



DIVISION OF  
LOCAL GOVERNMENT AND SCHOOL ACCOUNTABILITY

# Municipal Use of Local Development Corporations and Other Private Entities:

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BACKGROUND, ISSUES AND RECOMMENDATIONS

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State Comptroller

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## Executive Summary

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New York’s counties, cities, towns, and villages frequently utilize local development corporations (LDCs) and other private entities for economic development and other activities. These LDCs and similar private entities are exempt from many of the constitutional and statutory provisions that guide the operations and financial transactions conducted by local governments. For example, LDCs and similar entities are not subject to public procurement laws that require certain contracts to be bid competitively, and the debt that these entities issue, even if for the benefit of a local government, is not subject to the limits on debt established for most municipalities in the New York State Constitution. The use of LDCs and similar organizations to finance local government operations and projects increases the risk of waste, fraud, or abuse of taxpayer dollars or assets.

The Office of the State Comptroller (OSC) currently does not have direct authority to audit LDCs or most other private entities, even when these entities are controlled by a local government. However, in instances where a local government has a financial relationship with an LDC or other private organization, OSC can initiate an audit of the local government itself and examine the financial relationship in that way. Through these types of audits, OSC has identified a number of transactions in which LDCs have been used primarily to avoid constitutional or statutory provisions that apply to local government operations and/or finances.

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**Comptroller DiNapoli is advancing a reform agenda that would give OSC direct audit authority over LDCs and other private organizations controlled by one or more local governments, and would limit the ability of local governments to circumvent the law by utilizing LDCs and other private organizations to finance the operations or capital assets of the local government.**

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The extent to which LDCs and similar entities are used for improper or inappropriate activities has been difficult to determine. Therefore, Comptroller DiNapoli is advancing a reform agenda that would give OSC direct audit authority over LDCs and other private organizations controlled by one or more local governments, and would limit the ability of local governments to circumvent the law by utilizing LDCs and other private organizations to finance the operations or capital assets of the local government. The provisions of the reform agenda include:

- Expanding OSC’s audit authority to cover any organization—including LDCs and limited liability companies (LLCs)—under the control of one or more local governments.
- Restricting the permissible purposes and powers of LDCs, LLCs, and other not-for-profit corporations by prohibiting these entities from financing a local government’s operations or capital assets.
- Prohibiting the creation of LDCs solely for the generic purpose of “lessening the burdens of government and acting in the public interest.” Local governments have come to rely on this overly broad language in order to finance projects not related to economic development.
- Requiring that any contract between a local government and an LDC must be for fair value, and for a term not to exceed five years (subject to renewal).
- Prohibiting any additional compensation for board members, officials, and employees of certain LDCs in instances where those individuals serve or have recently served as officers or employees of a municipality.
- Requiring that the public notice of any proposed transfer of municipally-owned real property to an LDC include a description of the property to be sold or leased, the price or benefit received by the local government for the asset being transferred, the estimated fair market value of the asset, and a statement of the intended use of the property by the LDC.
- Clarifying that no local government or school district may guarantee or assume the debt of any not-for-profit corporation or LLC formed by, on behalf of, for the benefit of, or under the control of the local government or school district.
- Providing that the Local Finance Law (Section 176.00) is the exclusive law governing the manner in which municipalities, school districts, and district corporations finance their operations and the acquisition or improvement of their assets.



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LDCs may be created pursuant to Not-For-Profit Corporation Law, Section 1411 for the following purposes:

- Relieving and reducing unemployment;
- Promoting and enhancing employment opportunities;
- Instructing or training individuals to improve or develop skills;
- Conducting scientific research to attract or retain industry; and
- Lessening the burdens of government and acting in the public interest.

Local governments often rely on the “lessening the burdens of government and acting in the public interest” language as their authority to create LDCs whose primary purpose is to finance local government projects and/or operations which may or may not be related to economic development.<sup>2</sup>

To achieve the purposes for which they are created, LDCs have the power to:

- Construct, acquire, rehabilitate, and improve industrial or manufacturing plants;
- Assist financially in such construction, acquisition, rehabilitation, and improvement;
- Maintain such plants for others;
- Acquire by purchase, lease, gift, bequest, devise or otherwise real or personal property or interests therein;
- Borrow money and issue bonds, notes, and other obligations therefor;
- Sell, lease, mortgage or otherwise dispose of any such plants or any of their real or personal property upon terms determined by the LDC;
- Carry out their corporate purposes; and
- Foster and encourage the location or expansion of industrial or manufacturing plants in the territory where the LDC's operations are principally conducted.

