

THE CITY AS ENTREPRENEUR:
A LEGAL RATIONALE FOR SHARING
THE PROFITS OF DOWNTOWN DEVELOPMENT

by

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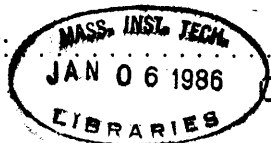
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ABSTRACT

This thesis examines the role of joint development projects by local government and private investors. These projects have gained increased importance in recent decades. An important question this thesis addresses is why municipal governments have begun to play an entrepreneurial role in development projects. The research will also evaluate whether sharing the profits of municipally inspired development is a legally valid objective of publicly subsidized downtown projects.

The entrepreneurial role of cities has, for several decades, been sanctioned by the courts. The revitalization of commercial districts and other central city communities has been legislatively defined as a public purpose since the advent of urban renewal. Although the sharing of project profits is a legitimate expectation of a city's participation in public-private partnerships, municipalities rarely secure a direct share of the proceeds from joint development ventures.

This thesis will offer a legal rationale for the city's entrepreneurial role and will illustrate, by example, how several cities have failed to achieve a share of project profits. Downtown development in Yonkers, New York, Detroit, Michigan, and Hartford, Connecticut are examined to understand the strengths and failures of municipal efforts to share the proceeds of development. This paper will prescribe a remedy for altering and strengthening the city's hand in negotiating joint development agreements and for securing a greater and more direct return on a city's publicly subsidized projects. This thesis concludes that the failure of municipalities to secure a share of project profits can be reversed by the implementation of a national urban development policy that requires city officials to recapture the value of public development subsidies.

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TABLE OF CONTENTS

Chapter One	Introduction.....	1
Chapter Two	Legal Justification For Municipal Entrepreneurship: A Rationale For Profit Sharing.....	6
Chapter Three	Development Partnerships: Illustrations of Failed Attempts At Profit Sharing.....	21
	A. City of Yonkers.....	23
	B. City of Detroit.....	24
	C. City of Hartford.....	27
Chapter Four	Conclusions: Remedies and Future Prospects.....	38
	NOTES.....	48
	BIBLIOGRAPHY.....	56

DEDICATION

In Memory of My Father

Harry Bressler.

Ohav Sholom

July 6, 1985 / 17 Tammuz 5745

Zaichar Tzaddek L'vrocha

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Chapter One

INTRODUCTION

The entrepreneurial role of cities has been sanctioned by the courts for several decades. The revitalization of commercial districts and other central city communities has been legislatively defined as a public purpose since the advent of urban renewal. Yet, although the sharing of project profits may be a legitimate expectation of a city's participation in public-private partnerships, municipalities have rarely secured a direct share of the proceeds from joint development ventures.

The revitalization of downtown and the use of financial incentives for development has become a valid public, municipal purpose. The influence of historical restrictions against municipal involvement in entrepreneurial activities has eroded over time as courts and legislatures have redefined the meaning of public use and blurred the distinction between the widely accepted public role of the city and the more highly scrutinized proprietary functions of a municipality. That numerous courts have had difficulty delineating between the government's rightful regulatory and proprietary capacities has allowed municipalities to expand their entrepreneurial role.

As cities become involved in proprietary activities, they lose their sovereign immunity and become subject to liability for preferential and anticompetitive treatment of development which the city actively or indirectly fosters. However, cities will not be found liable unless they engage in egregiously

and patently collusive behavior. A municipality's entrepreneurial behavior will be judicially sanctioned:

- (1) so long as the city has a valid interest in participating in downtown development;
- (2) and such municipal entrepreneurial activity is a clearly articulated and affirmatively expressed state legislative policy.

Consequently, since the revitalization of downtown is a clearly articulated state policy, a municipality may pursue revitalization by displacing competition, participating in profits and by securing for itself an entrepreneurial role in development.

Yet, despite judicial decisions which have unambiguously sanctioned an entrepreneurial role for municipalities, cities have only timidly assumed this function. The failure of cities to secure for themselves a share of project profits is illustrated by several development projects in which the municipality participated in highly touted "public-private partnerships." I will return to these examples throughout the thesis.

In the City of Yonkers in the early 1970's, the municipality sought to encourage the expansion of an industrial facility by the Otis Elevator Company. Yonkers condemned land and, at the request of Otis, sold the parcel for one-tenth its cost to the city. Yonkers conveyed the land to Otis in exchange for a letter of intent to retain facilities and jobs in the city. When Otis took title to the land, Yonkers released Otis of remaining obligations as a sign of good faith. Seven years later, Otis left Yonkers amidst contentions by the city that the company was unjustly enriched by the massive public expenditures used to entice the company to remain.

In the City of Detroit in the early part of this decade, the municipality sought to facilitate the construction of a new industrial plant by General Motors.

The city delivered the site requested by G.M. for development at one-twentieth the cost to Detroit. Detroit contributed a major share of the equity and assumed much of the risk for the project, described as "one of the most ambitious cooperative public private urban development ventures ever undertaken."^[1] However, five years after the city agreed to participate in the development of a new facility for G.M., Detroit has yet to benefit from additional tax revenue or from the creation of permanent jobs that were anticipated when Detroit entered into the agreement and partnership.

In the City of Hartford during the last several years, the municipality has entered into public-private partnership agreements for the construction and development of several downtown office buildings. In one instance, the city exchanged a 20-year tax abatement for the prospective share of fifty percent of the profits from office rentals, in accordance with a ground lease agreement. Early projections estimated Hartford's annual project income to be as high as \$1 million, but those projections remain unfulfilled in the first few years of the project despite a low vacancy rate during those early years of operation. Nevertheless, the profit sharing arrangements embodied in the ground lease secured by the city has been used as a model for other partnership agreements in spite of the failure of such agreements to achieve a share of profits for the City of Hartford.

The failure of city officials of Yonkers, Detroit and Hartford to secure a more direct return on their public investment dollars need not discredit the city's participation in those public-private partnerships. Municipal participation in joint development ventures can be justified when the prospects for return include secondary goals such as enhanced job opportunities, new tax revenues or a revitalized commercial district. On the other hand, the failure of Yonkers, Detroit

and Hartford to secure a more immediate financial return may be explained by the city's perception that it bargains from a position of weakness. Although the entrepreneurial role of cities is judicially sanctioned, municipalities may be reluctant to demand a return on its investment because the city may fear it risks unacceptably high economic losses to its employment and revenue base if it fails to be acquiescent in its negotiations, or the city may have incorrectly concluded that it is legally constrained.

Only a national urban development policy such as that embodied by the federal Urban Development Action Grant program can remedy the timidity of city officials and empower them to secure a greater and more direct share of project income from municipally fostered development. The UDAG program encourages cities to recapture the value of public development subsidies and helps change cities' perceptions about their role in the development process. During the early years of the UDAG program, the proportion of UDAG projects containing provisions for the recapture of public funds increased from 30% in 1978 to 62% in 1980. The City of Syracuse offers one notable illustration of how UDAG funds can be used to secure a direct share of project income. The hotel and conference center developed by Syracuse University not only offers the prospect of new jobs and additional tax revenues for Syracuse, but a direct share of the profits as a consequence of the city's ownership of the first 29 units of the condominium hotel.

This thesis will offer a legal rationale for the city's entrepreneurial role and will illustrate, by example, how several cities have failed to achieve a share of project profits. This thesis also will prescribe a remedy for altering and strengthening the city's hand in negotiating joint development agreements and for securing a greater and more direct return on a city's publicly subsidized projects.

This thesis concludes that the failure of municipalities to secure a share of project profits can be reversed by the implementation of a national urban development policy that requires city officials to recapture the value of public development subsidies.

Chapter Two

LEGAL JUSTIFICATION FOR MUNICIPAL ENTREPRENEURSHIP: A RATIONALE FOR PROFIT SHARING

Land use policy has traditionally been used to accelerate residential and economic development. Throughout our nation's history, the federal government has employed subsidies and incentives to foster settlement, expansion, industrialization and development. Massive grants of land by European powers fostered colonial settlement during the pre-revolutionary period. Homesteading encouraged farming in underpopulated, rural regions during the latter part of the 1800's. Railroad grants fostered cross-continental growth in the 19th century. Below-market rate leasing of land spurred oil and mineral exploration. And slum clearance has been used as a mechanism for redeveloping and reindustrializing declining metropolitan regions in the last thirty years.

Patterns of private land development in our nation's cities continue to influence government land policies, even as federally subsidized urban renewal programs dry up. The loss of federal aid to the cities has spurred municipalities to seek more creative solutions and assume greater responsibility for initiating economic development. Public subsidies and tax incentives comprise vital elements of many development projects, but limited public dollars have accentuated a need to leverage scarce government subsidies against maximum private investment. Efforts by municipalities to maximize the financial return on their investment is

characteristic of the city's new entrepreneurial role.

The roles of both cities and developers have evolved in the post-urban renewal period to encompass a wider range of shared costs and responsibilities. Municipalities, for many years, have borne a share of the development costs in order to stimulate private investment found lacking in the nation's cities. During urban renewal, cities assumed the lead in development by assembling land parcels, relocating current residents and clearing sites for eventual disposition to developers. Site improvements, such as the construction of access roads, pedestrian malls or public spaces, were commonly provided by the locality. In recent years, municipalities have employed more direct financial assistance such as loan commitments, financial subsidies or the below-market disposition of land to stimulate and control downtown development.

