ARROYO GRANDE REDEVELOPMENT AGENCY

ASSET TRANSFER REVIEW

Review Report

January 1, 2011, through January 31, 2012

BETTY T. YEE

California State Controller

May 2015

BETTY T. YEE
California State Controller

May 20, 2015

Steven Adams, City Manager
Arroyo Grande Redevelopment/Successor Agency
300 E. Branch Street
Arroyo Grande, CA 93420

Dear Mr. Adams:

Pursuant to Health and Safety Code section 34167.5, the State Controller's Office (SCO) reviewed all asset transfers made by the Arroyo Grande Redevelopment Agency (RDA) to the City of Arroyo Grande (City) or any other public agency after January 1, 2011. This statutory provision states, "The Legislature hereby finds that a transfer of assets by a redevelopment agency during the period covered in this section is deemed not to be in furtherance of the Community Redevelopment Law and is thereby unauthorized." Therefore, our review included an assessment of whether each asset transfer was allowable and whether the asset should be turned over to the Successor Agency.

Our review applied to all assets including, but not limited to, real and personal property, cash funds, accounts receivable, deeds of trust and mortgages, contract rights, and rights to payment of any kind. We also reviewed and determined whether any unallowable transfers to the City or any other public agency have been reversed.

Our review found that the RDA transferred $4,679,928 in assets after January 1, 2011, including unallowable transfers to the City totaling $38,369, or less that 1% of transferred assets. These assets should be turned over to the Successor Agency.

If you have any questions, please contact Elizabeth González, Chief, Local Government Compliance Bureau, by telephone at (916) 324-0622.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/mh

Attachment

cc: Deborah Malicoat, Director of Administrative Services
City of Arroyo Grande
Lenny Jones, Chair
Arroyo Grande Oversight Board
James P. Erb, CPA, Auditor-Controller
San Luis Obispo County
David Botelho, Program Budget Manager
California Department of Finance
Richard J. Chivaro, Chief Legal Counsel
State Controller's Office
Elizabeth González, Bureau Chief
Division of Audits, State Controller's Office
Scott Freesmeier, Audit Manager
Division of Audits, State Controller's Office
Claudia Corona, Auditor-in-Charge
Division of Audits, State Controller's Office

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Asset Transfer Review Report

Summary

The State Controller's Office (SCO) reviewed the asset transfers made by the Arroyo Grande Redevelopment Agency (RDA) after January 1, 2011. Our review included, but was not limited to, real and personal property, cash funds, accounts receivable, deeds of trust and mortgages, contract rights, and rights to payments of any kind from any source.

Our review found that the RDA transferred $4,679,928 in assets after January 1, 2011, including unallowable transfers to the City of Arroyo Grande (City) totaling $38,369, or less that 1% of transferred assets. These assets should be turned over to the Successor Agency.

Background

In January of 2011, the Governor of the State of California proposed statewide elimination of redevelopment agencies (RDAs) beginning with the fiscal year (FY) 2011-12 State budget. The Governor's proposal was incorporated into Assembly Bill 26 (ABX1 26, Chapter 5, Statutes of 2011, First Extraordinary Session), which was passed by the Legislature, and signed into law by the Governor on June 28, 2011.

ABX1 26 prohibited RDAs from engaging in new business, established mechanisms and timelines for dissolution of the RDAs, and created RDA successor agencies and oversight boards to oversee dissolution of the RDAs and redistribution of RDA assets.

A California Supreme Court decision on December 28, 2011 (*California Redevelopment Association et al. v. Matosantos*), upheld ABX1 26 and the Legislature's constitutional authority to dissolve the RDAs.

ABX1 26 was codified in the Health and Safety (H&S) Code beginning with section 34161.

H&S Code section 34167.5 states in part, ". . . the Controller shall review the activities of redevelopment agencies in the state to determine whether an asset transfer has occurred after January 1, 2011, between the city or county, or city and county that created a redevelopment agency or any other public agency, and the redevelopment agency."

The SCO identified asset transfers that occurred after January 1, 2011, between the RDA, the City and/or any other public agency. By law, the SCO is required to order that such assets, except those that already had been committed to a third party prior to June 28, 2011, the effective date of ABX1 26, be turned over to the Successor Agency. In addition, the SCO may file a legal action to ensure compliance with this order.

Objective, Scope, and Methodology

Our review objective was to determine whether asset transfers that occurred after January 1, 2011, and the date upon which the RDA ceased to operate, or January 31, 2012, whichever was earlier, between the city or county, or city and county that created an RDA, or any other public agency, and the RDA, were appropriate.

We performed the following procedures:

- Interviewed Successor Agency personnel to gain an understanding of the Successor Agency's operations and procedures.
- Reviewed meeting minutes, resolutions, and ordinances of the City, the RDA, the Successor Agency, and the Oversight Board.
- Reviewed accounting records relating to the recording of assets.
- Verified the accuracy of the Asset Transfer Assessment Form. This form was sent to all former RDAs to provide a list of all assets transferred between January 1, 2011, and January 31, 2012.
- Reviewed applicable financial reports to verify assets (capital, cash, property, etc.).

Conclusion

Our review found that the Arroyo Grande Redevelopment Agency transferred $4,679,928 in assets after January 1, 2011, including unallowable transfers to the City of Arroyo Grande (City) totaling $38,369, or less that 1% of transferred assets. These assets should be turned over to the Successor Agency.

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Details of our finding are described in the Finding and Order of the Controller section of this report.

Views of Responsible Officials

We issued a draft review report on August 4, 2014. William H. Ihrke, Rutan & Tucker, LLP, responded on behalf of the City by letter dated August 18, 2014, disagreeing with the review results. The City's response is included in this final review report as an attachment.

Restricted Use

This report is solely for the information and use of the City of Arroyo Grande, the Successor Agency, the Oversight Board, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record when issued final.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

May 20, 2015

Finding and Order of the Controller

FINDING—Unallowable asset transfers to the City of Arroyo Grande

The Arroyo Grande Redevelopment Agency (RDA) made unallowable asset transfers of $38,369, to the City of Arroyo Grande (City). The transfers occurred after January 1, 2011, and were not contractually committed to a third party prior to June 28, 2011.

