

Redevelopment: Rising From Ashes Or Final Death Rattle?

Law360, New York (October 25, 2012, 11:44 AM ET) -- Two cases filed in Sacramento County, City of Cerritos v. State of California and Syncora Guarantee Inc. v. State of California, have challenged the constitutionality of AB 1X 26, the 2011 bill that provided for the elimination of redevelopment in California.

While the California Supreme Court previously upheld the constitutionality of AB 1X 26 in California Redevelopment Association vs. Matosantos, the new cases raise an issue not raised in Matosantos: whether AB 1X 26 violates the provisions of both the California and United States constitutions prohibiting legislation impairing existing contracts. A previous post on our blog discussed a potential challenge to AB 1X 26 based on unconstitutional impairment of contracts.

Article I, Section 10 of the Constitution provides "No State shall ... pass any Bill of Attainder, ex post facto law, or law impairing the Obligation of Contracts ..." Similarly, Article I, Section 9 of the California Constitution provides that "a bill of attainder, ex post facto law, or law impairing the obligations of contracts may not be passed."

These constitutional provisions prohibit states from enacting bills that prevent the performance of existing contractual obligations. Legislation running afoul of these constitutional protections can be invalidated. Teachers Retirement Board v. Genest (2007) 154 Cal.App.4th 1012; Valdes v. Cory (1983) 139 Cal.App.3d 773.

City of Cerritos v. State of California, Case No. 34-2011-80000952, was the first of the Sacramento County cases to raise the unconstitutional impairment issue.[1]

Cerritos was filed before the California Supreme Court rendered its decision in California Redevelopment Association vs. Matosantos and was put on hold while that case was decided. After Matosantos was resolved, the Cerritos petitioners sought an injunction to prevent AB 1X 26 from going into effect, but the trial court declined to grant the injunction, stating that the petitioners had failed to meet their burden of demonstrating a likelihood of success on their claims. Since that time, the Cerritos case has been working through various pretrial motions and is still awaiting a hearing on the merits.

The second case is Syncora Guarantee Inc. v. State of California, Case No. 34-2012-80001215. Syncora sued the state to prevent the state from eliminating redevelopment agencies, claiming that AB 1X 26 deprived bondholders of money owed under existing contracts. Redevelopment agencies had sold bonds to fund local redevelopment projects. Each bond issue was secured by a pledge of property tax increment (the term for the increased property tax revenue resulting from such projects). Syncora had provided bond insurance supporting several such bond issues. As surety on the bonds, Syncora is subrogated to the rights of bondholders.

Syncora claims that application of AB 1X 26 violated provisions in both the California and the U.S. constitutions against impairing existing contracts by changing the nature and certainty of the funding available for repayment of the bonds.

Under redevelopment law, the bonds were issued with assurances, based on the California Constitution, that all property tax increment earned in a project area would be used solely for redevelopment activity in that project area, thereby increasing the likely availability of increasing property tax increment streams to pay such bonds. Under AB 1X 26, however, funds previously allocated for the exclusive purpose of redevelopment area debt service and project area redevelopment will now be diverted for schools and other local services.

Thus, rather than having a senior-most priority pledge of particular tax revenues from a particular project area — the tax increment — AB 1X 26 left the bondholders with a claim for payment out of property taxes generally, with the same priority as all other claimants against such property taxes.

Syncora offers as evidence that AB 1X 26 has negatively impacted the tripartite contracts between Syncora, the redevelopment agencies and the bondholders, the June 2012 downgrading by the ratings agency Moody's Investors Service of all California tax allocation bonds rated Baa3 or higher. Moody's cited increased uncertainty over timely debt repayments due to the elimination of the redevelopment agencies as the basis for this action. In addition to the unconstitutional impairment claims, Syncora also alleges that AB 1X 26 is an unconstitutional takings without just compensation.

To establish an unconstitutional impairment, however, it is not enough to show that AB 1X 26 negatively impacts existing contractual obligations; the impairment must be constitutionally impermissible.

In *U.S. Trust Co. v. New Jersey* (1977) 431 U.S. 1, the U.S. Supreme Court in striking down two New York and New Jersey statutes established a three-part test for determining whether a contractual impairment is unconstitutional: (1) whether there is a contractual obligation; (2) if yes, whether the legislation imposes a "substantial impairment"; and (3) if yes, whether the legislation is "reasonable and necessary to serve an important public purpose." [2] The court also noted that when reviewing impairments to contracts to which a state is a party, courts should not give complete deference to the legislature's assessment of reasonableness and necessity, as the state's self-interest is at stake.