As municipalities have assumed an increasingly entrepreneurial role in the development process, several changes have resulted. Cities have assumed a greater share of the costs and risks associated with urban development than in the past and have greatly expanded their role in the decision-making and project planning process. Most important, cities have developed the potential to share the earnings of publicly-subsidized development. This new relationship between city and developer, known as a "public-private partnership," characterizes the mechanism for current downtown development efforts. [1] Municipalities have assumed the role of partner in development by assuming a greater share of the costs and risks associated with urban development; they have provided more direct financial assistance and have expanded their role in the decision-making and project planning process.

The remainder of this chapter explains why the courts, especially in the last thirty years, have expansively characterized municipal participation in downtown development as a valid public purpose despite constitutional restraints which prohibit government subsidization of private enterprise. Courts have diminished the distinctions between traditional, acceptable public functions and more innovative proprietary activity. As a consequence, the potential for municipalities to share the earnings of publicly subsidized development has evolved as an outgrowth of the public's favorable view towards the city's entrepreneurial role, as evidenced by the ultimate sanctioning of such behavior by the courts and state legislatures.

Historical restrictions against municipal involvement remain in effect, but their influence has eroded over time as courts and legislatures have redefined the meanings of public use and purpose. [2] Most state constitutions contain one or more limitations of public assistance to private enterprise. [3] Among the constitutional restraints are debt limitations, electorate approval of borrowing, and prohibitions against state aid to private enterprise. Many constitutions have forbidden the use of the credit of a state in any manner to aid any individual, association or corporation. These restrictions were direct responses to common methods of providing financial assistance to railroads in the nineteenth century. [4]

In the twentieth century, the past three decades in particular have witnessed the courts' expansion of the municipalities' role in its economic revitalization. Public subsidies and investments have been justified by the courts because of their acceptance of downtown development as a public good. [5] The

public purpose doctrine has been redefined and expanded to encompass not only the condemnation of blighted areas of the city, but to justify the use of public industrial financing, as well. [6] Although the public purpose doctrine is recognized as a limitation on public entrepreneurial activity the courts have broadly interpreted that doctrine so as to make it "responsive to the forces of change in a dynamic society." [7]

The parameters of acceptable "public use" have never been subject to strict judicial scrutiny. This was true during the pre-industrial era when the emergence of major American corporations wielding massive amounts of capital raised fears that "a legislative conception of public advantage might lead it to authorize wholesale expropriation of farms and homes." [8] In 1860, for instance, the Massachusetts Supreme Judicial Court held that the taking of land under the mere assertion of public benefit has a presumption of validity. The court ruled that it was enough if the taking

tends to enlarge the resources, increase the industrial energies and promote the productive power of any considerable number of the inhabitants of a section of the State, or leads to the growth of towns, and the creation of new sources for the employment of private capital and labor, indirectly contributes to the general welfare and to the prosperity of the whole community. [9]

Consequently, even during the industrial age, courts gave the legislature much deference and discretion in formulating a notion of public use.

Public use and public benefit are even more broadly interpreted today, and scant evidence of judicial scrutiny exists to determine whether a particular taking meets the public use requirement. The recent use of eminent domain to

support industrial development in the Poletown community of Detroit offers one such example. [10] Here the taking was deemed valid even though the condemned land was subsequently conveyed to a private corporation. [11] The Michigan Supreme Court, in a highly controversial ruling, held that stimulating economic development and generating job opportunities in the city were valid objectives that fell within the legislative definition of public purpose. [12]

Although numerous commentators have characterized the Poletown decision as an exceptional expansion of the public use doctrine, [13] the decision may be characterized as a logical expansion of that doctrine espoused by the United States Supreme Court in 1954. At that time, the use of eminent domain had become a vital element of current urban renewal programs because of the Housing Act of 1949. In ruling on the legitimacy of condemnation in slum clearance efforts, the Supreme Court held that land may be taken by eminent domain and subsequently disposed of by sale or lease to private enterprise for redevelopment in accordance with a renewal plan. [14] The court's decision in Berman v. Parker acknowledged that public use may be broadly defined by the legislature, and that the judiciary had a limited role in determining whether the eminent domain power was exercised for a public purpose. Prior to Berman, some states already characterized the clearance of slums as a public purpose. [15] Even condemnation of a vacant undeveloped lot has been justified as a valid public purpose because such land could conceivably become a slum. [16]

On only rare occasions has the public use doctrine been restricted, and then only as a consequence of legislatively imposed limitations. The existence of statutory restrictions for determining what is a public use for purposes of assisting

development is often determinative in a court's assessment of the validity of the public act. [17] The one major requirement of the public use doctrine is that statutory authorization prescribe legislative objectives from which public use or benefit may be derived. This requirement helps the court determine whether the taking is for a valid public use. When the express purpose of land condemnation is to stimulate economic development, courts have invalidated such takings in the absence of statutory language defining such purposes as a public use. [18] The determination of public use is a legislative question. The absence of statutory authorization to condemn land for the purpose of revitalizing downtown was apparently the determinative factor for the court in ruling the condemnation not to be a public use.

The dichotomy between public and private or between proprietary and regulatory activities of local government has become increasingly blurred, particularly as the public purpose doctrine has been expanded. McQuillian, the noted authority on municipal law, has commented on how distinctions between the public and private role of local government have become blurred.

A municipal corporation is a public institution created to promote public, as distinguished from private, objects. . . . The modern trend of the decisions is to extend the class of public uses or purposes in considering the municipal activities sought to be included therein. The fact that other purposes will also be served does not invalidate the exercise of a power conferred on a municipality even if such other purposes alone would not have justified the exercise of power. [19]

Similarly, a recent United States Supreme Court decision commented on the difficulty in distinguishing between public and proprietary activities. In an action

challenging Congressional regulatory authority over the states and their subdivisions when engaged in non-traditional governmental functions, the Supreme Court noted:

The essence of our federal system is that within the realm of authority left open to them under the Constitution, the State must be equally free to engage in any activity that their citizens choose for the common weal, no matter how unorthodox or unnecessary anyone else -- including the judiciary -- deems state involvement to be. Any rule of state immunity that looks to the "traditional," "integral," or "necessary" nature of governmental functions inevitably invites an unelected federal judiciary to make decisions about which state policies it favors and which ones it dislikes. "The science of government . . . is the science of experiment." [citation omitted] and the States cannot serve as laboratories for social and economic experiment [citation omitted] if they must pay an added price by taking up functions that an earlier day and a different society left in private hands. [20]

when

Changes in the historical functions of states have resulted in a number of once-private functions being assumed by states and localities. The provision of a water supply, the operation of mass transit, the administration of education, and even the maintenance of parks for recreation are all appropriate examples of this trend. The Supreme Court said that the attempt to draw boundaries for state regulatory immunity in terms of "traditional governmental functions" is not only unworkable, but is inconsistent with established principles of federalism.

That numerous courts have had difficulty delineating between the government's rightful regulatory and proprietary capacities, has allowed municipalities to expand their entrepreneurial roles. The entrepreneurial role of municipalities is becoming a more widely accepted function of government. Since

the Supreme Court's approval of urban renewal efforts in 1954, [21] the participation by municipalities in development partnerships and the use of financial incentives for development have received judicial sanction because such activity serves a valid public purpose in revitalization of downtown. Moreover, local governments who attempt to lure industry and economic activity act in direct competition with neighboring localities who also offer financial incentives and other inducements to developers. [22]

The assistance offered by municipalities to private developers has been sanctioned by the courts. [23] In the last three decades, the judiciary has continually broadened the realm of municipal behavior that is permitted in the pursuit of a city's revitalization. Cities have been participating in more innovative forms of public-private partnerships as a consequence of the legislative and judicial characterization of downtown revitalization as a public purpose. However, when municipalities engage in municipal entrepreneurial activities, they become subject to liability for engaging in regulatory behavior which has the effect of restraining competition among developers. Nevertheless, as the ensuing discussion demonstrates, the obstacles to pursuit of a municipal antitrust claim make the prospect of municipal liability unlikely.

The municipality's role as regulator may be compromised by its participation in land development. One commentator has suggested that when government serves as land developer, it acts no differently than private profit-making firms.

Governments act . . . as referees in resolving disputes between land developers and aroused neighborhood defenders. If governments were

also land developers in their own right, however, they would be tempted to compromise their role as environmental regulators, especially in applying restraints to their own development activities. [24]

Consequently, when a city becomes involved with private enterprise in entrepreneurial activities, the municipality becomes subject to different standards of behavior. Chief Justice Marshall, in an early Supreme Court decision, stated that when a government entity becomes involved in a commercial venture:

[I]t divests itself . . . of its sovereign character, and takes that of a private citizen. . . . [I]t descends to a level with those with whom it associates itself, and takes the character which belongs to its associates, and to the business which is to be transacted. [25]

As municipalities become more involved in proprietary activities, they lose their sovereign immunity and become subject to liability they may not normally be exposed to. Preferential treatment of development projects may subject a municipality to claims of anticompetitive behavior and make it vulnerable to antitrust liability.

The municipality's use of regulatory powers to deny approval of certain development projects has been the basis of several suits challenging a city's development restrictions as an anticompetitive restraint of trade. [26] However, with the notable exception of one case in Richmond, Virginia, [27] no developer has ever successfully challenged a municipality on the grounds that it restricted development and illegally restrained competition. Unless a municipality engages in egregiously and patently anticompetitive or collusive behavior, it will not likely be subject to antitrust liability.