As of January 31, 2012, the RDA had transferred $38,369 to Fund 350 (City's CIP Fund) for the Police Station Project. This represents the RDA's portion of the construction costs of the project.

Pursuant to Health and Safety (H&S) Code section 34167.5, the RDA may not transfer assets to a city, county, city and county, or any other public agency after January 1, 2011, that were not contractually committed to a third party prior to June 28, 2011. The assets should be turned over to the Successor Agency for disposition in accordance with H&S Code section 34177(d) and (e).

Order of the Controller

Pursuant to H&S Code section 34167.5, the City is ordered to reverse the transfers in the amount of $38,369, and turn over the assets to the Successor Agency.

City's Response

> . . . the Successor Agency respectfully requests that the State Controller's Office ("SCO") reconsider its finding and order . . . Constitutionally, the SCO cannot order the $389,107 to be taken away from the City. This amount is comprised of tax increment funds that were allocated to the RDA and paid over to the City prior to the dissolution of the RDA on February 1, 2012. . . . The disputed amount is entirely comprised of payments made by the RDA to the City and, in turn, to private contractors, for construction of "publicly owned improvements" pursuant to applicable laws that expressly allowed the RDA to fund such improvements. . . . With respect to the $38,359 identified in the Draft Report as part of the Police Station Project, this amount was omitted by the RDA as part of the City's Fiscal Year 2009-10 approved budget, which ended prior to the January 1, 2011 commencement/coverage date for the SCO asset transfer review.

See Attachment for City's complete response.

SCO's Comment

The SCO acknowledges the receipt of additional information validating the $350,738 in transfers that were identified in the draft report. However, in reviewing the documentation provided by the City, the SCO found that the agreement for the Police Station Project had expired on its own terms. On November 12, 2014, the City responded via e-mail, stating that the City does not have records renewing the contract. Therefore, $38,369 in unallowable asset transfers must be turned over to the Successor Agency.

The Finding and Order of the Controller has been adjusted accordingly.

Attachment—
City's Response to
Draft Review Report

In addition to the attached letter, the city provided additional documents. Due to their size, the documents are not included with this report. Please contact the City of Arroyo Grande for copies of the following documents:

Exhibits

June 9, 2009 City Council/RDA Report for the FY 2009-10/ FY 2010-11 Biennial Budget
City of Arroyo Grande FY 2009-10/2010-11 Biennial Budget
City of Arroyo Grande FY 2008-09/FY 2009-10 Local Sales Tax Allocation Report and Local Sales Tax Actual and Budgeted Expenditures for Fiscal Years 2008-09 and 2009-10
City of Arroyo Grande Work Program FY 2009-10/FY 2010-11
Proposed Resolution for the Adoption of the FY 2009-10 Budget (item 11.a.)
Funding Agreement for the Le Point Street Improvements and Parking Lot Expansion project PW 2011-02 dated March 8, 2011
Contract Documents for the Le Point Street Improvements and Parking Lot Expansion, dated March 30, 2011
February 8, 2011 City Council/RDA Report for the Centennial Park and Short Street Narrowing projects
February 12, 2008 Council Report for E. Branch Streetscape Enhancement Project
January 9, 2007 Council Report for E. Branch Streetscape Enhancement Project
Subcontract documents for the East Branch Streetscape Improvements, dated January 17, 2008
February 22, 2011 City Council/RDA Report for the Short Street Narrowing project
Notice of Determination
Purchase and Sale Agreement dated February 23, 2010
Contract documents for the Centennial Park project, dated February 10, 2011
January 9, 2007 City Council/RDA Minutes for the East Branch Streetscape project

RUTAN
RUTAN & TUCKER, LLP

William H. Ihrke
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E-mail: bihrke@rutan.com

August 18, 2014

VIA E-MAIL AND
FIRST CLASS MAIL

Elizabeth Gonzalez
Chief, Local Government Compliance Bureau
California State Controller's Office
P.O. Box 942850
Sacramento, CA 94250-6874

Re: City of Arroyo Grande's Response and Comments to August 8, 2014 Letter Enclosing Draft Report of the State Controller's Office Asset Transfer Review

Dear Ms. Gonzalez:

Our office serves as special counsel for the Arroyo Grande Successor Agency ("Successor Agency"). This letter and all attachments (the "Response") are sent to respond to the California State Controller's Office's Draft Asset Transfer Review Report for the Arroyo Grande Redevelopment Agency, dated August 8, 2014 ("Draft Report").

As discussed in this Response, the Successor Agency respectfully requests that the State Controller's Office ("SCO") reconsider its finding and order that the Arroyo Grande Redevelopment Agency ("RDA")[1] made $389,107 in "unallowable transfers" (the "disputed amount") that must be returned from the City of Arroyo Grande ("City") to the Successor Agency for the following summarized reasons:

- Constitutionally, the SCO cannot order the $389,107 to be taken away from the City. This amount is comprised of tax increment funds that were allocated to the RDA and paid over to the City prior to the dissolution of the RDA on February 1, 2012. Furthermore, part of this amount was specifically tied to payments made by the RDA to the City for repayment on public works projects, and the SCO cannot "sweep away" either RDA tax increment or City local funds as part of the disputed amount to be turned over to the Successor Agency. Additionally, the RDA's tax increment funds here were an "indebtedness" of the RDA (before it dissolved) that had to be allocated to the City for purposes of paying private, third party contracts, and the SCO would unreasonably interfere with those private contractual obligations if it were to "claw back" the RDA funds committed to pay part of those third party agreements. Indeed, the Legislature cannot enact by

[1] The RDA acted as the City's redevelopment agency, as authorized by the Community Redevelopment Law, Health and Safety Code section 33000 *et seq.* ("CRL").

statute, and the SCO cannot order by statutory enactment such as Section 34167.5,[2] the return of the disputed amount because to do so would violate various provisions in the California and United States Constitutions, including:

- California Constitution, Article XIII, Sections 24 and 25.5 (enacted under Proposition 1A (Nov. 2004) and Proposition 22 (Nov. 2010));
- California Constitution, Article XVI, Section 16 (indebtedness of redevelopment agencies);
- California Constitution, Article I, Section 9, and United State Constitution, Article I, Section 10 (prohibiting unreasonable impairment of private contracts)

- Prior to the date the Governor signed Assembly Bill 26 from the 2011-12 First Extraordinary Session of the California Legislature ("ABx1 26") on June 28, 2011, the RDA committed what constitutes by far the majority of the disputed amount, or $342,334 (the "Le Point Parking Lot Amount") of the $389,107 identified by the SCO.
  - The Le Point Parking Lot Amount is governed by two applicable agreements relative to the SCO Draft Report and the SCO's authority under Section 34167.5. Both agreements were executed and operative by March 30, 2011. First, the City/RDA "Funding Agreement" that committed the Le Point Parking Lot Amount (along with additional amounts), to be paid with RDA tax increment funds, was executed and operative on March 8, 2011. Second, the contractor agreement for the "Le Point Street Parking Lot Project," to which the Le Point Parking Lot Amount applied, was executed and operative between Brough Construction Company and the City on March 30, 2011. Because the RDA transferred the Le Point Parking Lot Amount to the City as part of the payment made to Brough Construction Company under the third party contractor agreement, this amount is not subject to an order by the SCO under Section 34167.5.
  - While the City's bookkeeping system identified, for administrative convenience ***ONLY***, this amount had to be paid by June 30, 2011 by notations to Fund 350 (the Capital Improvement Fund), the actual payment obligation of the RDA to the City arose on March 8, 2011, and

[2] All references to "Section" or "§" are to the Health and Safety Code unless otherwise noted.

the City's payment obligation to the contractor--which governs (and limits) the SCO's authority under Section 34167.5--arose on March 30, 2011.

- Furthermore, the Le Point Parking Lot City/RDA Funding Agreement specifically designated $70,000 of the RDA funding amount as a reimbursement of the City's previously incurred costs from which it paid for a portion of this project with its own general funds. To the extent the Le Point Parking Lot Amount includes the $70,000 and would "claw back" city general fund moneys, that would be an unconstitutional order by the SCO for the reasons discussed below.

- At the time of the $389,107 payment by the RDA, applicable provisions of the redevelopment dissolution law included the City/RDA contracts, agreements, and arrangements, including City/RDA funding agreements, within the definition of "enforceable obligations." Because the SCO asset transfer review is governed under those same provisions, the repayments should be honored.

Summary of Draft Report's Finding and Order

According to the finding and order of the SCO from the Draft Report, a total of $389,107 constitutes an "unallowable transfer" amount that must be turned over to the Successor Agency. (Draft Report, p. 3.) The disputed amount is broken down as cash for loan repayments to the City from the following funds:

- From Fund 350, $38,369 for the Police Station Project
- From Fund 350, $342,334 for the Le Point Street Parking Lot Project
- From Fund 350, $1,650 for the Centennial Park Project
- From Fund 350, $104 for the E. Branch Streetscape Project
- From Fund 350, $6,650 for the Short Street Narrowing Project

No additional details concerning the timing of transfers or governing agreements are included in the Draft Report. For the reasons discussed in this Response, the Successor Agency disputes the SCO's finding and order in the Draft Report and respectfully requests that the final report, when issued by the SCO, be modified in accordance with this Response.

Brief Factual Background

The disputed amount is entirely comprised of payments made by the RDA to the City and, in turn, to private contractors, for construction of "publicly owned improvements" pursuant

to applicable laws that expressly allowed the RDA to fund such improvements.[3] All applicable City/RDA "Funding Agreements" were entered into before June 28, 2011, and applicable City/contractor approvals required by the City for such improvements were authorized by the City before June 28, 2011.

For the purpose of administering payments for publicly owned improvements, as well as other City Capital Improvement Projects ("CIPs"), Fund 350 is the "Capital Improvement Fund." This fund serves only as an accounting mechanism that allows for all projects that meet the City's definition of "capital" to be tracked in one fund, regardless of the source of funds or other funding mechanism that actually pays for a project. In other words, Fund 350 is meant to distinguish between projects that are ongoing operations from those that are capital in nature.

The sources of funds for projects accounted for in Fund 350 are varied and include water funds (collected by the City), sewer funds (collected by the City), development impact fees, grants received by the City, former RDA tax increment, and City sales and use and property taxes. All capital projects, which are those projects that will be depreciated over a useful life of more than one year and exceed $5,000, are tracked in Fund 350 for purposes of having one place in the general ledger to track all Capital Improvement Projects. Costs are incurred and paid throughout the fiscal year, and, at fiscal yearend (June 30), the City makes final accounting entries to "transfer" cash out of the fund that "owns" the project and into Fund 350.

It is important to note that that City's year-end adjustment of entries does not change the nature of the expenditure when it was incurred or when it was paid. For example, if the City receives an invoice for a waterline project on January 15 of a particular fiscal year, the expense gets funded in Fund 350 at the end of that fiscal year (i.e., June 30) even though the obligation to pay and the actual payment to the contractor for the waterline project arose on or about January 15 (date of the invoice). Rather than recording a transfer of cash from the fund that "owns" the project to the Capital Improvement Fund each week when the City cuts a check for that particular obligation, the City historically, including during the period of review under the Draft Report, opts to record the transfer at the end of the fiscal year only as an accounting mechanism, not to show the date of when the obligation to make a payment actually arose or when that obligation's payment actually occurred.

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[3] Under the CRL, the City had the express authority to provide the RDA with financial assistance for purposes of implementing redevelopment activities (see, e.g., Sections 33132, 33133, 33220, 33445, 33445.1, 33600, 33601, 33610, 33614; see also Government Code section 53600 *et seq.*). Also under the CRL, the RDA had express authority to fund "publicly owned improvements," including those owned by the City, with the RDA's "tax increment" revenue. (See Sections 33445, 33445.1.) Tax increment is described below.

