity" described above and follows the other procedures

described in *Maready* when approving an incentive, there remains a real risk that a court could strike down such payment as an unconstitutional gift or as failing to achieve a public purpose. However, the steps outlined above may mitigate the risk, and at the very least, may lead to the discovery that offering a loan to a developer provides adequate assistance—and that making a grant is not even *necessary*.

For more resources related to offering loans rather than grants for private real estate development projects, see these online publications:

> How a Mezzanine Loan Can Reduce Equity Requirements, Boost Returns, and Attract Investment to a Redevelopment Project
>
> Economic Development Incentives Must Be "Necessary" – A Framework for Evaluating Constitutionality of Public Aid to Private Enterprise (Harvard Law & Pol'y Review)

For an example of a North Carolina municipality that built public-owned infrastructure and offered a loan (not a grant) to assist a developer, see this post: Multiplex in Morganton: The Mimosa Theatre.

Links

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