With limited exceptions, the governing body of a county, city, town, or village may determine that any real property owned by the municipality is no longer required for municipal use and authorize the sale or lease of the property to an LDC. The sale or lease may be made without appraisal, public notice, or public bidding, although before the sale or lease is authorized, the municipality is required to hold a public hearing with at least 10 days prior published notice. The LDC must use the property for the purposes set forth in its certificate of incorporation, unless the LDC obtains written approval from the municipality to use the property for another purpose.

The income and operations of LDCs are exempt from taxation. Real property owned by an LDC may also be exempt from taxation, but only if the property is used for an exempt purpose.<sup>3</sup> Property owned by an LDC and leased to a for-profit corporation to carry out for-profit manufacturing activities on the property is not exempt from taxation.<sup>4</sup>

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## Transparency of LDC Operations

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Of the 279 known LDCs, 185 (including 17 located in New York City) have been determined by the Authority Budget Office (ABO) to be local authorities subject to the Public Authority Accountability Act of 2005 (PAAA), as amended by the Public Authorities Reform Act of 2009 (PARA).<sup>5</sup> The PAAA requires an LDC that has been determined to be a local authority to comply with a number of statutory requirements.

The PAAA (as amended) requires these LDCs to submit annual reports to the ABO and post information on their mission, current activities and finances on their websites. The information that must be reported includes:

- **Information on Governance Structure.** Among other things, local authorities are required to provide a mission statement, an annual self-evaluation based on stated performance measurements, an assessment of their internal controls, biographical information on all board members, information on any compensation of management with salaries in excess of \$100,000, and their bylaws and codes of ethics.
- **Financial Information.** Local authorities must also provide audited financial reports, information on grant and subsidy programs, current bond ratings and changes in ratings, debt schedules, compensation schedules, and detailed information on all real property transactions and transactions involving the purchase or sale of assets, services or both, without competitive bidding.

In addition, the Court of Appeals has held that LDCs created by or for a local government are considered agencies of the local government for purposes of the Freedom of Information Law (FOIL).<sup>6</sup> Citing this case, the Committee on Open Government has rendered advisory opinions concluding that such LDCs are also subject to the Open Meetings Law (OML).<sup>7</sup>

## 2009 LDC Data

For the 2009 fiscal year, more than half of the LDCs required to submit reports to the ABO failed to do so. Of the 86 LDCs that reported financial information to ABO:

- 51 LDCs reported outstanding debt totaling \$7.4 billion;
- 16 LDCs reported awarding grants totaling \$257 million; and
- 29 LDCs have made loans totaling \$137 million.

2009 LDC Financial Data			
	Number of LDCs Reporting	Number of Recipients	Amount (millions)
Loans	29	765	\$137
Grants	16	246	\$257
Bonds Outstanding	15	29	\$6,415
Debt Outstanding	51	NA	\$7,362

## OSC Audits

Currently, OSC lacks explicit authority to audit LDCs and most other private entities. However, many local governments have some type of financial arrangement with one or more LDCs or other private entities. In these cases, OSC can initiate an audit of the local government (rather than the LDC or other private entity) and examine the financial relationship between the two. Findings from several of these audits are highlighted below.

### Town of Watertown (2010M-147): Circumvention of Constitutional Gift Prohibition.

The Town established an LDC for economic development purposes and the Town Supervisor served as chair of the LDC's board. The Town authorized the transfer of \$60,000 in Town funds to the LDC and, on the same day that the payment was made, the LDC authorized the transfer of \$50,000 to a private ambulance service. The \$60,000 payment by the Town to the LDC was made without a contract, and there was no evidence that the Town received any consideration in exchange for the payment. Therefore, the payment by the Town to the LDC was a gift in violation of the State Constitution. Although the Town Supervisor/LDC chair indicated that the payment to the ambulance service was for start-up services to create paid positions for some of the current volunteers, there was no authority for the Town to give funds directly to the ambulance service, and there was no evidence that the Town received any consideration in exchange for the \$50,000 payment by the LDC to the ambulance service. Therefore, the Town improperly used the LDC to make an indirect gift of \$50,000 to the ambulance service.

