SHEPPARD MULLIN
SHEPPARD MULLIN RICHTER & HAMPTON LLP
ATTORNEYS AT LAW

Real Estate, Land Use & Environmental Law BLOG
Up-to -date Information on Real Estate, Construction, Environmental & Land Use Law

April 26, 2011

UPDATE ON REDEVELOPMENT LAW: NO NEWS IS...NO NEWS

This is the first in a series of blog entries monitoring the proposal to eliminate redevelopment agencies and describing alternative public funding sources for redevelopment projects.

By Michael Kiely

After much discussion, debate and lobbying in the last three months, the fate of California's redevelopment agencies is still uncertain. Legislative bills to eliminate the agencies, called RDAs for short, have failed by a single vote. Many political leaders are still pushing for elimination; others are now actively searching for compromise solutions that will allow RDAs to survive. What appears certain at this point is that there will be less tax increment revenue available for real estate development in redevelopment project areas. As a result, development projects in these areas, already suffering from market forces and limited debt availability, will face an even bigger challenge.

The Governor's Proposal

Jerry Brown's run to return to the governorship of California was predicated in large part on his ability to solve the State's looming budget crisis. The current year's budget deficit will exceed $25 billion. When the newly sworn in Governor presented his first budget proposal on January 10, 2011, he contemplated slashing $12+ billion in State spending in a wide array of areas, including, welfare, health services and higher education, and a comparably sized extension of expiring tax rates and fees to be placed on the ballot in the June election. The Governor's goal was to get a package approved by March, in sufficient time to have the tax extension measures placed on the ballot in the June special election.

Of particular concern to the real estate development industry and local governments was the proposed elimination of RDAs. According to the Governor's proposal, elimination of RDAs and their right to receive property tax increment in redevelopment project areas would free up $1.7 billion this year, and over $5 billion a year in

subsequent years.

Proposed Legislation

Six weeks after the Governor's proposal, AB 101 and SB 77 were introduced as the means to effectuate the elimination of RDAs. SB 77 fell one vote short of Assembly approval on March 16, and AB 101 has not yet been voted upon. As of the date of this blog entry, RDAs are still standing. They have been saved for the time being but not by local government and other pro-redevelopment forces. Rather, the legislation to kill the RDAs has not been adopted because it has been tied to the Governor's overall proposal, including provision for placing the tax extensions on the ballot. Insufficient Republican legislators were willing to sign on to the overall proposal to meet the 2/3 voting requirement. Several Republican legislators have engaged in talks with the Governor, the emphasis of which was that these Republicans would support the Governor's overall proposal, including tax extensions and the elimination of RDAs, if other concessions were made. According to reports, such concessions included items related to the budget, particularly pension reform, and others perhaps not so closely related, such as CEQA reform. In response to the breakdown of these talks and inability to get the tax extensions on the June ballot, the Governor is now looking for other areas to cut.

The Two Sides

At this point, the future of RDAs remains uncertain. However, since it appears that even greater cuts, perhaps the entire $25+ billion budget shortfall, will need to be cut, most observers think there will have to be some cutting on RDAs. Accordingly, the debate is now between total elimination and cutting of RDAs or shifting funding away from RDAs.

The political forces to eliminate RDAs remain strong and active. In the week following the Governor's initial proposal in mid-January, the State Legislative Analyst office issued a report that was highly critical of RDAs: that some RDAs have failed to produce affordable housing; that development projects in redevelopment project areas is simply development that would have occurred anyway, if not in the redevelopment area, then elsewhere in the state; that unworthy projects have been funded; that funds have been diverted for city uses; and that redevelopment activities will not lead to economic growth. On March 11, 2011, the State Controller released the results of a limited-scope review of 18 RDAs, identifying several missed payments to school districts and widespread accounting and reporting deficiencies, questionable payroll practices,

substandard audits, faulty loans, projects in obviously non-blighted areas, and inappropriate use of affordable housing funds. On the strength of these reports, leading political figures, including Governor Brown, Speaker of the Assembly John A. Perez and Senate Pro Tem Darrell Steinberg have all publicly dug in supporting elimination of RDAs.

The political forces to retain RDAs, led primarily by the California Redevelopment Association, or CRA for short, have also been fighting hard. Initially, CRA took a hard line stance: RDAs should survive because they are vital for job creation, and elimination of RDAs is illegal and unconstitutional. CRA threatened an immediate legal challenge if the proposed legislation was adopted. Under Article XVI, section 16 of the California Constitution, which established tax increment financing and requires tax increment to be paid to RDAs, and Article XIII, section 25.5 of the California Constitution (Proposition 1A and the recently adopted Proposition 22), the State would be prohibited from adopting legislation that requires redevelopment agencies to transfer tax increment revenues to the State, any agency of the State, or any local jurisdiction.