For the purposes of the Draft Report, all but one (the "Police Station Project") of the "unallowable transfers" identified by the SCO fall within this explanation. As noted above, the Le Point Parking Lot Amount ($342,334) is governed by (i) the City/RDA Funding Agreement, executed and operative on March 8, 2011, which committed the Le Point Parking Lot Amount (along with additional amounts) to be paid with RDA tax increment funds to the City, and (ii) the contractor agreement, executed and operative on March 30, 2011, that committed the City to pay the third party contractor the Le Point Parking Lot Amount (and other amounts) for the "Le Point Street Parking Lot Project." Thus, even though Fund 350 may show a transfer dated June 30, 2011, that notation was "lumped together" with all other Fund 350 obligations and payments made previously in Fiscal Year 2010-11. The actual payment obligation and transfer of the RDA funds to the City occurred on March 8, 2011, and the City's payment obligation to the third party contractor with those RDA funds arose on March 30, 2011.

A similar situation occurred with the following additional transfers of RDA funds, in that, while the City may have identified amounts transferred to Fund 350 as having occurred by June 30, 2011, the obligation of the RDA to transfer the money to the City, and the City's obligation to pay a third party contractor, actually arose before June 30, 2011:

(1) The $1,650 for the "Centennial Park Project" was committed by the RDA to the City on February 8, 2011, after the City had approved on January 25, 2011, a contract for improvements to the Village Green area to create the Centennial Park. On February 8, 2011, the RDA committed a total of $3,300 to the City, of which $1,650 went to the Centennial Park Project. (The other $1,650 went to the Short Street Narrowing Project, noted below.) Thus, on February 8, 2011, the RDA's payment obligation and transfer occurred, even though the Fund 350 transfer is reflected as having occurred by June 30, 2011.

(2) The $104 for the "East Branch Streetscape Project" was committed by the RDA to the City on February 12, 2008, and this payment was made pursuant to an agreement between the City and RRM Design Group dated January 14, 2008, and subcontract thereunder between RRM and C.P. O'Halloran Associates, Inc., dated January 17, 2008. Thus, even though Fund 350 reflects a transfer as having occurred by June 30, 2011 solely for keeping track of this "stray" amount as part of the City's Capital Improvement Projects, the RDA's payment obligation and requirement for transfer of that money arose well before that date on February 12, 2008.

(3) The $6,650 for the "Short Street Narrowing Project" was committed by the RDA to the City in two separate actions, each before June 28, 2011. The first RDA action was the $3,300 commitment to the City, of which $1,650 was for the Short Street Project, on February 8, 2011. The second RDA action was the $5,000 commitment to the City for this same project on February 22, 2011. The underlying City/third party

agreement for use of these funds dates back to February 23, 2010, when the City Council approved a Purchase and Sale and Improvement Agreement for the Shops at Short Street project, whereby the City agreed to fund improvements and sold right-of-way adjacent to Short Street to provide outdoor dining areas. Thus, while Fund 350 may show a transfer of $6,650, again, for purposes of tracking this Capital Improvement Project, the RDA's obligation to pay and transfer the total amount for this project arose no later than February 22, 2011.

With respect to the $38,369 identified in the Draft Report as part of the Police Station Project, this amount was committed by the RDA as part of the City's Fiscal Year 2009-10 approved budget, which ended prior to the January 1, 2011 commencement/coverage date for the SCO asset transfer review.

Background of Relevant Redevelopment Dissolution Law

Assembly Bill 26 from the 2011-12 First Extraordinary Session of the California Legislature ("ABx1 26"),[4] "froze" and provided for an eventual dissolution of redevelopment agencies, and Assembly Bill 27 from that same extraordinary session ("ABx1 27"),[5] provided for the continued functioning of redevelopment agencies pursuant to a process that exempted the RDA from the "freeze" and dissolution provisions in ABx1 26.

When the California Supreme Court upheld as constitutional ABx1 26 but struck down as unconstitutional ABx1 27 on December 29, 2011,[6] which led to the dissolving of the redevelopment functions of the RDA on February 1, 2012, the entire disputed amount had been approved by the RDA and the City for payment of capital improvement projects in place prior to June 28, 2011.

ABx1 26 and the "Suspension" and "Dissolution" of Redevelopment Agencies

The provisions of ABx1 26 that took effect immediately and governed redevelopment agencies (here, the RDA) until February 1, 2012, are in Part 1.8 of Division 24 of the Health and Safety Code ("Part 1.8"), commonly referred to as the "suspension" provisions. (§ 34161.) As the name implies, Part 1.8 suspended the general powers and authorities of all redevelopment agencies, including the ability to adopt ***new*** redevelopment plans or plan amendments, issue ***new*** bonded indebtedness, and enter into ***new*** contracts or incur ***new*** obligations. (§§ 34162(a), 34163(a) & (b), 34164(a).)

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4 Stats. 2011, 1st Ex. Sess., ch. 5.

5 Stats. 2011, 1st Ex. Sess., ch. 6.

6 *California Redevelopment Assn. v. Matosantos* (2011) 53 Cal.4th 231 ("*CRA*").

Notwithstanding those provisions, Part 1.8 expressly provides that, "Nothing in this part shall be construed to interfere with a redevelopment agency's authority, pursuant to enforceable obligations ***as defined in this chapter***, to (1) make payments due, (2) enforce existing covenants and obligations, or (3) perform its obligations." (§ 34167(f) [emph. added].) Part 1.8 defined "enforceable obligations" as including, among others:

> (5) Any legally binding and enforceable agreement or contract that is not otherwise void as violating the debt limit or public policy. (§ 34167(d).)

The provisions of ABx1 26 that became operative on February 1, 2012 (§ 34170(a); *CRA, supra,* 53 Cal.4th at 274-275), are in Part 1.85 of Division 24 of the Health and Safety Code. "Part 1.85" – commonly known as the "dissolution" provisions – generally has the same substantive definition of "enforceable obligations," which includes, among others:

> (E) Any legally binding and enforceable agreement or contract that is not otherwise void as violating the debt limit or public policy. (§ 34171(d)(1).)

