Downtown Development and Redevelopment: Challenges and Opportunities in "Public/Private Partnerships"

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Local Government officials – both elected and staff – continue to ask about ways that public and private sector cooperation might improve their downtown areas. But cooperative ventures between public and private entities often face legal challenges that must be recognized and overcome. This paper reviews an array of legal constraints on public-private cooperative mechanisms permitted under Washington law, and then suggests some approaches to making public-private cooperation work effectively. As noted below under "Tips for Successful Public-Private Partnerships," the most important thing for public officials considering public-private ventures is to know <u>why</u> they want to enter into a public-private venture, <u>what</u> the public will gain from the arrangement and <u>how</u> the cooperative undertaking will be carried out.

Constraints on Public-Private Arrangements

A number of recurring legal constraints affect many public-private cooperative arrangements. The key challenges are summarized below.

- **Statutory Constraints.** Although cities have broad police powers and do not need express authority to engage in activities to protect public health and safety, other governmental and proprietary activities require express or implied statutory authority. Elected officials often assume that because a particular activity might be "good for the city" or "good for the public," there *must* be authority somewhere for the city to undertake the activity. Yet on occasion the requisite authority simply does not exist. For example, city officials are often eager to engage in economic development activities, but statutory authority for city involvement in economic development is very weak. RCW 35.21.703. Ports, in contrast, have express authority to develop industrial parks and international trade centers, both good examples of public-private partnerships. RCW 53.08.020 and RCW 53.29.020. But cities have no such explicit powers. Therefore, it is important to check for adequate statutory authority before proceeding with any specific type of public-private cooperative arrangement.

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- **The State Constitution: Lending of Credit/Gifts.** Care must be taken to ensure that the public member of a public-private partnership is getting its money's worth. Although the state Supreme Court gives great deference to local determinations of the value of consideration, there must be a limit somewhere. One should assume that the Major League Baseball Stadium Public Facilities District's arrangement with the Seattle Mariners is the outside boundary of what will be permitted. There, the Mariners agreed to pay only $700,000 per year in stadium rent, but took on operation and maintenance expenses as well as a large construction risk. The Court found that this was adequate consideration. *Clean v. State*, 130 Wn.2d 782 (1996); *King County v. Taxpayers*, 132 Wn.2d 360 (1997). After ensuring that reasonably adequate consideration exists, the next most important thing is to document the consideration exchanged in order to reduce the odds of being second-guessed by the judiciary. Finally, one should beware of governmental action to assist a private party that might be viewed as a give away or a loan of credit. See, e.g., *Lassila v. Wenatchee*, 89 Wn.2d 804 (1978) (city purchase of land parcels for resale to private party viewed as loan of credit). Although the Court has been somewhat flexible in recent years, there clearly are limits, and no one wants his or her client to be the one that hits those limits.

- **Public Works Bidding.** The public works bidding requirements of Chapter 39.04 RCW (and its progeny) have a long arm. On occasion a developer and a city are working cooperatively on a project, and the developer agrees (or is required) to install infrastructure such as water, sewer and storm water systems. The city asks the developer to size the facilities larger than is needed for the specific project, and agrees to pay the developer for the over-sizing that will eventually serve future developments. But when the developer agrees to build extra facilities "at the cost of the city," what was a fully private construction project may now be subject to public works laws. This result from the classic case of *Edwards v. Renton*, 67 Wn.2d 598 (1965), where the City of Renton needed a new stoplight and corner improvements in connection with a shopping mall being developed. The City agreed to pay the developer for the improvements and stoplight, and allowed the developer to proceed with construction of the improvements according to City specifications. The Court ruled that this public-private cooperative arrangement contravened public works bidding laws as well as the gift and lending of credit provisions of the state constitution.

- **Eminent Domain for Private Purposes.** Private participants in public-private arrangements occasionally seek public sector assistance in the acquisition of property for the private partner's use. Outside of the community renewal (urban renewal) context, the principles set forth in *Hogue v. Port of Seattle*, 54 Wn.2d 799 (1959) and *In re Seattle (Westlake)*, 96 Wn.2d 616 (1981) are quite vibrant. In the latter case, the Washington Supreme Court in stated:

> If a private use is combined with a public use in such a way that the two cannot be separated, the right of eminent domain cannot be invoked . . . . Therefore, where the purpose of a proposed acquisition is to acquire property and devote only a portion of it to truly public uses, the

remainder to be rented or sold for private use, the project does not constitute public use.