In determining whether legislation is reasonable and necessary to serve an important public purpose, the California Supreme Court in *Sonoma County Org. of Pub. Employees v. County of Sonoma* (1979) 23 Cal.3d 296 pointed to the factors established by a Depression era U.S. Supreme Court case, *Home Building & Loan Assn. v. Blaisdell* (1934) 290 U.S. 398.

The issue before the court in *Blaisdell* was the constitutionality of a mortgage moratorium law in Minnesota that was designed to provide relief to landowners whose property was threatened with foreclosure. The statute in question was passed on April 18, 1933, and declared that the Depression created emergency conditions; required the statute to sunset at the earlier of the end of the emergency conditions or May 1, 1935; authorized the courts to extend the redemption period on foreclosures and postpone execution sales; required the homeowners to continue to pay to the bank the reasonable rental value of the property; and did not alter the principal or interest due on the loan.[3]

In upholding the constitutionality of the statute, the court identified four factors that led to its conclusion. First, the legislature had declared an emergency as a justification for the law and that declaration had an adequate basis. Second, the legislation sought to protect a basic interest of society rather than the advantage of particular individuals. Third, the law was an appropriate response to the emergency and the conditions imposed by the law were reasonable. Finally, the legislation was temporary.

In two later cases, *El Paso v. Simmons* (1965) 379 U.S. 497[4] and *Veix v. Sixth Ward Assn.* (1940) 310 U.S. 32[5], the court clarified that the *Blaisdell* factors are not a pass/fail test, but rather factors to consider in evaluating whether a contractual impairment is unconstitutional.

The trial court will likely evaluate AB 1X 26 under the four *Blaisdell* factors. In passing AB 1X 26, the Legislature found that California was in a fiscal emergency, for which most would acknowledge there was an adequate basis. The Legislature further found that the elimination of redevelopment was necessary to ensure adequate funding for essential government services such as schools, hospitals and public safety.

On this factor, litigants may attempt to challenge the notion that such services represent a “basic interest” of society, especially when compared with other state-funded programs that were spared in the 2011-2012 budget process. Another issue may be whether the court is able to consider the actual results of implementation of AB 1X 26, which has freed from redevelopment substantially smaller sums than predicted for application to schools and other local services.

The third factor — whether the law was an appropriate response to the emergency and whether the conditions imposed by the law were reasonable — seems like the area that may be subject to the greatest argument. Certainly the state faced a major budget crisis and cuts in funding were made to many programs in a massive and complex budget. And in another context, the California Supreme Court has already upheld the propriety of eliminating the 65-year-old redevelopment regime in that context.

With regard to the fourth factor, unlike the law in *Blaisdell*, AB 1X 26 is permanent. There is no means by which the tax increment pledges are reinstated after a period of time or upon achievement of fiscal or other economic goals.

The trial court is not limited to either striking down AB 1X 26 as unconstitutional or upholding it. The court could find that it results in an unconstitutional taking and order the state to pay compensation.

While the trial court's denial of the petitioners' requested injunction in the *Cerritos* case is certainly not a good omen for these cases, that *Moody's* later downgraded all redevelopment bonds means that these cases are far from over. On Sept. 5, 2012, the trial court ordered that the *Cerritos* and *Syncora* are related, and both are currently scheduled to be heard in early March 2013.

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[1] In addition to the contract impairment claim, the Cerritos case raises two other main claims. The first is that AB 1X 26, which was passed by a simple majority, effectively redefines redevelopment's tax increment as an ad valorem property tax, thus fundamentally changing the nature of the tax. That sort of change, petitioners argue, required a two-thirds majority vote in the Legislature. Second, petitioners claim that the Governor and the Legislature exceeded their authority by going after redevelopment funds, thereby responding to a short-term budget emergency with a remedy with effects that may last for 30 years, the lifespan of a redevelopment project area. These issues are beyond the scope of this post.

[2] U.S. Trust Co. v. New Jersey (1977) 431 U.S. 1, 22-27.

[3] Blaisdell at 415.

[4] In El Paso, a Texas statute limiting to a five-year period previously unlimited rights to reinstate interests in lands purchased from the state was upheld on the grounds that (1) a perpetual right to reinstatement was not a substantial inducement for the purchase, (2) the state's prior policy of allowing unlimited reinstatement privileges had unexpected and unforeseeable results, and (3) the purchaser was not seriously disadvantaged by the legislation in question whereas the state's interest in the subject matter of the legislation was an important one.

[5] In Veix a New Jersey statute that altered the withdrawal rights of shareholders in a savings and loan association was upheld on the ground that, while the statute might not have constituted emergency legislation, building and loan associations were vital to the state's economy and when the appellant purchased his shares such institutions were "already regulated in the particular" to which he objected. 295 U.S. at p. 62. Blaisdell was distinguished on the ground that the statute involved there was less restrictive.