Unlike Part 1.8, however, Part 1.85 has an "exception" to the broad definition of "enforceable obligation," which provides:

> For purposes of this part, "enforceable obligation" does not include any agreements, contracts, or arrangements between the city, county, or city and county that created the redevelopment agency and the former redevelopment agency. . . . (§ 34171(d)(2).)

ABx1 26 and the SCO's "Claw Back" Provisions

The "Clawback Provision" in ABx1 26 at issue -- Section 34167.5 -- is in the "suspension" portion of the law (Part 1.8) and purports to authorize the SCO to act as follows:

> Commencing on the effective date of the act adding this part [Part 1.8], the Controller shall review the activities of redevelopment agencies in the state to determine whether an asset transfer has occurred after January 1, 2011, between the city or county, or city and county that created a redevelopment agency or any other public agency, and the redevelopment agency. If such an asset transfer did occur during that period and the government agency that received the assets is not contractually committed to a third party for the expenditure or encumbrance of those assets, to the extent not prohibited by state and federal law, the Controller shall order the available assets to be returned to the redevelopment agency or, on or after [February 1, 2012], to the successor agency, if a successor agency is established pursuant to Part 1.85 (commencing with Section 34170). Upon receiving such an order from the Controller, an affected local agency shall, as

> soon as practicable, reverse the transfer and return the applicable assets to the redevelopment agency or, on or after [February 1, 2012], to the successor agency, if a successor agency is established pursuant to Part 1.85 (commencing with Section 34170). The Legislature hereby finds that a transfer of assets by a redevelopment agency during the period covered in this section is deemed not to be in the furtherance of the Community Redevelopment Law and is thereby unauthorized.

Unlike some of the other "freeze" provisions in ABx1 26 that were *not* stayed, Section 34167.5 *was* stayed by the California Supreme Court pending the court's decision in the *CRA* case, which was not resolved until December 29, 2011. Section 34167.5 was no longer stayed with the decision in the *CRA* case, and the SCO prepared and submitted the Draft Report pursuant to this provision.

AB 1484, Due Diligence Reviews, and Finding of Completion

In part as a response to the *CRA* decision, the Legislature enacted Assembly Bill 1484 ("AB 1484"),[7] a "budget trailer bill" for the 2012-13 Fiscal Year Budget Act, on June 27, 2012, which took effect immediately.

Among other provisions added to the redevelopment dissolution law (Part 1.85), AB 1484 set forth a process known as the "due diligence reviews" ("DDRs"). Under the DDR process, an independent audit was completed and used as a basis for determining amounts that successor agencies would remit to the taxing entities. Two separate DDRs were completed, one to review the Low and Moderate Income Housing Fund of the former redevelopment agency, and one to review all other funds of the former redevelopment agency. (§ 34179.6(a).) When a successor agency made a remittance payment to the taxing entities, based on the amount determined by DOF for each DDR, the successor agency was entitled to receive a "finding of completion." (§ 34179.7.)

Discussion of Applicable Constitutional Provisions

Proposition 22

The SCO may not order the City to return the disputed amount to the Successor Agency as an "unpermitted transfer" because the Legislature lacked the constitutional authority to enact a law that would result in the SCO's proposed order.

Proposition 22, adopted by the California voters in 2010, amended the State's Constitution to provide in pertinent part:

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[7] Stats. 2012, ch. 26.

> The Legislature shall not...[r]equire a community redevelopment agency to pay, remit, loan, or otherwise transfer, directly or indirectly, taxes on ad valorem real property and tangible personal property allocated to [a redevelopment] agency pursuant to Section 16 of Article XVI to or for the benefit of the State, any agency of the State, or any jurisdiction.

(Cal. Const., art. XIII, s. 25.5(a)(7).)

The purpose of Proposition 22 was to prohibit the State from requiring redevelopment agencies to shift their funds to schools or other agencies, and to eliminate the Legislature's authority to redirect a redevelopment agency's property taxes to any other local government.

The California Supreme Court's decision in *CRA* concluded:

> Proposition 22's limit on state restrictions of redevelopment agencies' use of their funds is best read as limiting the Legislature's powers during the operation, rather than the dissolution, of redevelopment agencies. Thus...those taxes so allocated to an operating redevelopment agency may not be restricted to the benefit the state by any further legislation.

(*Id.*, 53 Cal.4th at p. 263.)

The text of Proposition 22 and the decision in the *CRA* case establish that the Legislature cannot, directly or indirectly, reallocate tax increment paid or otherwise transferred by the RDA to the City or any other entity prior to the dissolution of redevelopment. By ordering a return of tax increment, which had been allocated to the RDA to pay an indebtedness owed to the City prior to the enactment of ABx1 26, the SCO is unconstitutionally ordering a reallocation of the RDA's tax increment for the benefit of the State.

In making the payments, the RDA provided funds that, under Article XVI, Section 16 of the California Constitution and the CRL (at § 33670(b)), were encumbered to repay an indebtedness of the RDA. Specifically, the RDA had an indebtedness to the City for the Capital Improvement Projects, which were committed to private third parties by the City for construction work on those projects.

A redevelopment agency's financial obligations to other public agencies and private parties constituted "indebtedness" of the redevelopment agency, which entitles the other public agencies and private parties – in this case the City and contractors – to payment from the redevelopment agency's available tax increment revenues. (See, Cal. Const., art. XVI, § 16; §§ 33670, 33675 [tax increment provisions]; *Marek v. Napa Community Redevelopment Agency* (1988) 46 Cal.3d 1070, 1087.)