96 Wn.2d at 627-28. The *Westlake* case involved city condemnation of property for a private shopping mall to be located next to a public park and a museum. In the earlier *Hogue* case, the court refused to allow the Port of Seattle to condemn property in order to assemble it and re-sell it for purely economic development purposes. Clearly, the Washington Supreme Court would have ruled differently than the U.S. Supreme Court in *Kelo v. New London*, 125 S.Ct. 2655 (2005). The Washington Court provided some leeway in *State v. Evans*, 136 Wn.2d 811 (1998), where it held that when a condemnation of a full parcel of property was necessary for convention center expansion, the sale of air rights above the publicly-developed portion did not violate the rule against the exercise of eminent domain for private development purposes. Note also that in the context of community renewal projects under Chapter 35.81 RCW, properties may be condemned in order to be assembled and resold to other private sector developers. *Miller v. Tacoma*, 61 Wn.2d 374 (1963). But there must be a true public-health-and-safety basis to a community renewal program in order to justify the use of eminent domain in this manner.

- **No Compromise of Police Powers.** Governments cannot contract away their regulatory authority. See, e.g., *Hudson County Water Co. v. McCarter*, 209 U.S. 349 (1908). For example, no matter how cooperative a city is with a private entity, the city government cannot agree to waive land use or other regulatory requirements or to apply regulations differently to a specific private party. This is often puzzling to business people, who sometimes assume that if they have a contract with "the City," that governmental body should be able to do anything to make the project work just the way a private company would. At best, the city can attempt to streamline the regulatory process to move a project along – as long as the law continues to be applied consistently.

- **Labor and Civil Service.** Union contracts and Civil Service practices may prevent certain types of privatization or public-private cooperation. Cities may find it difficult to transfer, to a private partner, governmental activities that traditionally been performed by civil service employees. *Wash. Fed. of State Employees v. State*, 86 Wn. App. 1 (1997). Cities must also observe the traditional rule that existing bargaining unit work cannot be contracted out in violation of the terms of a labor agreement, and the contracting out of bargaining work and other circumstances is still subject to consultation with union representatives. *Johansen v. D.S.H.S.*, 91 Wn. App. 737 (1998).

- **Federal Tax Constraints.** Federal tax law governing the tax exemption on municipal bonds place some constraints on the transfer of use of bond-financed facilities to the private sector. One set of rules governs "change of use" from public to private purposes, and such an action may force the redemption or defeasance of bonds or the application of proceeds of a sale of public property to public uses in accordance with detailed IRS rules. Treas. Regs. §§ 1.141-2(d) and 1.141-12. More important are the "management contract" rules, which constrain the long-term lease of public bond-financed property to the private sector or entrusting such property to private sector management on a continuing basis.

These fairly intricate rules govern both the length of such leases or management contracts and constrain the methods by which the private sector partner can be compensated for its involvement in the project. Rev. Proc. 97-13.

Public-Private Mechanisms Under Washington Law

Despite the constitutional and statutory constraints, there are still many useful tools available to governments and private sector entities that desire to work together in a cooperative manner. Those include the following:

- **Developer Reimbursement Areas (Latecomers).** RCW 35.91 (water and sewers) and RCW 35.72 (streets and roads). This statute authorizes a city to enter into an arrangement with the owner or developer of property, under which that private entity constructs public improvements with its own funds and are handed over to the city, together with appropriate easements. The improvements need to be consistent with city specifications. Since the work is not done "at the cost of the city," it is not considered a public work subject to bidding. After a hearing, a reimbursement area is established, and any other property owner who develops within that area within 15 years must reimburse, through the city, the entity that originally constructed the improvements.