After a few weeks, and at the behest of the largest cities in California, sometimes called the "Big 10," CRA's position shifted. The big cities and CRA began to push for a voluntary sharing of tax increment revenues with school districts. These proposals have been coupled with a request for automatic extension of the lives of redevelopment project areas for additional periods of 4 to 10 years. The political expediency of this shift is obvious. If all government programs need to be cut, the RDAs cannot avoid sharing the pain. However, there are legal questions whether such voluntary sharing arrangement could be undertaken in light of the same constitutional provisions described above.

Proposed RDA Elimination Legislation

There is still a chance that the legislation proposed to eliminate RDAs, AB 101 and SB 77, could be adopted. If it is adopted as urgency legislation and passed with a 2/3 vote, then it would become effective immediately. If it is adopted with only a simple majority, then it would become effective on January 1, 2012, though there are some who believe that a simple majority would achieve immediate effectiveness if the legislation is tied to a budget bill. The legislation, called in this blog entry the "Proposed RDA Legislation," can be summarized as follows:

- All RDA activity would be suspended except paying existing obligations;

- Invalidate, and extend the statutes of limitations for validation actions, on all agreements and arrangements undertaken by RDAs since January 1, 2011;

- All RDAs would be abolished on July 1, 2011 and "successor agencies," which will either be, or be created by, the cities or counties in which the RDAs operate, would be created to take over the assets and obligation of their former RDAs;

- The successor agency would be required to wrap up operations of its former RDA under the direction of an oversight board composed of 7 members, all but one of which are selected by the county board of supervisors or county superintendent of education;

- Property tax increment formerly payable to RDAs will be distributed to taxing agencies after first paying amounts due on existing obligations under current payment schedules; and

- Some, but not all, prior obligations would have priority over payment to the State and taxing agencies; some obligations which had a first priority on tax increment would be subordinated to payments to the State and taxing agencies

Potential Impacts of Proposed RDA Legislation

1. ***RDA Bonds or Notes*.** Generally, scheduled amounts payable under RDA bonds or notes for which the RDA pledged tax increments will be honored under the Proposed RDA Legislation. The successor agency will continue to receive tax increments for payments. However, there may be a loss of priority on the tax increment pledge.

2. ***Other Agency Tax Increment Pledges – Other Agency Agreements*.** The Proposed RDA Legislation appears to permit payment only on scheduled liabilities under existing obligations. However, many redevelopment agreements between RDAs and property owners (Disposition and Development Agreements, commonly called DDAs, or Owner Participation Agreement, which are called OPAs) contemplate future pledges of tax increment. Under some OPAs, upon completion of the required project, the RDA is required to issue a tax increment-backed promissory note to the developer. In others, the RDA commits to issue

tax allocation bonds upon completion of the required project or satisfaction of other conditions. In still others, RDAs set aside tax increment for payment upon certain milestones. It is uncertain how successor agencies and, potentially, courts, will treat such unscheduled obligations.

3. ***Loan from an Agency*.** RDAs have frequently provided loans to developers, especially affordable housing developers, and non-profit organizations. Frequently, given the community development and planning goals of the RDAs, enforcement of such loans has not been strict. Since the successor agencies are charged with maximizing revenues for distribution to the taxing authorities, borrowers' assumptions regarding loan extensions, modifications, enforcement or conversions to grants should now be re-examined.

4. ***Lease with a Redevelopment Agency*.** Where the RDA is the landlord, no lease amendment will be possible until after formation of the successor agency. Successor agencies are obligated to sell all assets, so the RDA's tenant should assume that future dealings with the landlord under the lease will be undertaken in the context of landlord revenue maximization rather than RDA planning and community goals. The sale requirement may create an opportunity for the tenant to acquire the fee interest.

   Where the RDA is the tenant, no lease amendment will be possible until after formation of the successor agency. Since the successor agencies are to receive only limited funding, landlords may expect successor agencies to default under, or at least try to renegotiate, lease obligations.

5. ***Agency Land Sale*.** Generally, an RDA sells land pursuant to a DDA, with closing upon satisfaction of certain conditions, usually including obtaining financing for development of a defined project. Successor agencies are obligated to sell all assets, but in a way that maximizes yield. If the purchase price under a DDA is below market value, then the successor agency could attempt to revoke such agreement.