In Richmond, Virginia, the city was sued for anticompetitive behavior by a developer who wished to build a Hilton Hotel in the city. The developer claimed antitrust damages of \$250 million. [28] The plaintiffs in the action claimed that the City attempted to deny their proposal for development in order to prevent a competitive threat to the city's own downtown development plan, and by so acting, had conspired to restrain the hotel trade in Richmond and attempted to monopolize it. Richmond city officials attempted to thwart construction of the Hilton because it was "a threat to the viability of [the city's] own program for the rejuvenation of downtown Richmond." [29]

The City of Richmond had established a redevelopment plan which sought to: (1) broaden the city's convention serving potential through development of a new hotel/convention center; and (2) strengthen the tax base of the city through new development in the project area. [30] The City, which had already committed \$17 million for construction of a municipal convention center and other public improvements, argued:

- (1) that only a hotel located within the downtown development district could adequately serve the proposed convention center;
- (2) that without the success of the downtown development project, continued erosion of the downtown core could be expected; and
- (3) that without the downtown redevelopment project, there would be no economic impetus to development in other parts of the City of Richmond. [31]

Richmond's proposed hotel was to be developed by private interests with the encouragement of the city, but without any direct financial investment by the city. The city contended that commencement of the Hilton Hotel would threaten the viability of its own downtown redevelopment project which had not yet located a private developer for the hotel.

To protect against development of the Hilton Hotel, the City enacted an ordinance amending the zoning regulations. The zoning amendment imposed upon developers the additional requirement that any proposed project be consistent with the objectives of the downtown redevelopment plan, as well as Richmond's master plan. On the basis of this new zoning ordinance, city officials denied the Hilton's petition for development approval because of concern about the economic viability of Richmond's downtown plan. The proposed Hilton was disapproved only two weeks after the zoning amendment was passed. The City of Richmond ultimately settled out of court for \$2 million plus attorney's fees,[32] despite the existence of several legal precedents that suggest that Richmond may have had a strong defense.

In the Richmond case, zoning was used to protect the viability of the City's downtown redevelopment plan. The salvaging of Richmond's downtown economy required a hotel, and such a hotel could not succeed unless the city prevented the construction of any competing hotel outside the development area. [33] Several recent federal cases support the proposition that regulatory action of the type taken in Richmond may validly benefit one competitor at the expense of another. [34] A municipality does not engage in an unlawful restraint of trade by rejecting a project that is contrary to the public's interest in downtown redevelopment.

A municipality's use of its regulatory powers to limit development may also be justified by the state action doctrine. [35] In order for anticompetitive conduct to gain protection under the state action doctrine, one of three conditions must be met:

- (1) the state must have a valid interest in displacing competition through regulation; [36] or
- (2) the state's policy to displace competition must be clearly articulated and affirmatively expressed; [37] or
- (3) the protected activity must be actively supervised by the state. [38]

The displacement of competition is authorized by the State legislatures and is supported by the federal courts. [39] In each instance, the court held that redevelopment of substandard and blighted areas was authorized by the legislature and immunized the city from antitrust liability. The prohibition of commercial development that conflicted with the city's redevelopment plan was proper because state urban development laws were clearly articulated state policies which authorized the displacement of competition. Zoning is therefore a proper mechanism for revitalizing depressed areas of the city.

Local laws and zoning ordinances, in particular, inevitably displace competition. Antitrust laws which are intended to promote competition inevitably collide with those state and local laws that have a tendency to displace competition. [40]

Government has traditionally stepped in where the private sector was unwilling or unable to supply needed services or where services which became essential were abused and misused by private enterprise for its own profit to the detriment of the public generally. [41]

Consequently, local government policy may even be antithetical to antitrust theory.

Other potential antitrust problems have not yet been resolved by the courts. The granting of tax abatements or the use of industrial revenue bonds has not been considered in any antitrust case, but municipal liability for such action is deemed unlikely.

[I]t would seem that a city would in general be as free from antitrust problems in choosing whom to

finance as is a bank. Liability would seem likely only in egregious situations of obvious impropriety, for example, an intentional effort in cooperation with one competitor for the direct purpose of destroying another. [42]

Another area of concern may be the matter of fee arrangements between municipality and developers.

The FCC has provisions that allow cities to charge [cable] T.V. companies a franchising fee of 2 to 5 percent of the revenue. Do these fees make regulatory activity into a proprietary activity? Is the city then a partner in a business venture, and how do the antitrust laws apply there? [43]

Unresolved then is the question as to whether the municipality's collection of a percentage of a development project's rents is a proprietary activity that subjects the city to antitrust liability.

Yet, even if a municipality's participation in public-private partnerships does subject the city to antitrust liability, such behavior would not conclusively be deemed unreasonable. [44] Courts would likely apply a "rule of reason" analysis to consider the validity of the municipality's behavior and would consider the nature of the restraint and its effect, actual or probable, the history of the restraint and the purpose or end sought to be attained. [45] Since a municipality's entrepreneurial activity is not motivated by mere profit alone, the public purpose of the municipal activity would justify any anticompetitive effects. It is, thus, highly likely that municipalities charged with anticompetitive behavior would survive scrutiny by the Court.

To protect itself against antitrust liability, the municipality can document its land use decisions to prevent claims of collusion. Perhaps the wisest course for municipalities to protect itself against possible liability is to be certain

that all land use decisions which are the basis of joint development ventures are made openly, in strict compliance with fair procedural standards, in recognition of conflicts of interest, and with a detailed disclosure of any economic or public interest considerations upon which they are based. [46] Municipalities' fear of liability may explain why some cities have not adequately protected their legal and financial interests when negotiating development agreements. One nationally known municipal defense counsel suggests that municipalities are approving many more projects than they normally would to avoid any appearance of improprieties. [47]

Nonetheless, the difficulties in pursuing an antitrust action against a municipality are numerous and onerous. A city's use of its regulatory powers to restrict development will receive judicial protection as a state sanctioned activity. Courts are likely to immunize many municipal development activities from antitrust liability, even when the effect of a city's regulation is to block projects that compete with their own. Furthermore, proof of conspiracy between a municipality and a developer is almost impossible to prove because an inference of collusive behavior cannot be drawn by evidence of a developer's support for subsequently enacted zoning changes. [48]

Courts have unambiguously sanctioned an entrepreneurial role for municipalities. The revitalization of downtown and the use of financial incentives for development is a valid public purpose and is within the realm of acceptable municipal behavior. Unless cities engage in patently collusive behavior, municipalities would not become subject to liability for the preferential or anticompetitive treatment of development which the city fosters. The participation

by a municipality in proprietary activities is judicially sanctioned: (1) so long as the city has a valid interest in participating in downtown development; and, (2) such municipal activity is a clearly articulated state legislative policy. Because the revitalization of downtown is a valid public purpose and a clearly articulated state policy, a municipality may pursue revitalization by displacing competition and, ultimately, by sharing in the profits of downtown development as well.

Despite the clearly sanctioned entrepreneurial role of municipalities, cities have only timidly assumed this entrepreneurial function. Perhaps municipal officials are reluctant to assume the more aggressive role of profit earner because of their misperception that the capacity to earn profits is an invalid or questionable governmental activity. One can speculate that municipal officials, unlike the courts, more cynically question the validity of innovative, proprietary activities. The perception of municipal officials that they are legally constrained from sharing the profits of publicly subsidized development may be the biggest stumbling block to the effective recapture of development subsidies. This may be a rationale for the timid negotiating stance of some municipal officials.

The failure of cities to secure for themselves a share of project profits may be illustrated by several highly touted public-private partnerships. The following chapter will describe the development experiences in the cities of Yonkers, Detroit and Hartford.

Chapter Three

DEVELOPMENT PARTNERSHIPS: ILLUSTRATIONS OF FAILED ATTEMPTS AT PROFIT SHARING

In addition to the legal rationale, municipal involvement in downtown development is justified on several economic grounds. First of all, local government is financially capable of combatting the shortcomings of the capital market which tends to be averse to risk and geared towards short term return. Government can more effectively pool the risks of projects that it participates in since the likelihood of failure is far greater for an individual private investor. Government has stability because of its size; therefore, its investment decisions can be more rational and foresighted. Municipal aid to private investors lowers the risk inherent in land development and makes downtown development a more attractive investment opportunity.

To encourage downtown development, cities have used several mechanisms to lower the risks of developers. In the last several decades, municipalities have used its resources to elicit and leverage private downtown investment. The use of tax increment financing, the abatement or exemption of taxes, the provision of direct loans and even the use of ground leases all lower the developer's up-front risk and encourage their participation in downtown development.

Cities have employed financial inducements to stimulate or maintain

industrial development. However, the economic benefits secured for those cities and their residents may prove tenuous, at best. Yonkers and Detroit offer useful illustrations of cities which have contributed significant aid for development projects they were anxious to attain without securing binding commitments for a return on their public expenditures.

Cities also have historically fostered development by reducing or stabilizing taxes, or with more traditional incentives such as grants, site assembly (with write-down of costs), utility and street improvements, or public financing of garages. More recently, cities have become involved in the leasing of both land and buildings, making loan commitments, and sharing operating and capital costs. Subsidies provided by municipalities have served to spread the risks of development among both public and private participants by lowering the equity required of developers. Thus, the partnerships of today are often characterized as joint development activities in which both partners share more fully in the costs and risks associated with economic development.