- **LID Preformation Expense Reimbursements.** RCW 35.43.184 allows a city to enter into a contract with a property owner under which the private person carries out engineering and other preliminary activities for a project that may later be financed through a local improvement district. If the city decides to form an LID, the property owner is reimbursed for its early work or receives a credit against its assessment. This mechanism permits the private sector to take the risk of preliminary engineering on projects where the local government is not yet sure that it wishes to proceed, and does not desire to use public funds for exploratory engineering work.

- **Developer Agreements.** RCW 36.70B.170-.210 authorizes development agreements between a county or city and the developer of property. These agreements are typically thought of in the context of the zoning and permit process, but RCW 36.70.170(4) provides that a "development agreement may obligate a party to fund or provide services, infrastructure, or other facilities," and this can provide the legal basis for significant public investments in infrastructure that will aid a private development that a city or county sees as being beneficial.

- **Design/Build and General Contractor Construction Manager**. Chapter 39.10 RCW provides two distinct construction management methods that shift more (and earlier) responsibility to the private sector. This is available only to the state, the state's two largest universities, large counties, ports and public utility districts, public facilities districts, and cities with a population of more than 70,000. The design/build approach involves a fairly complicated competitive process that takes proposals from architecture/engineering/construction teams. The government involved picks a team based on pre-established criteria, but has to reimburse the runners up for some of their costs. Once construction beings, the compression of the design and construction process

is seen as reducing costs and bringing overall efficiency. The general contractor/construction manager process permits the selection of a construction manager that will oversee a complex project for the local government. There is public works bidding for the major contracts on the job, but the construction manager guarantees a maximum allowable construction cost. This is something like traditional public works bidding, but provides more flexible delegation of management responsibilities to a skilled private sector entity.

- **Water Quality Joint Development Act and Solid Waste Service Provider Arrangements.** Chapter 70.150 RCW (Water Quality Joint Development Act) and RCW 35.21.156 (solid waste service contracts) establish similar processes under which cities may contract with private entities for any of the design, construction, operation and/or ownership of governmental facilities. These are true "public-private partnership" statutes. The solid waste statute is used frequently, but most local government officials are unaware of the flexibility permitted under the Water Quality Joint Development Act. Both of these statutes allow for the facilities concerned to be designed and constructed outside the traditional public works process, and/or fully operated and owned by the private sector. The process is not available for construction of free standing solid waste transfer stations.

- **Lease-Purchase Acquisition of Facilities**. Chapter 35.42 RCW contains two separate statutes that permit cities to acquire buildings and certain other facilities on a lease-purchase basis. These statutes are poorly drafted and difficult to use, but the bottom line is that if a city already owns the parcel or property concerned, the "lessor" who develops the building will have to be picked through a process that resembles public works bidding. On the other hand, if the private sector entity owns the parcel of property concerned, public works bidding is not required. The City can negotiate with the property developer, who will undertake to build a facility with city specifications and rent some or all of it to the City on a long-term basis. Under state law, if 50% or more of a facility is constructed for lease to a governmental entity, prevailing wage laws apply. RCW 39.04.260. Sometimes the arrangements involve financing leases under which the city builds equity as lease payments are made. In other instances, the parties arrange a true lease under which the city retains an option to purchase later at fair market value. The key to these lease-purchase arrangements is that construction period risk falls on the private developer who is responsible for cost overruns and for delivering a final product consistent with city specifications. One of the best known (and financially most successful) examples of this is the Pacific Place Garage in downtown Seattle, where the City of Seattle lease-purchased an underground parking garage condominium unit that was built as part of a major retail development on top of the garage. An excellent summary (and approval) of that transaction is provided in an April 10, 1998, Attorney General's Memorandum from Mary Jo Diaz to Jan Jutte of the State Auditor's Office.

- **63-20 Financings.** "63-20" projects are a variation of the lease-purchase transaction described above. IRS Revenue Ruling 63-20 allows nonprofit corporations to issue tax-exempt bonds on behalf of governments so long as the bond proceeds are used to construct capital facilities for governmental use. In a typical 63-20 transaction, the

nonprofit corporation contracts with a private design-build team, which delivers the building. The facility is then leased to the government involved, either on a true lease or financing lease basis. In either case, when the tax-exempt bonds are paid off the facility must be handed over to the government with no strings attached. 63-20 arrangements are complicated and should not be undertaken without a good reason to do so. They have been used in the past either because a city desires more flexibility in the public works process or to proceed with a project in the face of a tight general obligation debt limit.

