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Quick Takes

May 2006

Writing an "Accountable" MOU

"I repeat... that all power is a trust—that we are accountable for its exercise—that, from the people, and for the people, all springs, and all must exist."
Benjamin Disraeli (1804 - 1881)
Prime Minister of Great Britain

So, we're "accountable". But, what does that mean? And what's an "MOU", anyway?
Let's take the easy one first. An "MOU" is a "Memorandum of Understanding." In the world of new and expanding business and industry, it's the preliminary "deal document" for a project. An MOU is particularly needed when inducing a company to locate its project in the state and a community involves the public sector's investing its scarce resources in incentives negotiated for the benefit of the project.

At the insistence of a site location consultant many years ago, on behalf of the community selected by the company, I prepared one of the first, if not the first, of the MOU's ever used in Georgia. The consultant wanted an MOU in order to document the commitments from all sources for his project. The company's counterparty signatory to the MOU was the local development authority, but attached commitments came from many other state and local departments and public bodies.

Since then, MOU's have become virtual "aircraft carriers", laden with provisions designed to serve a variety of purposes. Among the purposes served, is "accountability." Like the early MOU mentioned above, today's MOU's contain "clawbacks", or performance standards designed to obtain reimbursement to the public sector of some measure of its incentives if the private company fails to live up to its commitments. In my experience, private companies are not overly resistant to having clawbacks, but will negotiate them, often at great length. Typically, if the company does not meet the jobs or investment goals that it has agreed to, the community will want to recover a proportionate (to the shortfall in meeting such goals) share of abated property taxes (or sometimes to terminate the abatement schedule entirely), if abatement is a negotiated incentive. In case of such a shortfall, the community will also want to recover as well as a proportionate share of any cash or in-kind investments in the project it may have made. Sometimes additional goals are included, such as average wage, annual payroll, etc. In the past, all of this has been negotiable, although communities sometimes are constrained by local policies, local officials' tolerances, etc.

Now, there is a "new Sheriff" in the world of projects in Georgia! This is the new clawback and accountability policy promulgated as of December 31, 2005 by the Georgia Department of Community Affairs, in partnership with the OneGeorgia Authority and the Georgia Department of Economic Development. The main thrust is simple- “the repayment, recapture or deobligation of a portion or all of funds [is required] should the [company] fail to deliver at least 70% of the committed public benefit within the specified grant period; however, in no event would repayment be required within the first 24 months following the completion of the assisted activity. Public benefit will be calculated as the average of the percentage of created jobs and the percentage of actual capital investment versus committed jobs and investment.” Examples of how this is calculated are at the end of this issue of *Quick Takes*.

Simple enough, huh? But remember, “the devil is in the details.” And the details include not just the new “accountability” policy, but additionally the general and special grant conditions that have also been evolving while all of this has been going on. I have been applying these new rules in drafting MOU’s for some time now.

Let me share with you some of the “lessons learned” from writing “accountable” MOU’s. These are oriented towards Georgia projects in which state grant money is invested. Many of the points travel well, however, because they deal with some basic issues in pulbic sector subsidies, financing projects, etc. Here they are-