Tax increment revenue consisted of a portion of the local property taxes generated from within a designated redevelopment project area. (§ 33670; *Craig v. City of Poway* (1994) 28 Cal.App.4th 319, 325.) The tax increment financing system, prior to dissolution of redevelopment agencies, worked as follows:

> Redevelopment agencies have no power to tax. Instead, to finance their activities, they are funded primarily through tax increment financing. [Citations.] Under the tax increment system, the assessed value of property within a redevelopment project area is frozen when the redevelopment plan is adopted. (§ 33670.) For the duration of the redevelopment plan, the agency is entitled to the difference between the taxes levied on the base year assessed value and those generated from current assessed value. (*Ibid.*) This increase in, or "increment" of, property tax revenue is known as "tax increment revenue." (*Ibid.*)

Tax increment was ***not*** a general levy on the City's residents and was unique in its allocation to redevelopment agencies, like the RDA here. Once that money was allocated to the RDA, the Legislature could not, by statute, reallocate the RDA's tax increment prior to the RDA's dissolution (or, at a minimum, until it was "frozen" under Part 1.8). Either way, the disputed amount here would be protected.

Therefore, under Article XIII, Section 25.5(a)(7), and Article XVI, Section 16 of the California Constitution, the SCO does not have the authority to order the Amount to be returned to the Successor Agency.

Proposition 1A and Lack of Intent to Appropriate City's General Funds

Section 1 of ABx1 26 sets forth the Legislature's findings and declarations in enacting ABx1 26. The findings describe the increasing shift of property taxes away from the various taxing agencies that has resulted from the growth and expansion of redevelopment agencies (see, Stats. 2011, 1st Ex. Sess., ch. 5, § 1(e), (f), & (g).) In passing ABx1 26, the Legislature, in Section 1(j), expressly stated that its intent was to:

> (1) Bar existing redevelopment agencies from incurring new obligations, prior to their dissolution.
>
> (2) Allocate property tax revenues to successor agencies for making payments on indebtedness incurred by the redevelopment agency prior to its dissolution and allocate remaining balances in accordance with applicable constitutional and statutory provisions.
>
> (3) Beginning [February 1, 2012], allocate these funds according to the existing property tax allocation within each county to

> make the funds available for cities, counties, special districts, and school and community college districts.

Based on the expressly-stated intent of the Legislature, it was ***not*** the Legislature's intent to appropriate general fund monies from cities and counties.

As a corollary (or even alternative) to the constitutional protection established by Proposition 22 (discussed above), if the money ordered to be returned by the SCO was *not* deemed tax increment -- an assumption that the Successor Agency does not advocate based on the timing of the payments from the RDA to the City and the timing of the obligations that gave rise to the allocation of the RDA's tax increment -- then the City still has constitutional protection that prohibits the SCO from ordering the disputed amount (and especially the $70,000 in the "City's Previously Incurred Costs" specified in the City/RDA Funding Agreement for the Le Point Parking Lot Amount) to be distributed to other taxing entities by returning that amount to the Successor Agency.

If the disputed amount is determined not to be tax increment, then it is City money. This too has significant constitutional implications.

With the adoption by the voters of Proposition 1A in 2004, certain provision in Article XIII, Section 25.5 of the California Constitution were added to ensure that the percentage allocation of sales and use taxes and ad valorem property taxes to local taxing agencies were not decreased from the percentages that were established in November 2004. Specifically, the constitutional requirements are, in pertinent part:

> (a) On or after November 3, 2004, the Legislature shall not enact a statute to do any of the following:
>
> (1) . . . modify the manner in which ad valorem property tax revenues are allocated in accordance with subdivision (a) of Section 1 of Article XIII A so as to reduce for any fiscal year the percentage of the total amount of ad valorem property tax revenues in a county that is allocated among all of the local agencies in that county below the percentage of the total amount of those revenues that would be allocated among those agencies for the same fiscal year under the statutes in effect on November 3, 2004. . . . .
>
> (2)(A) . . . restrict the authority of a city, county, or city and county to impose a tax rate under, or change the method of distributing revenues derived under, the Bradley-Burns Uniform Local Sales and Use Tax Law

> set forth in Part 1.5 (commencing with Section 7200) of Division 2 of the Revenue and Taxation Code, as that law read on November 3, 2004.
>
> . . .
>
> (3) . . . change for any fiscal year the pro rata shares in which ad valorem property tax revenues are allocated among local agencies in a county other than pursuant to a bill passed in each house of the Legislature by roll call vote entered in the journal, two-thirds of the membership concurring. . . .

(Cal. Const., art. XIII, § 25.5.)

Additionally, in 2010, the voters approved as part of Proposition 22 provisions amending Article XIII, Section 24 of the California Constitution to add subdivision (b), which reads:

> The Legislature may not reallocate, transfer, borrow, appropriate, restrict the use of, or otherwise use the proceeds of any tax imposed or levied by a local government solely for the local government's purpose.

Relevant to the Draft Report, the City's general fund is comprised of sales and use tax revenue and ad valorem property tax revenue (***not*** tax increment), portions of which are specifically dedicated for the City. The Legislature may not change the City's percentage allocation of these tax revenues. No authority exists under Article XIII, Sections 24(b) and 25.5(a)(2) to reallocate sales and use tax revenue allocations of the City here, and no ability exists under Article XIII, Section 25.5(a)(1) & (3) because neither ABx1 26 nor AB 1484 passed with a 2/3 majority vote from each house of the Legislature.

If the SCO were to require the City to turn over amounts equal to the disputed amount, the SCO would be ordering a reallocation of the City's sales and use/property taxes to other taxing entities. Such an order violates Article XIII, Sections 24(b) and 25.5(a)(1), (2) & (3) of the California Constitution.

Discussion Concerning Applicable Statutory Provisions and Impairment of Contracts

Section 34167.5, the authority for the SCO's review and Draft Report, provides in pertinent part:

> ...If such an asset transfer did occur during that period and the government agency that received the assets is not contractually committed to a third party for the expenditure or encumbrance of those assets, to the extent not prohibited by state and federal law, the Controller shall order the available assets to be returned

> to the redevelopment agency or, on or after [February 1, 2012], to the successor agency, if a successor agency is established pursuant to Part 1.85 (commencing with Section 34170).

The language of Section 34167.5 lacks clarity and must be interpreted in light of the Legislature's apparent intent in including it in ABx1 26.[8] The terms "asset" and "transfer" are not defined and so the context is critical to understanding the intent of the Legislature and why no "asset transfer" occurred when the RDA made the payments during the subject time period.