The projects in Yonkers, Detroit and Hartford are described in this chapter because of the high visibility of joint development ventures in those three cities. In Yonkers, New York, city officials have been greatly disappointed over their participation in the expansion of an industrial facility for the Otis Elevator Company. Recently, Yonkers brought their claims against Otis to federal court. In Detroit, Michigan, the city contributed a major share of the equity in an industrial project which is one of the most ambitious public-private urban development ventures ever undertaken. There, too, the city may have failed to secure a minimal return on its massive public expenditures. Finally, in Hartford, Connecticut, the municipality has been participating in several highly regarded partnerships with

private developers. Yet, despite the city's unusual opportunity to share in project profits, Hartford has yet to procure any income from its development efforts. Among the most heralded public-private partnerships are those in the City of Hartford where the municipality has leased land and provided an abatement of taxes for the construction of office buildings by regional developers. Yet, early enthusiastic projections of project profits remain unfulfilled. Hartford offers another illustration of a city that failed to successfully pursue its entrepreneurial function.

(a) The City of Yonkers

In Yonkers, New York, during the early 1970's, Otis Elevator Company, the city's largest employer, urged the city to assist the company in securing land needed for the expansion of the industrial facility. The company threatened to leave Yonkers if it could not expand its facility to land adjacent to the Otis plant. Faced with the prospect of a loss of several hundred jobs integral to the city's economy, Yonkers condemned the property under the state sanctioned powers of urban renewal. The condemnation withstood court challenges despite the fact that: (1) the city openly signed an agreement with Otis before taking the property; and (2) Otis openly expressed a desire to acquire the land to assure its own economic viability in Yonkers. [1] In 1972, the City of Yonkers sold nine acres of land to Otis to facilitate construction of a new plant. The parcel was sold for a mere one tenth its cost to the city. Otis accepted the land for expansion of its existing plant in exchange for a written promise to the city to boost local employment. At public hearings, local company officials projected the creation of up to 600 new jobs. Otis

signed a letter of intent to retain facilities and jobs in Yonkers. However, when Otis took title to the land two years later, Yonkers released the company of any remaining obligations of this letter as a sign of good faith.[2]

In the years following Otis' construction of the new manufacturing facility, orders for gearless machines plunged by 75% in less than four years, and employment steadily declined. By 1983, only 350 workers (down from a high of 1400 in 1977) remained at the plant. Otis subsequently consolidated its operations at the request of its parent company, United Technologies of Hartford, Connecticut, and Otis finally left the City of Yonkers. The city is now suing Otis contending that the company was unjustly enriched by the massive public expenditures used to entice the company to remain.[3]

Yonkers claims that Otis failed to give the city a "reasonable" time to recover the investment and expenses made on behalf of the elevator company. It is seeking \$16 million from Otis for the cost of acquiring and preparing the land a decade earlier. While Otis claims no promises were made, the city asserts the existence of an implied contract. No formal binding commitment between the parties exists and the dispute is now before a federal district judge in New York. [4]

(b) The City of Detroit

A similar course of events transpired in Detroit, Michigan. There, too, one of the city's largest industrial employers, General Motors, threatened to leave the city, along with 3,800 jobs (amounting to one third of Detroit's manufacturing jobs) if a suitable location for G.M. was not found. G.M. offered to build a new industrial plant to replace two outmoded facilities, and preserve several thousand

factory jobs in the process. The company told Detroit officials that in light of its special requirements, only one feasible location existed in the city for its plant; moreover, it threatened to leave Detroit if it could not have this site. If the city succeeded in delivering the site, G.M. offered the prospect of retaining and creating as many as 8,000 permanent jobs, generating a projected \$42 million in new business activity and increasing Detroit's property tax base by 4.5%. The city concluded that failure to produce the site would result in "unacceptably high" economic losses to the industrial employment and revenue base of Detroit. [5]

Extensive residential and commercial condemnations were necessary to prepare the 465-acre site for development by G.M. The City of Detroit spent \$200 million to condemn and acquire 1200 parcels of land, relocate 3800 residents, and clear the site for disposition to G.M. This land was subsequently conveyed to G.M. at one twentieth of the cost to the city. Detroit assumed an enormous financial burden in a project that was described as "one of the most dramatic and ambitious cooperative public-private urban development ventures ever undertaken." [6] The development of the G.M. facility in Detroit makes use of a federal subsidy of \$30 million, which at the time of the award had been the largest Urban Development Action Grant ever awarded a single development project. Furthermore, the City of Detroit provided G.M. with a twelve-year 50% tax abatement. As a consequence, the prospect of projected tax gain is even further delayed. The city, by its disposition of the site, provided a major share of the equity and assumed much of the risk for the project. However, more than three years after the projected starting date of the plant's operation, the G.M. facility has not yet begun production.[7]

Five years have passed since the City of Detroit offered to participate in, and expedite the development of, a new facility for G.M. Although nearly 30% of

the capital needed for development of the G.M. facility was provided by Detroit, the city has not yet benefitted from the additional tax revenue, nor from the creation of permanent jobs it anticipated when it entered into this agreement and partnership. [8] In addition, the City of Detroit does not have legal recourse against G.M. Although the disposition of land to G.M. could be characterized as an investment of equity in the project, the City of Detroit made no provision to eventually share in the proceeds of the plant. Nor has the city required the pay-back of loans or the reimbursement of land acquisition costs. As in Yonkers, the city failed to secure any formally binding commitments from the company.

G.M., in its defense, may assert that the failure to complete construction as scheduled illustrates the risks and uncertainties which accompany any major development project. [9] And, as was claimed by the Otis Elevator Company, the failure to begin production at the plant may be attributed to "market conditions" which the company is powerless to control. [10] However, these claims do not justify the failure of a publicly-subsidized company to maintain its commitments since contractual agreements may always be conditioned on market fluctuations, such as level of sales or rate of inflation.

The experiences of Yonkers and Detroit illustrate the importance to the city of obtaining a minimum financial return. In Yonkers and Detroit, the city could have maintained a reversionary interest in the property conveyed, respectively, to Otis and G.M. Ownership of the property could revert to the municipality if the subsidized company were to abandon the city. Alternatively, the city could specify in its agreement with the developer that it share the proceeds from the sale of land or the industrial plant. Several reasons justify a municipality's efforts to share in the benefits of development it helps facilitate.

Sharing the proceeds of development can recapture the public subsidy easing the government's ultimate financial burden. The recapture of public investment can also increase future community benefits which directly result from such projects.[11]

(c) The City of Hartford

The City of Hartford provides a context within which to examine the efficacy of profit-sharing mechanisms which were explicitly incorporated into public-private partnership agreements for the development of downtown office buildings. In Hartford, during the last few years, city officials entered into formal agreements which allow for the sharing of profits with the developer. What follows is a brief description of Hartford's experience to spur downtown development, and an assessment of the lessons to be learned from those efforts.

In the 1970's, David Chase of Chase Enterprises, a major Hartford developer, made a proposal to city officials for the development of an office building in downtown Hartford, an area that had not seen any major office construction in nearly a decade. In exchange for land leased from the city, and in consideration of a tax abatement that would run for 20 years, Chase offered to construct a 385,000 square foot office tower and gave the city the potential to share in the building's profits. Chase's reputation as a developer in Hartford was established in the mid-1970's when he invigorated the Hartford office market with the construction of Financial Plaza and earned for Chase a reputation as a risk taker. "The marketplace determines how well any of us do," said Chase. Developers can afford things like [sharing in profits] under the right circumstances and to a

limited degree." [12]

The tax abatement for the new office building appealed to Chase because it signified that the city would share his risk in undertaking a \$30 million project. The prospect of profit participation appealed to the city because it meant that Hartford was to receive 50% of the net cash flow for the project. [13]

The technique used in Hartford to increase public sector rewards is called a percentage-rent ground lease agreement. [14] City-owned land is leased in exchange for a percentage of the project's income and the payment of rents in-lieu of taxes. A long term ground lease permits the municipality to share in the income of a project while expanding the leverage of developers. A properly structured ground lease can decrease the developer's equity investment by eliminating the purchase price of land or the developer's exposure to risk. The ground lease is usually subordinated, i.e., the city executes a mortgage of its land as security for the development loan made to the lessee. For the developer, such long term leases can greatly improve the net return on investment through improved financing terms, reductions in equity outlays and tax advantages. As a result, the developer's leverage is increased at little cost to the city. [15] The lease agreement would require a minimum base payment plus a percentage of income generated by the project. If the project does well, the city shares in the income and will recover some or all of its costs. Lease agreements may require in-lieu of tax payments to the city based on per square footage of building space. These payments provide tax certainty to developers and assures them that tax increases will come only after designated time periods and in predetermined amounts.