- **Can you borrow against the project?** State grant general conditions will prohibit a transfer of the project in which grant funds have been invested out of public ownership (i.e., title being held by the development authority) until “closeout” (i.e., the determination that the expected public benefit has been received). The 24 month period mentioned above is the normal period allowed for this public benefit to be generated. Sometimes an even longer period of public ownership is imposed via special conditions of the grant. Unless the project will be paid for out of 100% company equity (unlikely), the party responsible for financing the project (usually the company, but sometimes the development authority) will want to borrow against it; *i.e.*, grant a security deed and/or security agreement encumbering the project to a lender such as a bank. The lender will, in turn, want to foreclose if it is not paid. If the participants are not careful, the general and special grant conditions could prevent foreclosure, which would preclude the project from being used as collateral. Result- a project that’s not financeable! The solution is to be sure that what the general and special conditions prohibit, is the project’s “voluntarily” being taken out of public ownership (and that the conditions don’t treat the voluntary grant of the security instruments as a voluntary transfer).
- **Can the development authority grant the company a purchase option, allowing it to buy the project?** Same issue. This time, the development authority is voluntarily granting the purchase option, and the company would voluntarily be exercising it, if it does. Both of these events are perfectly normal in connection with bond financing, for example. Since a premature exercise of the purchase option could result in the public sector’s not getting all of the public benefit it bargained for, the consequence, according to the general grant conditions, would be the requirement for the <u>entire</u> amount of the grant to be repaid. The solution is to either remove the purchase option from the MOU (not usually feasible), to preclude an early exercise of the purchase option, or for the MOU to require the company to indemnify the development authority against any grant repayment obligation resulting from the company’s early exercise of its purchase option.
- **What’s a “job”?** The Georgia Department of Community Affairs has exposed some literature regarding implementation of the new “accountability” policy, including a draft form of tri-party agreement between the development authority, the company, and (whichever is the source of the grant) DCA or the OneGeorgia Authority. The policy requires testing for the number of “permanent full-time equivalent jobs.” The tri-party agreement will define a “full-time” job in terms of a minimum number (to be determined)

of hours per week. In the past, many MOU's have used the definition from the state's job tax credit program, which is based on 35 hours per week, determined from the company's monthly wage withholding reports. Communities often modify the definition to exclude leased or temporary employees from being counted. Companies don't seem to mind the 35-hours/week requirement, and most companies accept the monthly averaging approach to counting the jobs. A number of other companies, however, want to use a "snapshot" of headcount as of a particularly time, either at the end of each year, or one-time (at the end of a ramp-up period). If a "snapshot" approach is used, the community will want to include some anti-manipulation language, to mitigate against just enough people being hired, for just long enough, to avoid clawbacks. No job counting methodology has been prescribed as yet under the new "accountability" policy. If and when one is, it should be followed. Until then, the methodology to be used for the particular grant should be specified in the MOU (and, until a state-prescribed methodology can be included, an "overriding" provision should be included, that specifies that whatever the state ultimately requires will apply, at least as to state incentives). If the company and the development authority have negotiated and agreed to a methodology for purposes of the MOU, and want to be sure it will be used for purposes of the state grant, then the development authority should include a request to such effect in its application for the grant. The purpose of such a request would be to get the state to include the requested provisions in the grant award and its conditions, and to have the provisions apply for purposes of the tri-party agreement. It is important to avoid a situation where the company has met its state incentives goals for purposes of the MOU, but not for purposes of the tri-party agreement.

- **What counts towards satisfying the investment goal?** Same issue as with jobs, except that there are no signs as yet that the state is planning to prescribe a methodology for determining investment (however, documenting investment <u>is</u> required). I like to provide some guidelines in the MOU; e.g., machinery and equipment under an operating lease could be counted, transferred machinery and equipment could be counted at an agreed value such as net book value, and, for other purposes, the effect of depreciation could be ignored but if property is removed from the project, the amount of investment should be decreased accordingly. As with jobs, if there is a negotiated methodology in the MOU that the parties want to be sure that the state will apply, the development authority should request this in its grant application. Again, it is important to avoid having the company be in compliance with its goals for one purpose, but not for another.
- **Do you have to keep "two sets of books"? Should you?** "Two sets of books" should always be avoided, if possible. However, the MOU will already have "two sets of books" if jobs are counted differently for purposes of community incentives than for purposes of a state grant. Suggestion- avoid this if possible! Another disconnect could occur if the methodology used to determine attainment of the performance goals is different for purposes of the community incentives than for purposes of the state grant. Under the new "accountability" policy, the state tests for attainment of the goals one-time, at the end of the performance period; e.g., the 24 month period mentioned above. At least as to its tax abatement incentives, which will normally extend for more than two years, the community will normally want annual accountability. If so, the community and the state already are on different schedules.