It is important to note that the Governor's initial redevelopment dissolution proposal, announced in January 2011, subsequently became Senate Bill 77 and an identical companion bill, Assembly Bill 101. Senate Bill 77 was rejected by the Legislature on March 16, 2011.[9] There was no active redevelopment dissolution bill in the Legislature until mid-June 2011 when ABx1 26 was launched and eventually signed into law on June 28, 2011.

After the Governor's initial proposal was announced in January 2011 and prior to enactment of ABx1 26, some redevelopment agencies in the State made "no consideration" transfers of property and money to their cities. The Legislature obviously responded to these "no consideration" transfers of real property by some redevelopment agencies by including Section 34167.5 in the subsequently enacted ABx1 26.[10] By forcing a return of these transferred assets to the account of the dissolved redevelopment agency, the cash and value of non-cash assets may be used to help pay the enforceable obligations of the dissolved redevelopment agency.

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[8] Section 34167.5 was not amended by AB 1484.

[9] SB 77 failed to obtain the required votes for passage and later was amended to address to a completely different topic. AB 101 was never voted on when it addressed redevelopment dissolution. Ultimately, AB 101 was amended to address a completely different topic. From March 16, 2011 until June 14, 2011 when ABx1 26, previously a placeholder budget bill, was amended in the Legislature to add redevelopment dissolution provisions, there were no active bills in the Legislature to dissolve redevelopment agencies.

[10] The California Attorney General's office itself has stated on the record that it is "far from clear" that ABx1 26 invalidates all city-redevelopment loans and that the apparent intent of those provisions of ABx1 26 was to invalidate only the "last minute" loan agreements and other arrangements between cities and their redevelopment agencies that took place *after* January 1, 2011. The statement was made on January 27, 2012, by the Deputy Attorney General Ross Moody (who also argued before the California Supreme Court on behalf of the State in the *CRA* case) in Sacramento County Superior Court at the hearing for preliminary injunction in the case *City of Cerritos et al. v. State of California, et al.*, Sacramento County Superior Court Case No. 34-2011-80000952. That hearing was prior to the enactment of AB 1484 but AB 1484 did not amend Health and Safety Code section 34171(d)(1)(B).

By contrast, the RDA funding commitments to the City here were not "asset transfers" as contemplated by Section 34167.5 nor the type of transaction Section 34167.5 seeks to remedy. The funding commitments were for lawful and valid third party CIPs that pre-dated the effective date of ABx1 26. These types of financing/funding commitments were clearly contemplated by the Legislature as being ***outside the purview*** of Section 34167.5, which specifically excludes assets transferred that are "***contractually committed to a third party***" and ***not subject to claw back "by state and federal law."***

To expand on the latter concept (claw back order not permissible under state or federal law), it must be noted that the purported legal basis for the SCO ordering a claw back of the disputed amount would not be on the grounds that the RDA funding commitments were *unlawful* at the time when entered into and when made. Indeed, they were expressly authorized under the CRL, and the RDA and City made all requisite findings to use the RDA's tax increment to pay for the publicly owned improvements/CIPs. (§ 33445.)

Rather, the purported legal basis for having the SCO claw back the disputed amount is premised on the State being permitted to effect an "impairment of contract" by retroactive application of a law. The State, however, may not do so in this case.

Under Article 1, Section 9, of the California Constitution, the State may not adopt a law impairing the obligations of contracts. There is an analogous and binding provision set forth in Article 1, Section 10, of the United States Constitution, which prohibits states from enacting laws impairing the obligations of contracts. Section 34167.5, if sought to be applied here, obviously would result in an impairment of contract, but presumably the State's theory would be that a redevelopment agency and a city are subordinate entities of the State and therefore the Legislature may lawfully impair contracts between a redevelopment agency and a city (including impairment to the extent of voiding and reversing lawful contracts). That theory rests on a number of debatable assumptions, but that theory should not be applicable here, where the impairment would effectively ***result*** in an impairment of the City's contractual obligations to private, third party contractors. For instance, with respect to the Le Point Parking Lot Amount -- the most significant portion of the disputed amount -- the State's impairment of the City/RDA Funding Agreement of March 8, 2011, results in the impairment of the City/Brough Construction Company private third party contract of March 30, 2011. This impairment the State cannot do under the California and United States Constitutions.

Other sections of the ABx1 26 and AB 1484 evidence the clear intent of the Legislature to uphold valid and binding third party agreements and arrangements under which a redevelopment agency had committed funding assistance to private contractors. Section 34179.5, which applies to the DDR process, is instructive on this point.

AB 1484 established the DDR process "in furtherance of" Section 34177(d). (See, §§ 34179.5, 34179.6.) Section 34177(d) provides in pertinent part, that successor agencies are required to:

> Remit ***unencumbered*** balances of redevelopment agency funds to the county auditor-controller for distribution to the taxing entities, including, but not limited to, the unencumbered balance of the Low and Moderate Income Housing Fund of a former redevelopment agency.

The DDR was intended to determine "the ***unobligated*** balances" of "cash or cash equivalents" previously held by the redevelopment agency prior to dissolution available for distribution to the taxing entities. (§ 34179.5(a).) As part of that determination, AB 1484 has a very specific definition of "transferred" that is to be applied when an accountant or auditor, performing the DDR, was to determine whether any specific assets, cash, or cash equivalents should be included in the calculation of funds available for remittance to the taxing entities. (See, §§ 34179.5(c)(1)-(6); 34179.6(c).) Specifically, Section 34179.5(b)(3) defines "transferred" for purposes of the DDR as:

> [T]he transmission of money to another party that is not in payment for goods or services or an investment or where the payment is de minimus. Transfer also means where the payments are ultimately merely a restriction on the use of the money.

Here, the funds from the RDA to the City were for payments of third party contractor services. Under the DDR process, then, the "transferred" RDA funds were completely authorized. The SCO asset transfer review basically reviews RDA transfers for the same purpose, and should follow this statutory language to fulfill the Legislature's intent.