Chase, the developer of the building known as Corporate Center, or the "Stilts" Building, projected that the city's share of office rentals during the first

year of the building's operation would be \$1 million, substantially more than the tax bill for the property prior to development (which was then \$654,500 annually).[17] The Hartford Courant attributed one source close to the project suggesting that the figure could run as high as \$1.5 million. Chase, who was the only developer in Hartford to agree to share profits in exchange for tax cuts, confirmed in 1981 that the city would receive profits of \$3 per square foot *above* the \$1.70 per square foot rate normally assessed under the standard tax formula. [18] In 1981, during the first year of the project, rents for the Stilts Building were projected at \$20-\$22 per square foot, twice the level that had been anticipated when the lease was signed several years earlier. At the time, Chase said he would stand by the agreement and not ask the city to renegotiate the profit sharing formula. [19] However, more recently, the general counsel for Chase revealed that the developer was so concerned over the extent of rental income that might be owed the city that Chase was "seriously considering buying out of the agreement" in order to pay the lower, standard amount of taxes. [20]

Negotiations for the tax abatement and lease for the Stilts building had been characterized by overly optimistic projections of earnings. Chase had suggested to municipal officials that the City of Hartford would receive a minimum of \$340,000 during each of the first five years of the building's operation. None of these projections have materialized. During the third year of the building's operation, the financial statement submitted by the developer revealed an operating deficiency of nearly \$600,000 despite vacancies of perhaps no more than 5%. [21] Four years into the project's operation, the city has yet to share any "profits" from the property. Had the property not been subject to a tax abatement, the City of Hartford would have received \$1 million in taxes for the current year.

[22] The discrepancy between projected and actual earnings is explained by the developer as a consequence of competitive development forcing rental rates down. Thus, the projections made in 1981 were overly optimistic. In only "a matter of time," the city will be sharing in the profits, claims the developer. [23] However, unless the building is refinanced or sold in the near future, the verdict on the success of the agreement will not be known for years.

The lease for the Stilts Building contained the following provisions for payment of minimum rental and in-lieu of tax payments. During the first four years of the building's operation, the minimum in-lieu of tax payment ranged from a low of \$10,000 to a high of \$160,000 after 15 years. The lease required a minimum base rental of \$75,000 per year, plus \$5,000 in back rent accrued during construction, plus 10% of the net cash flow. As additional payments in lieu of taxes, the city was owed 40% of the net cash flow: at least \$10,000 during the first four years, and a minimum of \$160,000 during the last five years of the 20-year tax agreement. In addition, 50% of the profits from any resale or refinancing would accrue to the city, offering the greatest potential yield to the city.

Chase explained that the discrepancy between projected and actual earnings was based on changed market conditions. "At different times, we thought [the city] would be sharing much earlier, but the market changed." [24] For the last three years, the financial figures for the project were similar and the developer insisted that there was no dispute with the city. "The auditing firm for the city has never disagreed with us about how we approach the cash flow formula. "The auditing firm for the city signed off on everything and said everything we were doing was fine," said Chase. [25]

Indeed, Chase has operated well within its legal rights and has complied

with all technical reporting requirements. Nevertheless, many city officials are disappointed and frustrated over the city's financial returns because the leasing arrangement should have been "an absolute bonanza" for Hartford. [26] The leasing arrangement for the Stilts Building did not meet the expectations of the City, according to Woodrow Wilson Gaitor, the city manager for Hartford during negotiations for the project. Gaitor felt the award of contracts for the project was "somewhat political." The land, he explained, was held by one of the members of the city council, and Chase was the only one to bid on the property. [27] City Councilman Alan Taylor suggested that the project had been refinanced under a loophole in the contract. [28] Another suggestion offered to explain the discrepancy in projected profit figures is that office space is rented to Chase-affiliated organizations at "below-market" rates.[29] This project, said Councilman Taylor, "should not be a model for public-private partnership." [30]

The enormous complexity of drafting of commercial lease agreements may have been a further source of confusion to the City of Hartford. Anticipating problems and preventing potential conflicts between the parties to the agreement require very fine drafting. Terms and concepts within the contract must be precisely defined. For example, the lease agreement must determine whether the rent schedule will be based on a percentage of income. The total project costs must be accurately defined to determine whether they include construction costs or developer's overhead. If developer's overhead is included, the lease should specify whether overhead will be calculated on a per unit or per project basis. Operating and maintenance expenses must be defined and the extent to which these figures are deducted from net cash flow must be determined. Unless the lease agreement is carefully drafted and thoughtfully structured, a developer may be able to avoid the

requirement of sharing profits by using various creative write-offs.

The city's task of monitoring very complex leasing agreements presents officials with "an administrative nightmare." [31] Moreover, Chase's method of operation has not been particularly helpful to the city. The developer characterized the city's monitoring of the lease agreement as problem-free because Chase "inundates" the city with quarterly financial statements, audits and other records to "educate" them about the development process. [32] However, according to a Hartford attorney who has negotiated several leases with Chase, even a "Big-eight" accounting firm would have difficulty in ascertaining whether the developer is fully complying with the terms of the agreement. [33]

Although the City of Hartford has not yet had the opportunity to share in the profits of the Stilts Building, city officials characterize the lease agreement as mutually beneficial. Former city manager Woodrow Gaitor readily concedes that when the lease for the Stilts Building was negotiated, it was "a good deal" for the city. The building was the first major downtown project in an area that, until then, had seen very little development, and even fewer prospects for revitalization in the future.[34] Public and private sector participants both receive benefits from their participation. The developer receives a tax abatement and need not risk as much up-front cash. The city gets a new office building and benefits from revitalization of downtown. Hartford's Director of Development, William Cochran, concluded that by the end of the 20-year abatement period, the city would be collecting far more than the amount of full taxes owed for the parcel.[35] Consequently, the lease for the Stilts Building has been a model for several other development projects in and outside of Hartford.

Across the street from the Stilts Building, a new office tower known as

Commercial Plaza was developed by Chase with another similar lease agreement from the city. The agreement assesses minimum rental payments in exchange for a 20-year tax abatement. One interesting dilemma not contemplated at the time the lease was written concerns the sale to a tenant of the top three floors of the office building. The transaction was characterized by Chase as a 99-year *prepaid* lease and not as a sale for which the developer would be obliged to share with the city 50% of the proceeds. Because of the agreement's ambiguous language, the City of Hartford was left with no legal recourse. [36] This highlights the difficulty that cities experience in drafting agreements that fully protect their interests.

Chase has recently taken his entrepreneurial spirit and the lessons learned in Hartford to the City of New Haven. In conjunction with the developer Olympia & York, Chase developed a proposal for a Government Center complex for the City of New Haven. The \$87.5 million development proposal calls for the construction of 420,000 square feet of office space, erection of a new city hall annex, and construction of parking. The City of New Haven will be leasing land for development for 125 years and will also provide a 20-year tax abatement. The developer has agreed to make minimum rental payments, in addition to a percentage of the net cash flow during the 20-year abatement period.

The lease for New Haven Government Center is structured much like the lease agreements between Chase and the City of Hartford, with one major exception. In New Haven, the lease reserves for the developer the right to "buy-out" the tax abatement, a right which Chase apparently sought during the early years of the tax agreement for the Stilts Building in Hartford. This "buy-out" provision permits cancellation of the tax abatement at the option of the developer, and for the subsequent appraisal of full taxes for the property in the event the project is

unusually successful. If the developer decides to cancel the abatement, a "transition impositions" rent is applicable. For the first five years, this rental would be \$1 million. [37]

Chase characterized this "buy-out" provision as "the best of both worlds for the city and ourselves." The city, Chase reasons, is primarily interested in taxes and jobs and is not looking at profit sharing per se. "Sometimes you can't measure the city's objectives in dollars," explained the developer. [38] Indeed, attorneys who are negotiating the lease on behalf of the City of New Haven agree that the focal point of the agreement and the primary interest to the City of New Haven is the construction of a new City Hall annex by the developer, Chase. [39]

The construction of the Government Center project rests on several forms of public support. First, the project is subsidized by a UDAG loan for construction of the City Hall annex. The loan does not charge interest for the first five years, and thereafter, the rate is 4.5%. The loan is also subordinate to the developer's project loans. The second form of public support is the 125-year lease of land and the 20-year tax abatement. Lastly, the city has offered to construct an underground road leading to the parking facility for the Government Center complex. [40]

The lease for New Haven's Government Center is characterized by a tax financing formula, a provision for buy-out of the tax abatement and a complex formula for net cash flow participation. The lease calls for minimum rental payments for the first ten years, and a fixed in-lieu of tax payment during the first five years. The percentage pilot rent of 50% of "net available cash" is to be determined by deducting from the gross revenue all expenses including debt repayment deposits, minimum rents, UDAG payments, and operating deficit

advances. A supplementary rent is also required by the lease providing the city a share of profits upon sale of the property. In adopting this provision of the lease, the City of New Haven took a cue from the Hartford experience with the Chase project at Commercial Plaza. The lease agreement for the Government Center project characterizes the sale to tenants of units or floors of the office complex as a sale, and not as a prepaid rental payment for the duration of the lease. Fifty per cent of the net cash proceeds of such sales would accrue to the City of New Haven.[41]

The experience of Hartford highlights the difficulties of securing for a city a share of the profits of a project that it assisted with subsidies and other aid. Nonetheless, Hartford's experience does not negate the effect of a city's participation in profit sharing arrangements, nor does it diminish the importance of a city's participation in downtown development. A city's decision to encourage and participate in a development project need not depend on a "bottom line" assessment of losses and profits. Other criteria can be used to evaluate the effectiveness of a municipality's entrepreneurial activity. When the prospects for return include enhanced job opportunities, new tax revenues or a revitalized commercial district, these criteria can also justify municipal participation in joint development partnerships.