  I have not found companies to be too resistant to having to make two sets of calculations for these purposes. In the interest of simplicity, I would have expected companies to want community cash and in-kind incentives treated the same for clawback purposes as state grants; i.e., if the company has attained its goals for state purposes at the end of the state's performance period, then it will be deemed to have also attained its goals for community incentives purposes. If it hasn't, then there is a proportionate clawback against both state and community incentives using the same methodology, with recoveries being paid to the state and the community, respectively. In practice, this approach is OK with some companies, but not with others. The issue is whether a company's attaining its goal in one year takes that year's share of the incentives value "off the table" for clawback purposes. In other words, if there is a 10 year abatement period, a 10 year lease, and a 10 year accountability period, and in year 1 the company attains all of its goals, is it excused from accountability later on to the extent of 10% of the total cash and in-kind incentives? With a community, that is negotiable. However, the state wants all of its public benefit, not just 90% of it. So, the methodology for state grant purposes requires the entire state grant to be "on the table" on the goals attainment determination date. However, as discussed above, only a 70% attainment on average is required for state purposes, and clawbacks are prorated if there is a shortfall below that level. This approach can have benefits for the company. However, a company that wants as much of its accountability to be excused as possible as it performs from year to year, will want everything but the state grant covered by the annual "off the table" approach, and will want the state grant, only, covered by the state's attainment determination date methodology.

- **Can the company "overperform" (i.e., attain more than 100% of its goal)? Does it do any good to do so?** The new "accountability" policy leaves open the possibility of a company having, for example, twice the number of jobs it promised on the goals attainment determination date. This would mean, technically, that the company had 200% performance, with respect to its jobs goal. Assume that this percentage is averaged with an investment goal percentage of 40%. The result of 120% would technically be in compliance with the new "accountability" policy, meaning that no clawback of state incentives would be required. Based on informal discussions, DCA does not seem to have a problem with this interpretation of the new "accountability" policy. However, if this interpretation is likely to be an issue with a particular grant, it would be best to request approval of that interpretation in the development authority's grant application.
- **Do you have to have two goals? And what if it takes more than two years for the project to reach its goals?** The text of the new "accountability" policy, and the literature available so far concerning it, are all oriented around the test, for whether public benefit has been received, being based on both jobs and investment. Likewise, this literature uses 24 months ("from the date of the issuance of the Certificate of Occupancy for a new facility to be operated by the Company or the installation of the incentive funded asset") as the normal performance period. This is the time normally allowed for the company to create the requisite public benefit by creating the jobs and making the investment. Note that the company initially controls what the job and investment levels are- these are based on figures provided by the company to the community and state. The state has said that its approach to this "accountability" policy is based on prospects being "financially viable and [using] conservative job and investment commitments…" The trade off is that more conservative numbers can be expected to result in smaller grants.

The secret to making the "accountable" MOU workable in light of all of these issues is simple- be realistic! The state's recommendation letter (from the Department of Economic Development to DCA, recommending that a grant be made) will be the initial reflection of what public benefit is expected. It is at that point when a company that will, for example, create a lot of jobs but not make a large amount of investment, could ask that its performance be measured in jobs terms alone. And this request should be carried over to the grant application submitted by the development authority. Likewise, if a company has a "slow" project, which will take longer than 24 months to reach its potential, this issue should be addressed at the recommendation letter stage, and carried over to the grant application.

Another issue is *force majeure* (events beyond the control of a party, that are agreed to excuse, or delay the time for, its performance). Companies often negotiate *force majeure* clauses for their MOU's. Now, such clauses have to be limited to community incentives requirements, only, to avoid conflicts with the state's requirements. However, DCA's draft of the tri-party agreement mentioned above does provide that: "Extensions of the performance period may be granted for good cause." The company and the development authority could agree to seek an extension from the state, when needed, with respect to the state's performance period in justifiable situations.