Furthermore, prior to February 1, 2012, city-redevelopment agency contracts were included as enforceable obligations under Part 1.8 of ABx1 26 (Section 34167(d)(5)), and applicable constitutional and case law, namely Article XIII, Section 25.5(a)(7) added by Proposition 22 (2010) and *Marek v. Napa Community Redevelopment Agency* (1988) 46 Cal.3d 1070, 1082. (*See also, CRA, supra,* 53 Cal.4th at pp. 253-254.) While city-redevelopment agency contracts were largely excluded from the definition of "enforceable obligations" under Part 1.85 (see Section 34171(d)(2)), that part was not in effect when the RDA obligations to fund the City for private third party contracts were operative. Part 1.85 did not become operative until February 1, 2012.[11]

[11] Our office is aware that there have been Sacramento County Superior Court decisions that have ruled, in the context of a writ of mandamus, that some city-redevelopment agency agreements do not constitute "enforceable obligations" while others do. To the extent these

In summary, applicable provisions from ABx1 26 and AB 1484 support the position that the disputed amount, and at a minimum the Le Point Parking Lot Amount, is not an "unallowable transfer" subject to return to the Successor Agency.

The City/RDA Loan Agreements Are Forever Valid under Validation Proceedings

At the time the City/RDA Funding Agreements were approved, such as the March 8, 2011 Le Point Street Parking Lot Project Funding Agreement, applicable law provided (and still provides) that any challenge to the validity of the warrants, contracts, obligations, or other evidence of indebtedness of the RDA to the City had to be brought within 60 days of the date of the action approving such indebtedness. (Gov. Code §§ 53510, 53511; Code Civ. Proc. §§860-870.5; *City of Ontario v. Superior Court of San Bernardino County* (1970) 2 Cal.3d 335, 341-344.) The relevant City/RDA agreements, as a City/RDA contract, obligation, and evidence of indebtedness -- which committed RDA tax increment for payment -- falls squarely within this ambit of local agency "financial obligations" that are subject to the validation/reverse validation action statutes. (See, e.g., *City of Ontario, supra,* 2 Cal.3d at 344; *City of Cerritos v. Cerritos Taxpayers Assn.* (2010) 183 Cal.App.4th 1417, 1423, 1427-1428 & fn.3; see also, Code Civ., Proc. § 864.) As such, challenges to the Funding Agreements as not being a valid indebtedness of the RDA could only be brought within the 60-day limitations period, and none were timely brought. As such, any attempt to invalidate the City/RDA funding agreements and the payments made pursuant to those agreements, including by the SCO, is forever barred.

In *City of Ontario,* the California Supreme Court explained that, when public agency actions are subject to the validation provisions in Code of Civil Procedure Section 860 *et seq.*, "an agency may indirectly but effectively 'validate' its action *by doing nothing to validate it;* unless an 'interested person' brings an action of his own under *section 863* within the 60-day period, the agency's action will become immune from attack whether it is legally valid or not." (2 Cal.3d at 341-342; see also *McLeod v. Vista Unified Sch. Dist.* (2008) 158 Cal.App.4th 1156, 1169.) On the flip side, if a "validation action" is timely brought by a public agency, or a "reverse validation action" is timely brought by any other interested person, the final adjudication of that action is "forever binding and conclusive" as to all matters adjudicated ***or***

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superior court cases tangentially may have common operative facts to Arroyo Grande's situation, they are not binding on Arroyo Grande or any other agency other than the one in the litigation. No appellate court has decided the constitutionality of a SCO-ordered "claw back" that results in the reallocation of city general fund moneys comprised of sales/use and property taxes, or the retroactive "undoing" of RDA funding commitments by shifting RDA's tax increment revenues that could not be shifted by the Legislature under Proposition 22 prior to the dissolution of redevelopment. While it is expected these issues will likely be decided by the court of appeal, until such time of such decision there is no binding case that governs Arroyo Grande's situation.

that could have been adjudicated, and on all parties ***and all other interested persons.*** (Code Civ. Proc. §§869, 870; see also, *Cerritos, supra,* 183 Cal.App.4th at 1428-1429.)

The purpose behind the short limitations period is "to further the important policy of speedy determination of the public agency's action." (*McLeod, supra,* 158 Cal.App.4th at 1166.) If either the RDA were continuously subject to challenge for funding publicly owned improvements owned by the City, or the City were continuously susceptible to challenge (as it is now by the SCO) for using that RDA funding for publicly owned improvements, then both agencies would be impeded in their ability to operate based on the reliance of those funds being available under the agreed upon terms. (*Id.* at 1169.)

The SCO like any other "interested person" under the validation statutes is bound by the longstanding validity of the City/RDA funding agreements from the dates they became "validated." (Code Civ. Proc. §§869, 870; see also, *Moorpark Unified Sch. Dist. v. Superior Court of Ventura County* (1990) 223 Cal.App.3d 954, 956, 959 [county and school district all "interested parties" under validation statute].) Indeed, the CRL expressly provided (and still provides) that, "[f]or the purpose of protecting the interests of the state, the Attorney General and [DOF] are interested persons pursuant to Section 863 of the Code of Civil Procedure . . . ." (§ 33501(d); see also, 41A West's Ann. HSC (1999 ed.) former § 33501(b) [DOF is an "interested person" to protect the interests of the State].) SCO cannot now, through the "asset transfer review audit" or otherwise, invalidate RDA funding commitments made under the terms provided in City/RDA funding agreements, which, as a matter of law, are deemed valid for all time. (*City of Ontario, supra,* 2 Cal.3d at 341-342; *McLeod, supra,* 158 Cal.App.4th at 1169.)

Conclusion

For all of the foregoing reasons, the RDA's repayments of the disputed amount to the City were, and remain, lawful and valid payments. If you have any questions concerning the above, please do not hesitate to contact me.

Very truly yours,

RUTAN & TUCKER, LLP

William H. Ihrke

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cc: Steven Adams, City Manager (via e-mail)

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