An analysis of the various projects discussed in this chapter demonstrates that when municipalities participate in joint development ventures, securing a share of project income is often not of primary or overriding importance to the city. In Hartford, we saw how the city leased a site for office construction in exchange for a share of the profits. During the first few years of the project's operation, the income to the city did not yield the financial bonanza it

anticipated. Even when the sale of several floors of a Hartford office building offered the city, for the first time, an opportunity to share substantially in proceeds, the city was precluded from sharing in the profits because of ambiguities in the lease. Nevertheless, even those who suggest the lease has not met the city's expectations acknowledge that the financial incentives embodied in the ground lease brought benefits to the city that are difficult to quantify. The city's willingness to share development risks has, in the opinion of city officials, effected a boom in office construction in areas that had not previously experienced significant construction activity.

In New Haven, as well, the potential to share in the profits of publicly subsidized development is a prime element of a lease now being negotiated to develop a Government Center/office complex. The existence in the lease of a provision permitting the developer to "buy-out" the profit sharing requirement if the city's share of earnings exceed the ordinary level of taxes appears to negate any possibility for the city to actually share in the profits. The implication is that the city's annual return from the project will never exceed the ordinary level of taxes for the property. However, the city will derive other public benefits. In addition to a boost in the city's economy resulting from new office construction, the city will benefit from the construction of a new City Hall annex which is highly desired by the City of New Haven.

New Haven may not earn an attractive return on their investment but their future interests are protected by a 1976 lease agreement which secures for them a minimum recapture of the public subsidy. Furthermore, the contractual protection offered by the lease is an important mechanism for controlling the form and nature of development in the city. Moreover, the ground lease secures for the

city a highly needed public amenity in the form of a new City Hall annex. Finally, the lease provides the city with a minimum financial return which is far more than the cities of Yonkers and Detroit obtained when they offered incentives to local industry.

Chapter Four

CONCLUSIONS, REMEDIES AND FUTURE PROSPECTS

Cities need not be compelled to balance their investment in private development against the potential financial yield that a project may return. In Yonkers and in Detroit, city officials may have been negligent in failing to secure for the city a formally binding agreement in exchange for the city's good faith investment in local industry. Nevertheless, after assessing the city's options, officials of both Detroit and Yonkers concluded that they had to provide such subsidies or risk unacceptably high economic losses.

The offer of subsidies by Detroit and Yonkers without any formal binding commitment suggests that the private investor has greater bargaining power than the city since the company can simply "pack its bags" and leave town. The experience of Yonkers and Detroit also suggests that the offer of lucrative development incentives by one city can encourage competing municipalities to follow suit.

Once a locality does grant land on "give-away" terms, other localities may feel obligated to follow its lead in order to preserve their industrial job bases. Not only do taxpayers suffer, but all the firms that had located in the jurisdiction earlier risk having to compete with newcomers whose rents they have, in effect, subsidized through their own taxes. [1]

In the final analysis, a company that is subsidized, as G.M. was in Detroit, will benefit from the subsidy, as would the city who maintains the industry. However,

the benefits to Detroit may be gained at the cost of economic efficiency.

The use of subsidies to inspire development could be characterized as a transfer of development costs from the developer to the taxpayer. In a Wall Street Journal editorial criticizing the UDAG program, the Journal maintained that:

In most cases, stores, factories and homes that were economically justifiable would have been built anyway, albeit possibly in a different part of town. The effects on the economy would be the same, although most likely with some improvement in efficiency brought about by better siting [2]

Economic inefficiency may be resolved by greater collusion and cooperation among the cities. However, unless federal urban policy effectively discourages the extension of subsidies except when absolutely necessary, individual municipalities may remain at a competitive disadvantage. To overcome that disadvantage, municipalities may need to secure a minimum return on their development subsidies through recapture provisions.

Municipal efforts to obtain a share in the income of a project may be characterized as the recapture of the value of a public subsidy. "Value capture" is a policy term used to connote public efforts to defray the outlay of public funds by capturing the value of public investment which traditionally accrues to private interests. [3] This theory is comparable to the late Donald Hagman's proposals known as "windfalls for wipeouts." Hagman suggested schemes for compensating people whose land is injured by governmental activity, and to recoup for the public some portion of the increased land values resulting from public actions. [4] The roots of value capture policy lie in the policy area of urban mass transit development. Publicly funded development, such as urban rapid transit systems, has resulted in the accrual of value, and, in some cases, a windfall to private

landowners. The value of public investments has been recaptured through the use of excess condemnation, special benefit assessment districts, special tax assessments and air rights development. Moreover, it has enabled the public authority charged with mass transit development "to reap the fruit of their own efforts." Recapturing the excess value created by the vast expenditure of public funds has permitted the government agency to recycle the public financing, and allows municipalities to be perpetually capable of enhancing downtown development. [5]

Lessons for recapturing the value of public subsidies can be taken from other contexts, as well. For instance, in terms of health care the federal government requires private hospitals to provide a minimum level of free services if their construction was subsidized by federal grants. The federal Hill-Burton Act requires that recipients of federal grants for the construction of hospital and health care facilities provide "a reasonable volume of services to persons unable to pay therefor." [6] Hospitals who receive Hill-Burton funding must make free services available at a level not less than 3% of operating costs; or equal to 10% of all federal assistance provided. [7] The requirement that free services be made available remains in effect for not more than 20 years after completion of construction of the hospital facility or beyond the period that the loan remains unpaid. [8]

A similar statutory requirement could be imposed on developers of publicly-subsidized projects. Under appropriate circumstances, developers could be assessed a percentage of their earnings, as an exaction to support some public good or service. This is already happening in the cities of Boston and San Francisco where "linkage" programs impose upon developers of downtown office buildings an exaction of funding to support construction of low and moderate income housing

within the city. [9] Such evidence supports the contention that value capture policies may be implemented in joint ventures between public and private parties so that both municipality and developer can benefit from government inspired development.

The recapture of municipal development subsidies and the allocation of project earnings among both public and private sector participants may encourage additional development projects, even when efforts to share profits are of limited financial success. That explains why the Hartford experience with profit sharing, although beset with disappointments and misunderstandings, has still been the model for other joint development projects in Hartford, and in New Haven as well. Furthermore, New Haven's ability to direct development in the interests of the city is another example of the benefits of a municipality's entrepreneurial activity. Ultimately, the capacity for both government participant and private developer to derive mutual benefit will contribute to the more widespread use of risk sharing and profit sharing as tools for inspiring economic development.

The UDAG program offers an illustration of value capture techniques.[10] The recapture of UDAG funds is important because it can facilitate a movement towards local self-sufficiency. In view of declining federal aid, resistance to higher taxes, and the high cost of bond issues, the recycling of public development funds may be the only way for cities to assure themselves of future revenue for housing, community and economic development activities. [11] The UDAG program uses several mechanisms to recapture public funds used to subsidize development: (1) land disposition, which allows for the sale of publicly-owned land; (2) lease agreements, which provide that a share of the net proceeds or a share of the income, cash flow or rents of a private development project go to the

municipality; and (3) net cash flow and equity participation which permit a city to share net cash flow after the developer receives a specified return. [12] In 1980, 62% of UDAG projects included such provisions for recapture. [13] Together, these mechanisms help to ensure that municipalities share in the value generated by public investments.

In addition to providing low interest loans, UDAG grants also support city-constructed public improvements, transportation-related improvements and funds for acquisition, preparation and clearance of sites. Awards of UDAG grants by the federal Department of Housing and Urban Development are based on competitive, discretionary criteria that consider:

- the leveraging ratio of private dollars to public dollars (a minimum of \$2.5 private dollars for each public dollar invested);
- job generation (a minimum of 1 new job to every \$10,000 granted is expected);
- anticipated increases in tax revenue;
- the city's past performance in housing and community development;
- the impact of the project on the city's physical and economic condition;
- timely completion of project;
- extent of commercial and residential relocation required; and
- the city's ranking on HUD's list of distressed cities. [14]

Participation in the UDAG program requires legally binding commitment letters from the developer and the approval of contracts between the city and participating private parties. Each grant is negotiated individually. Developers are usually expected to guarantee project completion and offer a personal guarantee to repay the loan, as well. Interim financing commitments must be secured and letters of commitment from conventional lenders must be obtained. Interest payments during the early years of a project are normally forgiven, but once the

project is operational, the developer is expected to share a percentage of the income with the municipality. UDAG funds have been used for direct incentives such as below market rate loans for rehabilitation, interest subsidies, land value write-downs and on-site improvements.

Municipalities who sponsor UDAG supported projects benefit from the developer's pay-back of the federal subsidy to the locality. Although the recovery of this subsidy does not constitute a share of project profits, the pay-back is a discrete financial benefit and can arguably be characterized as a form of profit. [15] Indeed, the UDAG program was not designed for the purpose of providing "one-time development expenditures"; UDAG funding is meant to be an "investment" enabling municipalities to recapture and recycle funds for future development projects. [16]

Tax abatements are generally discouraged by UDAG officials "unless the city absolutely convinces us that in a given case it's the only way to make a deal work." [17] This comment, from David Cordish, the Director of the UDAG Office at the time of the program's inception during the Carter administration, belies the widespread use tax abatements for development, even among UDAG funded projects. One out of every four UDAG projects is supported by tax abatements, [18] despite efforts by HUD officials to discourage their use. Thus, the projected increases in local public finance may not be accurate indicators of the return to the municipality. Each UDAG dollar is expected to secure an additional 16 cents in tax revenues on an annual basis. [19] When lucrative tax abatements are given these projects, municipalities may not even experience any net local tax gains. [20] This is particularly true in the case of Detroit's assistance in the development of the new G.M. facility in Poletown. That project makes use of a \$30 million subsidy, the

largest federal grant ever awarded a single development project until then. The City of Detroit also provided G.M. with a 50% tax abatement. Consequently, many municipalities who participate in UDAG-funded projects may not be experiencing any net tax gains for many years to come.

