



LEGAL ALERT

January 13, 2012



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## California Supreme Court Kills Redevelopment Agencies. Now What?

by Sean M. Sherlock

California's redevelopment agencies (RDAs) receive 12 percent of the state's property tax revenue. In this economic climate, that put a bull's-eye on their heads. Upon taking office, Governor Brown pushed through legislation to abolish RDAs, so the tax increment revenue they receive can be used for other purposes – mostly education. In a political compromise, the legislature passed two bills – AB 1X 26, which abolished RDAs; and AB 1X 27, which permitted municipalities to keep their RDAs if they remit certain "voluntary" payments into the state's fund for education. The RDAs sought immediate Supreme Court review, asking the Supreme Court to invalidate both of the bills. On December 29, 2011, the Supreme Court handed down the RDAs' worst nightmare – upholding AB 1X 26, and thereby abolishing the RDAs, while invalidating AB 1X 27, which was their lifeline.

Ironically, the RDAs' undoing was Proposition 22, a ballot initiative the RDAs had fought for and won just over a year ago.

The result has potential to create complications for developers who have projects in the works with RDAs.

### **Evolution of California's Property Tax Struggles**

In 1910, the voters approved a constitutional amendment giving local government exclusive control over property tax revenue. Each local jurisdiction (cities, counties, school districts and special districts) could levy and collect its own independent property tax. That system resulted in significant disparities in school funding between affluent communities and impoverished communities, and in 1971 the California Supreme Court in *Serrano v. Priest* invalidated that system, holding that financing dependent on local property tax bases denies students equal protection of the law.

In response to *Serrano v. Priest*, the state achieved funding equalization by capping individual districts' abilities to raise revenue and enhancing state contributions to ensure minimum funding levels.

In 1978, California voters passed Proposition 13, which, in addition to capping ad valorem property taxes, replaced the multiple property taxes imposed by multiple local political subdivisions with a single tax to be collected by the counties and apportioned by the state. In the eyes of the Supreme Court, Proposition 13 "created a zero-sum game in which political subdivisions (cities, counties, special districts and school districts) would have to compete against each other for their slices of a greatly shrunken pie."

In 1988, voters approved Proposition 98, which established constitutional minimum funding levels for education and required the state to set aside a designated portion of the general fund for public schools. In response to Proposition 98, the legislature created county educational revenue augmentation funds (ERAFs). It reduced the portion of property taxes allocated to local governments, deposited the difference in the ERAFs and distributed these amounts to the

school districts. Periodically thereafter, the legislature passed supplemental legislation requiring local government entities to further contribute to ERAFs in order to defray the state's Proposition 98 school funding obligations. As the state's financial belt tightened over the last decade, it also looked to the RDAs' tax increment revenue, periodically requiring RDAs to pay funds into ERAFs. This triggered much public debate about the state "raiding" local revenues.

In response, in 2004, local government interests advanced and obtained approval of Proposition 1A, which prohibited the state from statutorily reducing or altering the existing allocations of property tax among cities, counties and special districts. Proposition 1A did not, however, protect RDAs. So the state continued tapping RDAs for further ERAF payments.

In November, 2010, RDA interests advanced and obtained approval of Proposition 22. Proposition 22 provides, in part, that "the Legislature shall not enact a statute to do any of the following: . . . (7) Require a community redevelopment agency (A) to pay, remit, loan, or otherwise transfer, directly or indirectly, taxes on ad valorem real property and tangible personal property allocated to the agency . . . to or for the benefit of the State, any agency of the State, or any jurisdiction. . . ." In effect, Proposition 22 was intended to prevent the state from raiding the RDAs' revenues.

Ironically, in the same election in which the voters passed Proposition 22, they also elected Edmund G. Brown, Jr. Governor of the State of California. Immediately upon his taking office, Governor Brown announced his intent to abolish RDAs in California, to gain control over their tax increment revenue.

In January, 2011, Governor Brown called a special session of the legislature to address the state's budget crisis. Although he proposed eliminating the RDAs entirely, the legislature passed and the Governor signed a compromise set of two bills – AB 1X 26 and AB 1X 27.

Assembly Bill 1X 26 abolished RDAs in two steps – first freezing RDAs from incurring further indebtedness, making new plans or changing existing ones and entering into new

partnerships or joint ventures. The bill also prohibits cities and counties from forming new RDAs. Next, the bill dissolves all RDAs and transfers control of their assets to successor agencies which are contemplated to be the city or county that created the RDA. The bill provides the manner of distribution of the RDAs' assets, liabilities, unencumbered funds and future tax increment revenues.

Assembly Bill 1X 27 offers an exemption from the dissolution requirements of AB 1X 26, for cities and counties that agree to make specified payments on behalf of their RDAs to both the county ERAF and a new county special district augmentation fund.