6. ***Real Property Located in a Redevelopment Project Area*.** For owners of real property located in a redevelopment project area, any anticipation of entering into a subsidy redevelopment deal involving RDA tax increment would be off the table. Other subsidy sources will remain available, and there is contemplation in Sacramento of an expansion of the infrastructure financing district laws to make

such financing more readily available. These alternative funding sources will be explored in subsequent posts in the Sheppard Mullin Real Estate and Construction Law Blog.

There may also be land use implications. Some local jurisdictions include the RDA in their land use planning regulations. Examples include delegating authority to RDAs for design review, or permitting certain variances only for projects subject to RDA agreements. Some cities have already made alterations to their planning codes regarding a transition of such powers to other agencies, such as planning commissions.

RDAs and their successor agencies are barred from creating new or expanding existing redevelopment project areas.

State land use planning laws that may also be implicated. For example, the State Outdoor Advertising Act provides certain benefits for freeway-adjacent properties located in redevelopment project areas. The effect of the Proposed RDA Legislation on such regulation is unclear; however, a measure, AB 994, has been put forth to address these concerns.

7. ***Sale of Redevelopment Agency Assets*.** Under the Proposed RDA Legislation, successor agencies are obligated to sell all former RDA assets in a way that maximizes yield. Some estimate that in Los Angeles County alone, there may be over 2,000 sites coming on the market. Although this suggests opportunities to acquire valuable sites without the baggage of typical RDA requirements (for example, no-flip provisions, development covenants with deadlines, RDA design review, prevailing wage, living wage, local hiring requirements, public art requirements, etc.), there is a possibility that successor agencies flooding the market may result in downward pressure on property values.

The Missing $1.7 Billion

As noted above, part of the rationale for elimination of RDAs is that it would free up $1.7 billion of tax increment to apply to the State's budget deficit this year. Actions taken by RDAs to shield or use up such funds may have already made that assumption illusory.

Within days after the issuance of the Governor's proposal to eliminate redevelopment agencies, many RDAs and their local governments (i.e., the cities or counties that

formed the RDAs) took formal steps to try to shield their anticipated tax increment. Such arrangements generally have taken the form of a cooperation agreement between the RDA and the city, in which agreement the city agrees to undertake responsibility for the installation of public improvements, the creation and preservation of affordable housing projects and other redevelopment projects. These various public and private projects are specifically enumerated in such agreements. In exchange, the RDA pledges its future tax increment to the city. Some RDAs were able to issue additional tax allocation bonds. Still other RDAs have entered into agreements for projects with larger RDA commitments or on shorter timeframes than might otherwise have occurred. The idea is that such agreements would be treated as an existing RDA indebtednesses and therefore be unaffected by elimination of RDAs.

The Proposed RDA Legislation contains provisions purporting to invalidate RDA agreements entered into after January 1, 2011. Also, the statutes of limitations for such challenges are extended by several years, and the venue for any such challenges is set in Sacramento. Whether such provisions are adequate for their intended purposes may become the subject of litigation, including federal Constitutional challenges to the right of the State to impair contracts between the RDAs and cities or private parties. However, the actions undertaken by RDAs in response to the Governor's proposal have certainly clouded the ability of the State to count on the availability of the RDAs revenues for this year. Even if the Proposed RDA Legislation is adopted and survives legal challenge, the timing for recoupment of funds already transferred or expended may push their availability into future budget cycles. Similarly, if the Proposed RDA Legislation is not adopted as urgency legislation, then it would not be effective until next year, making use of RDA funds from this year to solve the State budget crisis even more unlikely.

Conclusion

Property owners and others that may be affected should follow the debate and analyze the Proposed RDA Legislation or any modified version of it to determine their best course of action. For those with redevelopment projects that were close to becoming a deal, then there may still be time before legislation is adopted to get the deal done. For those in existing agreements with an RDA, proposed modifications or clarifications should be processed as soon as possible, before any legislation is adopted.

If the Proposed RDA Legislation, or a variation of it, is adopted, then the appropriate response may to wait and see what happens after that. As noted, CRA and the several

of the largest cities in the State have promised to sue the State challenging the constitutional validity of any legislation eliminating RDAs.

If the Proposed RDA Legislation, or a variation of it, is adopted and withstands legal challenge, then the response might be to wait and see what the applicable successor agency does with respect to particular properties or agreements. Conversely, if pending sales, refinancings or other transactions require certainty, it might make sense to move aggressively, either by negotiation or litigation, with a successor agency in order to more clearly establish rights with respect to particular properties or agreements.

If the Proposed RDA Legislation continues to stall, then RDAs may be safe. But having been exposed to such scrutiny and criticism in this budget cycle, it seems unlikely that redevelopment law will remain unchanged for much longer.

Authored By:

Michael Kiely
(213) 617-5587
MKiely@sheppardmullin.com