HUD officials have been urging localities to include "kicker" provisions to increase the city's rate of return on investment. The "kicker" provision, when incorporated in the development agreement, provides the city with a share of the project income based on a percentage of earnings when the development becomes operational. Susan Clarke reports that many cities are reluctant to include "kicker" provisions in UDAG agreements for fear of "jeopardizing private sector participation." [21] Although statistics are not available on the extent to which "kicker" provisions are a part of UDAG agreements, Clarke reports that HUD's brokerage role has helped encourage the sharing of profits and net cash proceeds. [22] As a consequence of prodding by federal UDAG program administrators, municipalities' behavior and perceptions about their role in the development process may have begun to change. In some measure due to the UDAG program, cities are learning to become more sophisticated in their negotiation of development agreements, and more entrepreneurial in their pursuit of a share of project income.

Many of the more innovative profit sharing agreements between localities and developers were made possible because of the UDAG program which extends public subsidies to developers when capital financing is otherwise unavailable. Required by law to be the lowest amount necessary to make the project feasible, UDAG subsidies are granted to projects that demonstrate a capacity to leverage private investment, and a potential for increasing tax revenues and

generating new job opportunities. The UDAG program is structured on the premise that a developer should get a fair return on its investment, not a windfall.[23]

One development project which seems to have incorporated the principles embodied in the UDAG program is the Syracuse University hotel and conference center. The center, jointly developed by the university and the City of Syracuse, offers an unusual illustration of a project that involves a direct investment in development by the city. The conference center provides for a unique form of public financing. It is a "one-of-a-kind" condominium investment hotel in which the city bought the first 29 rooms with a \$3.8 million UDAG subsidy. Other private investors are buying the hotel's remaining two hundred rooms, individually, and in condominium fashion.

"This is first and foremost a business investment," says David Michael, the city's commissioner of economic development. "Prospective owners will be looking at tax shelters, depreciation opportunities, and resale values." . . . The hotel management [to be a franchise operation under Sheraton Inns, Inc.] will book the vacant rooms in the customary hotel fashion and will pool all income. Then shares of the profits from the hotel operations will go out quarterly to all individual condominium owners. The city, because the Syracuse Economic Development Corporation owns those first 29 units, will share in the profits of the hotel operations, as well as those from the eventual resales of the individual rooms.[24]

However, the likely accrual of profits inherent in the project will not evolve at the expense of other public needs. The development of a conference center by the City of Syracuse brings public benefits to the city and is not strictly a "business investment" as it was characterized by the City Development Commissioner. Indeed, the competitive, discretionary criteria of the UDAG program would not permit the award of a subsidy to be used as a mere business investment by the city. In addition

to a share of the profits, Syracuse will derive economic benefits which include the creation of 300 new jobs, construction of the city's first hotel/conference center and an anticipated increase in the city's tax revenues. [25]

The federal UDAG program seeks to encourage entrepreneurial activity of the kind initiated by the City of Syracuse. Several elements of the UDAG program make this policy objective possible. First of all, the UDAG program requires maximum leveraging of private dollars against public subsidies. Secondly, development subsidies are awarded only to projects which would likely generate new jobs and new tax revenues. Furthermore, the award of subsidies is usually conditioned on a pay-back of the subsidy, thus effecting a recapture of public investment. Recapture of the public subsidy allows additional municipal investment in development and reinforces the city's entrepreneurial role.

Without the strong guidance of federal policy directives, however, cities would not likely pursue a direct return on publicly subsidized development. The competition among municipalities across the country to extend subsidies and incentives to attract development puts individual cities at a competitive disadvantage. In the absence of collusion and cooperation among the cities, only a uniform national policy could encourage municipalities to demand a minimal recapture of public subsidies. Without minimum guidelines which dictate municipal development policy, some cities may continue to undercut their own financial interests, as may have happened in Yonkers and Detroit, in their zeal to attract and maintain downtown development. Furthermore, urban development guidelines must originate at the national rather than the local or state level because the federal government remains the most important source of public subsidies for downtown development. Accordingly, it is the most logical and most effective

source of regulation. State government could also initiate such municipal development policy, but only uniform national guidelines would likely eliminate the competitive negotiating edge of municipalities who are not similarly regulated by state guidelines. The characteristics of an effective municipal development policy would require further and more extensive study.

The failure of municipalities to secure a share of project profits can be reversed by implementation of a national urban development policy that requires city officials to recapture the value of public development subsidies. Only strong uniform federal guidelines can strengthen the city's hand in negotiating joint development agreements and offer the assurance that municipal officials in Yonkers, Detroit and Hartford will secure a greater and more direct return on the city's publicly subsidized development.

NOTES

Chapter One

1. See the text adjoining Note 10, Chapter Three.
2. See the text adjoining Note 13, Chapter Four.

Chapter Two

1. See, e.g., Bernard J. Frieden and Lynne B. Sagalyn, *Downtown Shopping Malls and the New Public-Private Strategy: Working Paper*. Cambridge: Massachusetts Institute of Technology, 1984.

2. The Fifth amendment of the United States Constitution limits the exercise of the sovereign power of eminent domain by requiring that takings meet a "public use." State constitutions have similar restrictions. See, e.g., Mass. Const., Pt. I., Art. X.

3. See, e.g., Fla. Const. Art. 7, Section 10; Minn. Const. Art. 11, Section 2; Oregon Const. Art. XI, Sections 7, 9. See also, D. Lawrence, "Constitutional Limitations on Governmental Participation in Development Projects," 35 *Vanderbilt Law Rev.* 277, 278 (1982), hereafter "Lawrence."

4. Pinsky, "State Constitutional Limitations on Public Industrial Financing: An Historical and Economic Approach," 111 *Univ. of Penn. Law Rev.* 265, 278 (1963), hereafter "Pinsky."

5. D. Lawrence, "Constitutional Limitations on Government Participation in Development Projects," 35 *Vanderbilt Law Rev.* 277 (1982).

6. Even the leasing of private commercial space in a publicly owned garage is proper because the revitalization of a city's downtown is a public purpose. See, e.g., *State v. Coghill*, 207 S.E.2d 113 (W. Va. 1973). The analysis employed by the court in this case is typical of the reasoning employed by courts throughout the country to defend municipal activities to revitalize the city's downtown.

7. Pinsky, p. 323.
8. Nichols, "The Meaning of Public Use in the Law of Eminent Domain," 20 *Boston Univ. Law Rev.* 615, 618 (1940).
9. Talbot v. Hudson, 82 Mass. 417 (1860).
10. See discussion of this industrial development project in the City of Detroit in Chapter Three, Section (b).
11. Poletown Neighborhood Council v. City of Detroit, 304 N.W.2d 455 (Michigan 1981).
12. See, e.g., T. Ross, "Transferring Land to Private Entities By Eminent Domain," 51 *Geo. Washington Univ. Law Rev.* 355 (1983).
13. See, e.g., P. Millspaugh, "Eminent Domain: Is It Getting Out of Hand?" 11 *Real Estate Law Journal* 99 (1982).
14. Berman v. Parker, 348 U.S. 26 (1954).
15. New York City Housing Authority v. Muller, 1 N.E.2d 153 (1936)
16. Cannata v. City of New York, 182 N.E.2d 395 (1962), appeal dismissed 371 U.S. 4 (1962).
17. See, e.g., Opinion of the Justices, 250 N.E.2d 547 (1969). This case involved the financing, construction and operation of a stadium.
18. City of Little Rock v. Raines, 411 S.W.2d (1967); Opinion of the Justices, 131 A.2d 904 (Maine 1957). The determination of public use is a legislative question. The absence of statutory authorization to condemn land for revitalizing downtown was determinative in the court's ruling that the condemnation was not a public purpose.
19. E. McQuillan, The Law of Municipal Corporation, Section 10.31 (3d ed. 1971).
20. Garcia v. San Antonio Metropolitan Transit Authority, 53 L.W. 4135 (1985).
21. Berman v. Parker, 348 U.S. 26 (1954).
22. In Unity Ventures v. County of Lake, No. 81-C2745, 1984-1, Trade Case P65,883 (N.D. Ill. 1984), the federal district court, in ruling that a municipality was subject to anti-trust liability, noted that cities compete with other neighboring localities for development.
23. As a general rule, restrictions against direct public subsidization of, or investment in, private enterprise remain in effect. See, e.g., Morris v. City of Salem, 174 P. 2d 192 (Oregon 1946). In Morris, the court held that a city may not lend credit or assist a private corporation, in accordance with state constitutional restrictions. See also, City of Corbin v. Johnson, 316 S.W.2d 217 (Kentucky 1958). In City of Corbin, the court held that a city may not convey land to a private corporation to construct

a factory building to be leased-back to the city to induce industry to sublease property and, ultimately, relieve unemployment.