### **California Redevelopment Association v. Matosantos**

The California Redevelopment Association and others promptly sought extraordinary writ relief from the California Supreme Court, asking that each measure be declared unconstitutional. As a matter of constitutional law, the California Supreme Court has original jurisdiction "where the matters to be decided are of sufficiently great importance and require immediate resolution." The court was satisfied that those circumstances were met.

The court first took up petitioners' challenge to AB 1X 26 and had little difficulty upholding it. Simply put, RDAs were created by the legislature and may be abolished by the legislature. Petitioners argued that Proposition 22, by insulating RDA revenues from the legislature's control, demonstrated the intent of the voters to endow RDAs with a constitutional right to exist that cannot be denied by the legislature. The court found no such intent expressed in the ballot materials for Proposition 22 and concluded that "[t]he constitutionalization of a political subdivision – the alteration of a local government entity from a statutory creation existing only at the pleasure of the sovereign state to a constitutional creation with life and powers of independent origin and standing – would represent a profound change in the structure of state government. . . . It would be unusual in the extreme for the people, exercising legislative power by way of initiative, to adopt such a fundamental change only by way of

implication . . .”

The court then took up petitioners’ challenge to AB 1X 27. Ironically, the RDAs’ undoing was their very own, beloved Proposition 22. The court found AB 1X 27 unconstitutional because it requires what Proposition 22 prohibits – direct or indirect payments or transfers of the RDAs’ tax increment revenue to the state for the benefit of its agencies including school districts and special districts. Proposition 22 was intended to end the shifting of RDA tax increment revenue into the ERAFs, yet that is exactly what AB 1X 27 required as a condition of an RDA’s continued existence.

### **Now what?**

Because the court decided matters of purely state law, there is no potential for the United States Supreme Court to review this case. It is over.

The legislature may try to fix AB 1X 27. What that will be, and whether it would survive the governor’s veto, is anyone’s guess.

In the meantime, developers and lenders invested in redevelopment deals need to know what they are up against.

Effective February 1, 2012, RDAs “are hereby dissolved, and shall no longer exist as a public body.” Further, “[a]ll authority to transact business or exercise powers previously granted under the Community Redevelopment Law [] is hereby withdrawn from the [RDAs].” The law provides extensive and complex procedures for their winding down.

Under the “freeze” provisions of AB 1X 26, RDAs have been prohibited since June 29, 2011, from engaging in a fairly comprehensive list of transactions, including taking on new or expanded monetary or legal obligations, incurring further indebtedness, restructuring indebtedness that existed as of January 1, 2011, making new loans or advances, providing financial assistance of any sort, entering into new agreements, amending existing agreements, acquiring real property, disposing of assets or entering into a new partnership or joint powers authority. Any such transaction

undertaken by a RDA on or after June 29, 2011, is void.

Additionally, the State Controller is required to review the activities of all RDAs to determine whether they transferred any assets to another public agency after January 1, 2011. Any such transferred assets could be required to be returned to the RDA or its successor agency.

Notably, however, RDAs must continue to meet existing obligations. In that regard, each RDA must prepare an Enforceable Obligation Payment Schedule, identifying all of its obligations, subject to review and challenge by the Department of Finance.

The dissolution provisions of AB 1X 26 provide for successor agencies to be appointed to “[e]xpeditiously wind down the affairs of the redevelopment agency.” The law contemplates that the successor agency will most likely be the city or county that created the RDA, although cities and counties may choose other options. All assets, properties, leases, books and records of the RDAs will be transferred, effective February 1, 2012, to the successor agencies. The law caps the liability of the successor agencies for RDA obligations to the total sum of property tax revenues and RDA assets that it receives in the course of the winding down process. Each successor agency must create a Redevelopment Obligation Retirement Fund, from which to pay the RDA’s enforceable obligations. In addition, each county auditor-controller must create a Redevelopment Property Tax Trust Fund to receive the RDAs’ tax increment revenues, and from which to fund the successor agencies’ Redevelopment Obligation Retirement Funds.

For projects in process, the law requires the successor agency to “[c]ontinue to oversee development of properties until the contracted work has been completed or the contractual obligations of the former redevelopment agency can be transferred to other parties.”

## **Conclusion**

The effects of this Supreme Court decision will be far-reaching and significant. Unless the legislature enacts a fix to address

the court's decision, redevelopment in this state is over. Given that the Governor's initial goal – an outright abolishment of the redevelopment agencies – has been achieved, it seems unlikely that any legislative cure will clear the Governor's desk.

Moreover, notwithstanding the legislature's efforts to draft comprehensive provisions to address the dissolution and necessary winding down of the RDAs, considerable uncertainty exists with regard to the fortunes of redevelopment projects in the works. The potential for unforeseen disputes and losses is as vast as the numerous redevelopment agreements and related private contracts are numerous and complex. Our already over-burdened court system just got busier.

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