- **Concessions**. Concessions have been granted for centuries, particularly in the context of park public recreational facilities such as golf courses. The local government contracts with a private sector entity to provide facilities and services on public property. Typically, at the expiration of the contract, any facilities constructed are turned over to the local government. Concession contracts are often accompanied by formal leases of the real estate involved, and either rent and/or operating payments are often made to the government.

- **Other Joint Ventures**. Although there is no express statutory authority to do so, several cities have entered into joint venture arrangements with the private sector under which facilities are owned in common. This appears to be a legal exercise of property acquisition and ownership powers of cities. A key to the success of such an arrangement is to ensure that the city has control over the design and construction process equal to its financial and ownership share. Further, the city cannot provide a guarantee or backstop to its private sector partner or lend credit in contravention of Article I, Section 7 of Washington's constitution. A fair share of management control of the project appears mandated by *Chemical Bank v. WPPSS*, 99 Wn.2d 772 (1983). The best known example of a public-private joint venture of this type is the Tri-Cities Coliseum, which is 49% owned by the City of Kennewick, with the balance by a private developer. The project was the subject of a Washington Supreme Court decision to the effect that only the private portion of the property was subject to property tax. *Kennewick v. Benton County*, 131 Wn.2d 768 (1997). Note that joint projects of this type are likely to be subject to public works bidding laws because they are built, at least in part, "at the cost of" the city.

- **Street Franchises**. The grant of franchises for private transportation systems (i.e., street cars) is usually overlooked as a variety of public-private cooperative venture. When street cars, cable cars and similar facilities were developed in the late 19th and early 20th century, local governments would grant long-term right of way franchises to private sector developers who would operate important transportation facilities on public streets. These arrangements are permitted by statute (see, e.g., RCW 35.22.280(9)) but are constrained by constitutional, charter and statutory constraints (see, e.g., Article I, Section 8 of the Washington State Constitution, Tacoma City Charter, Article VIII, and RCW 35.23.380).

- **Service Contracts.** A variant of public-private partnership arrangement advocated by some is the simple shedding of traditional governmental activities and proprietary activities to the private sector. In other words, the local governments would simply leave these areas of activity to the private sector. These privatization programs are most

commonly advocated for utilities, for major transportation facilities (such as toll highways) and parks..

- **Community Renewal.** Substitute House Bill 2357 (Chapter 218, Laws of 2002) provided a comprehensive update and rewrite of Washington's 1950's-era urban renewal law. The statute, at Chapter 35.81 RCW, is renamed the "Community Renewal Law," and a number of new tools are added to make redevelopment work more effectively on a public-private cooperative basis. One of the most important aspects of this statute is a change that allows community renewal agencies to purchase property within community renewal areas with a specific developer in mind. The developer is selected through a competitive process. One of the biggest problems with the old urban renewal law is that the government agency was required to buy or condemn large pieces of land, not knowing whether the private sector had any interest in purchasing the assembled parcels. In several notable cases (e.g., Seattle's Yesler-Atlantic Urban Renewal Project) large blocks of land lay undeveloped for decades. The revised statute permits cities, through their community renewal agencies, to work closely with the private sector in the redevelopment of blighted areas. Note that the purchase of property for resale to a pre-selected developer may be upheld by the courts only in the context of activities to remove blight that presents a true hazard to public health and safety. (See, the discussion of *Lassila v. Wenatchee, Miller v. Tacoma* and *In re Seattle*, above.) The new community renewal statute also makes it easier, in the context of community renewal projects for governments to make loans and payments to private sector businesses to encourage them to stay or relocate in formerly blighted areas. Housing authorities may serve as community renewal agencies with the full array of powers granted to other community renewal agencies. And cities may provide technical assistance and job retention funds to assist businesses in designated community renewal areas.

Tips for Successful Public-Private Partnerships

Given the array of possible public-private cooperative arrangements and the equally large number of constraints, some words to the wise may be in order.