24. Lefcoe, "When Governments Become Land Developers: Notes on the Public Sector Experience in the Netherlands and California," 51 *S. Calif. Law Rev.* 165, 183 (1978), hereafter "Lefcoe."

25. Bank of the United States v. Planters' Bank, 22 U.S. (9 Wheat) 398, 399 (1824).

26. Municipalities became subject to antitrust liability as a result of the Supreme Court's decision in City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389 (1978). A municipality becomes immune from antitrust liability only when the state, acting in its role as regulator, enacts enabling legislation authorizing anticompetitive practices. Community Communications Co. v. City of Boulder, 102 S.Ct. 835 (1982). Land use and zoning decisions are subject to antitrust laws because of the interstate aspects of real estate financing. McClellin v. Real Estate Bd. of New Orleans, 444 U.S. 232 (1980).

27. Since the City of Richmond reached an out-of-court settlement with the developer, the case does not constitute a legal precedent.

28. Richmond Hilton Associates v. City of Richmond, No. 81-1115-R (E.D. Va. 1981).

29. Hanky v. City of Richmond, 532 F. Supp. 1298, 1300 (E.D. Va. 1982).

30. Hanky, 532 F. Supp. at 1306, note 23.

31. Ibid., at 1303.

32. Martha Middleton, "Municipalities Still Vulnerable: New Antitrust Act May Do Little To Stem Suits," *National Law Journal*, December 3, 1984, p. 1, hereafter "Middleton."

33. An agreement with a developer to prevent any other facility from competing may be defended as a necessary "ancillary restraint." See, e.g., United States v. Addyston Pipe and Steel Co., 85 F. 271 (6th Cir. 1898), affirmed 175 U.S. 211 (1899). Some restrictions on competition may be permitted if they are essential to the accomplishment of a desirable economic goal such as the revitalization of a depressed area.

34. See, e.g., Mason City Center Associates v. City of Mason City, 468 F. Supp. 737, affirmed 671 F. 2d 1146 (N.D. Iowa 1979).

35. The state action doctrine which permits a state to authorize anticompetitive behavior was established in Parker v. Brown, 317 U.S. (1943).

36. See, e.g., Cantor v. Detroit Edison Co., 428 U.S. 579 (1976).

37. See, e.g., Goldferb v. Virginia State Bar, 421 U.S. 773 (1975).

38. James V. Siena, ed., Antitrust and Local Government: Perspectives on the

Boulder Decision, Wash., D.C.: Seven-Locks Press, 1982, pp. 15-16, hereafter "Siena."

39. Jonnet Development Corp. v. Calaguiri, 558 F. Supp. 962 (W.D. Penn. 1983), affirmed 676 F. 2d 686; Cedar-Riverside Associates v. United States, 459 F. Supp. 1290 (D.Minn. 1978), aff'd 606 F.2d 254 (8th Cir. 1979); Scott v. City of Sioux City, 736 F.2d 1207 (1984).

40. U.S. Legislative and Administrative News for 1984, Legislative History for the Local Government Antitrust Act of 1984, P.L. 98-544, p. 4609, hereafter "Legis. History."

41. Legis. History, p. 4609, quoting prepared statement of Robert J. Logan at March 29, 1984 Hearing at pp.4-5.

42. Siena, p. 108.

43. Ibid., p. 166.

44. Certain antitrust behavior is *per se* invalid if it has a "pernicious effect on competition and lacks any redeeming virtue." Northern Pacific Railway v. United States, 365 U.S. 1 (1958).

45. The rule of reason is the test for determining whether a certain restraint imposed promotes competition or whether it suppresses or even destroys competition. Chicago Bd. of Trade v. United States, 246 U.S. 231 (1918).

46. Siena, p. 107.

47. Personal Interview with Dwight Merriam, Hartford attorney on February 12, 1985.

48. A zoning decision made at the urging of a publicly subsidized developer would not be circumstantial evidence of an antitrust agreement. Even developers who lobby for zoning changes may be immune as a result of United Mine Workers of America v. Pennington, 381 U.S. 357 (1965); Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc., 365 U.S. (1961).

Chapter Three

1. Yonkers Community Development Agency v. Morris, 335 N.E.2d 327, 331 (New York 1975).

2. "How a Company Let Down a Town," New York Sunday News Magazine, March 6, 1983, hereafter "New York News."

3. *New York Times*, May 20, 1984, Section IV, p. 6; *New York News*.
4. *New York News*.
5. K. Warner, J. Ehrmann, L. Jackson and J. Lax, "Detroit's Renaissance Includes Factories," *Urban Land*, June 1982, p. 3, hereafter "Detroit Renaissance."
6. Detroit Renaissance.
7. The start of production has been delayed at least until the Fall of 1985. Detroit Renaissance, p. 14.
8. G.M. was also granted a 12-year, 50% tax abatement. However, this abatement may be revoked by Detroit if the City Council determines that the project is not being carried out in accordance with the initial expectations of government. Detroit Renaissance.
9. Detroit Renaissance, p. 14.
10. Ibid.
11. D. Callies, "A Hypothetical Case: Techniques To Reduce the Public Costs of Public Improvements," 16 *Urban Law Annual* 155 (1979), hereafter "Callies."
12. "David Chase works Alone in Town He Made His Own," *Hartford Courant*, February 8, 1983, p. 1.
13. "City Deal Costing Him More: Developer Now Regrets Tax Break," *Hartford Courant*, August 28, 1981, p. 1, hereafter "Courant, 8-28-81."
14. Leasing for redevelopment is proper because of the public purpose doctrine, and land that is taken by eminent domain may subsequently be disposed of by sale or lease to private enterprise for redevelopment in accordance with an urban renewal plan. Berman v. Parker, 348 U.S. 26 (1954). See also discussion on the public purpose doctrine in Chapter Two.
15. Urban Land Institute, Downtown Development Handbook, Wash. D.C., 1980, p. 155.
16. So named because the structure appears as though it stands on stilts.
17. Courant, 8-28-81.
18. Taxes for the property were \$1.70 per square foot in the late 1970's. Courant, 8-28-81.
19. Ibid.
20. Personal Interview with Cheryl Chase Friedman, General Counsel for Chase Enterprises, on February 26, 1985, hereafter "Chase."

21. Courant, 8-28-81.

22. Ibid.

23. Chase.

24. Ibid.

25. Ibid.

26. Telephone interview with Hartford City Councilman Alan Taylor on March 1, 1985, hereafter "Taylor."

27. Telephone interview with Woodrow Wilson Gaitor, on February 28, 1985. Gaitor was the Hartford City Manager during the negotiations for the Stilts Building in the late 1970's, hereafter "Gaitor."

28. Taylor.

29. Courant, 12-18-84.

30. Taylor.

31. Personal interview with Edward Scherer, Hartford attorney on February 15, 1985. Scherer has been involved in the development negotiations for several projects sponsored by Chase Enterprises. Scherer represents the City of New Haven in its negotiations for the New Haven Government Center project being developed by Chase.

32. Chase.

33. Scherer.

34. Gaitor.

35. Courant, 12-18-84.

36. Scherer.

37. Proposal to the City of New Haven for Government Center, August 15, 1984, hereafter "New Haven proposal."

38. Chase.

39. Personal interview with Steve Kopelman, Hartford attorney on February 15, 1985. Kopelman, together with Edward Scherer, represents the City of New Haven in its negotiations with Chase.

40. New Haven proposal.

41. Ibid.

Chapter Four

1. Lefcoe, p. 169.
2. *Wall Street Journal*, March 25, 1981, p. 28.
3. D. Callies, C. Sharpe and D. Williams, "Value Capture Policy Gives the Public an Added Payoff," *Planning*, October 1976, hereafter "Callies, Sharpe and Williams."
4. See, e.g., Donald Hagman, Urban Development and Land Development Control Law, St. Paul: West Publishing Co., 1975, p. 649.
5. Callies, Sharpe and Williams.
6. 42 U.S.C.S. 291c(e).
7. 42 C.F.R. Section 53.111(d).
8. 42 C.F.R. Section 53.111(a).
9. The constitutionality of "linkage" in Boston and San Francisco is currently being challenged by developers in both cities.
10. The UDAG program, established by Section 1219 of the Housing and Community Development Act of 1974, provides grants for development to distressed cities that have pockets of poverty.
11. S. Clarke and M. Rich, "Partnerships for Economic Development: The UDAG Experience," *Journal of Community Action*, Vol. 1, No. 4, 1982, p. 54, hereafter "Clarke."
12. Clarke, p. 55.
13. Clarke, citing HUD Impact Evaluation of Urban Development Action Grant Program, 1982, p. 147.
14. L. Zax and A. Ain, "HUD's UDAG Program: A Potent Source of Capital for Developers," *National Law Journal*, June 25, 1984, p. 32, hereafter "Zax."
15. One commentator characterizes cities that recapture even a small portion of their action grant as "entrepreneurial" because they are "making money" with their action grant. Clarke, p. 54.
16. Clarke.

17. Richard P. Nathan and Jerry A. Webman, eds., *The Urban Development Action Grant Program*, N.J. : Princeton University, 1980, p. 46.

18. *Urban Outlook*.

19. *Urban Outlook*, September 15, 1984, hereafter "Urban Outlook."

20. *Urban Outlook*, September 15, 1984.

21. Clarke, p. 55.

22. Ibid.

23. *Zax*.

24. *Urban Land*, November 1984, pp. 28-29.

25. Ibid.

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