- **Who is liable to the state if the company underperforms?** An initial concern with the first exposure draft of the "accountability" policy arose out of its "provisions for the use of security agreements and upfront liens to 'secure' the state claw-backs." Or, worse yet, the notion that the development authority, which would actually receive the grant from the state for purposes of the project, would have its own personal liability to the state for repayment. Provisions to address these concerns have been drafted for the tri-party agreement mentioned above, and are now being reviewed by the Attorney General's office. If approved, then pursuant to the separate tri-party agreement, the development authority will assign its rights to recovery payments for state grants to DCA or the OneGeorgia Authority, as appropriate, as well as its rights under the tri-party agreement. Although the state might go to court later (after a default) to enforce its rights, like any creditor, a real advantage of this approach is that the ability to finance the project (use it as collateral) is not impaired thereby. Regarding exculpation of the development authority from liability, these draft tri-party agreement provisions also state: "In general, [DCA / OneGeorgia] will hold no recourse against the Development Authority for the Company's failure to create jobs and private investment under this Agreement unless the Development Authority explicitly accepts such recourse." However, in addition to these "legal sanctions", DCA's "accountability" materials also contemplate "administrative sanctions" that might affect the development authority, such as "ineligibility, withholding of payments, etc."
- **If the company "underperforms", who gets to keep the recovery payments?** Recovery payments related to a state grant will (assuming Attorney General approval, as mentioned above) be paid by the company directly to the state, pursuant to the above-referenced tri-party agreement and assignment. The clawback provisions related to the community incentives operate separately, and could, for example, make recovery payments with respect to abated property taxes payable directly by the company to the Tax Commissioner.

If you have any questions or comments about "accountable" MOU's, please let me know.

Daniel M. McRae

May 15, 2006 interest rates on IDBs (variable rate demand bonds; AMT; 7 day general markets; rates are market extracted and approximations):

Interest Rates:
tax-exempt 3.73%
taxable 5.13%

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General note: This issue of *Quick Takes* is a quick-reference guide for economic developers, participants in the real estate and financial industries, company directors, executives and managers, and their advisors. The information in this issue is general in nature. Various points that could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case.

Special notes:

1. Certain quoted language above is from literature provided by DCA.
2. In order to simplify the discussion above, and to focus it on the topic of "accountability", discussion of the proper structures to legally provide the incentives mentioned above has been omitted. Implementing proper structures, in compliance with applicable laws, is a requirement, however. *See* general note, above.

EXAMPLES FROM "ACCOUNTABILITY" POLICY OF CALCULATIONS

<u>Repayment Required</u>

A $500,000 state grant to assist with site development was part of Company A's consideration to locate in Georgia rather than an out-of-state location. As part of the deal, Company A committed to create 600 jobs and make a $5,000,000 capital investment to construct and operate a new production facility in Georgia. 24 months following the opening of the facility, Company A has actually created 400 jobs and invested $3,500,000 into a small facility.

- Grant Amount $500,000
- Original Commitment – 600 jobs & $5,000,000 investment
- Actual jobs delivered – 400 (66% of Commitment)
- Actual investment delivered -- $3,500,000 (70% of Commitment)
- 66% + 70% = 136/2 = 68% Overall Benefit Actually Delivered
- $340,000 (68%) of grant is OK
- $160,000 (32%) would have to be repaid

No Repayment Necessary

A $500,00 state grant to assist with the purchase of production equipment was part of Company B's consideration to locate in Georgia rather than an out-of-state location. As part of the deal, Company B committed to create 600 jobs and make a $5,000,000 capital investment to construct and operate a new manufacturing facility in Georgia. 24 months following the opening of the facility, Company B has actually created 600 jobs and invested $4,250,000 into a redesigned facility that saved $750,000 in capital investment

Grant Amount $500,000

Commitment – 600 jobs & $5,000,000 investment

Actual jobs delivered – 600 (100%)

Actual investment delivered - $4,250,000 (85%)

100% + 85% = 185/2 = 92.5% Benefit

No repayment required