- **Know What You Want to Do, and Why.** There are a bewildering array of types of public-private partnerships. Elected officials often talk about "privatizing" government operations or "cooperating" with the private sector without being clear in their own minds just what type of arrangement they want, or why. Before seeking private sector help or involvement, think through the purpose of the arrangement, the variety of choices and zero in on the approach that you think most likely to succeed.

- **Don't Always Assume the Private Sector is More Cost-Effective.** It is often assumed that the private sector is more efficient than the public sector, and this assumption is taken as a verity by many in the construction field. However, the empirical research to support this assumption is not as complete as one would like. It is worth taking the time to carefully think through the allocation of public and private tasks to make sure that a proposed arrangement will work as well as possible in each circumstance. Interestingly,

research suggests that private non-profit organizations are the most cost-efficient providers of many services, beating out both the public and for-profit sectors. Nonprofit organizations often have a public orientation with some of the entrepreneurial characteristics of the private sector. Rowan Maranda, "Governments or Markets? The Privatization of Municipal Services" 8 *Research in Governmental and Nonprofit Accounting* 235-64 (1994); Rowan Maranda, "Contracting Out: A Solution With Limits" in *Urban Innovation: Creative Strategies for Turbulent Times*, 197-211 (1992).

- **Understand the Other Guy.** Public and private sector people often attribute negative motives to each other. Long time public servants sometimes assume that for-profit enterprises and their leaders are interested only in making money. Conversely, private sector personnel assume that public employees mostly care about job security and that "government bureaucracy" exists mainly to perpetuate itself. These attitudes, while naïve, do exist and they do drive behavior. The fact is that public and private sector players are driven by positive motives, <u>but they are different motives</u>. The fact that the two sectors choose to work together does not make the public side any less "public" in its mission, or the private side less "private." One cannot expect public section employees or elected officials to make decisions or to take approaches which, in the name of "efficiency," might be seen as harming community interests. Correspondingly, those in the for-profit sector cannot be expected to act in ways that are likely to result in substantial economic losses. When negotiations begin on a public-private arrangement, the parties should be very open about their respective missions, goals, concerns and ground rules. Because those in the private and public sectors have different world view and speak different languages, contract negotiations can be like international negotiations. Just like international bargaining, each side needs to understand what the other side needs and wants; a thorough understanding can lead to real success.

- **Keep an Eye On Risk Shifting.** When structuring a public-private partnership, much of the negotiating will focus on who takes what risks. It is fair for each side to share risk, but public sector players should remember that sometimes the transfer of risks to the private sector will lead the private player to pass those risks on to consumers (<u>i.e.,</u> the public). Therefore, it may sometimes make more sense for the government to assume certain risks in order to hold down costs of service.

- **Bring Along Your Own Folks.** Some public-private cooperative ventures fall apart because of internal sabotage on either or both sides. Entrenched opponents of such cooperation within a government or company can make success much more difficult to attain. Therefore, educate and involve your own personnel and work to have them invested in the success of the project.

- **Think Through the Deal Points First.** Don't go into negotiations with the private sector without a solid idea of what risks you are able to undertake, how much money and staff you are willing to devote to a project, and a through understanding of what you want the public side to get out of a deal. As the saying goes, it's amazing where you might wind up if you don't know where you're going. If selection of a private sector partner is being handled through a competitive process it often makes sense for the public side to

fully draft the contract or lease it plans to enter into with a prospective partner. Then, proposers should be required to accept the proposed contract or to propose explicit alternative language. However, if alternative language is proposed, the proposer should be required to state the increase in compensation that it would receive if it were to go along with the original public-proposed language. That way, the public body can compare various private sector proposers on an apples-to-apples basis. The more time and preparation that is taken in details of a proposed arrangement before negotiations commence, the easier the negotiations will be and the more likely the outcome will be successful from the viewpoint of both parties.

Public-private projects can be very successful, but it is always important to think through why the public entity desires to work with the private sector, to identify the desired outcomes, to select the public-private cooperative mechanism carefully and to be aware of the legal land mines that still exist. If those things are carefully kept in mind, a project can be a real success.