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**Nyack Fire District (2009M-38): Circumvention of Competitive Bidding/Voter Approval Requirements.**

The commissioners of the Fire District created two LDCs for the acquisition of land and construction of a new firehouse, despite the fact that there is no authority for a fire district to create an LDC. The establishment of the LDCs appeared to be part of an effort to enable the District to circumvent the voter-authorized project cost and the statutory requirements (e.g., competitive bidding and the Wicks Law) applicable to the construction of a new firehouse. As a result, the taxpayers in this Fire District could pay up to \$9.9 million more than the amount approved by the voters for a firehouse that the District will not own.

**City of Yonkers (2006M-57): Circumvention of Local Finance Law and General Municipal Law.**

The City of Yonkers issued bonds for the acquisition of property to construct a new school district headquarters and public libraries, and transferred the property to the Yonkers Industrial Development Agency (YIDA) to complete the construction. The City subsequently disbursed nearly \$670,000 to the YIDA for costs outside the project's contracted costs, even though the description on the invoices submitted to the City gave the appearance that the payment from bond funds was consistent with Local Finance Law (which requires that bond proceeds only be used for the purpose for which they are issued). The City School District subsequently authorized a payment of the same amount to YIDA from City bond proceeds, in violation of the construction contract and without the necessary Board authorization. Upon receipt of the duplicate payment from the School District, the YIDA loaned a nearly identical amount to a for-profit corporation organized by YIDA to develop a baseball stadium in the City. The YIDA lacked authority under the General Municipal Law both to establish the for-profit corporation and to lend it money.

**Town of Cicero (2004M-82): Indirect Capital Financing.**

The Town transferred approximately 100 acres of Town-owned land to an LDC to develop a comprehensive community campus known as the Cicero Commons. The LDC issued bonds to finance the development. The Town entered into a financial agreement with the LDC, pursuant to which the Town pledged to back the LDC's bonds subject to an appropriation for that purpose in the Town's budget. The LDC defaulted on the bonds and Town had to pay approximately a quarter of million dollars to the bondholders. At the time, the Town's credit rating was also reduced to speculative quality.

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## Other Examples of Local Government Uses of LDCs and LLCs

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### Indirect Deficit Financing.

Although OSC has not completed any audits that have revealed that LDCs are being used as vehicles to alleviate budget pressures, recent news articles indicate that some local governments may be using LDCs as a way to take debt off the books or to provide quick infusions of cash. For example, Monroe County created an LDC to assume ownership of a County-owned power plant and convert it from coal to natural gas. The LDC purchased the plant from the County for \$7 million, thus providing the County with this amount for its budget, and subsequently issued \$32 million in bonds to upgrade the plant. The County now purchases power from the LDC operating the power plant through a 32-year contract. This arrangement appears to be inconsistent with provisions in the County Law and the Not-For-Profit Corporation Law conditioning the transfer of real property to an LDC on a determination that the property is no longer required for county purposes.

### Loan of Credit by a Local Government.

In 2004, the City of Rochester sought to continue ferry service between the City and Toronto, Canada, and formed the Rochester Ferry Company, LLC (RFC) to purchase and operate the ferry. The City was the sole member of RFC. The RFC borrowed \$40 million to purchase and operate the ferry, and the City entered into an agreement to guarantee the loan. The ferry was purchased by RFC at an auction for \$32 million, and the City took a mortgage on the ferry to secure payment of RFC's loan. When the ferry service was terminated in 2006 because of mounting operating losses, the City shortly afterward dissolved the RFC and assumed its debt. The City later sold the ferry for \$30 million, leaving a balance of nearly \$20 million owed to the RFC's lender. In *Summers v City of Rochester*, the Court stated that the City of Rochester's guarantee and assumption of the debt did not violate the prohibition contained in Article VIII, Section 1 of the State Constitution against loans of credit by local governments to or in aid of any public or private entity.<sup>8</sup>

Although the court suggested that these transactions were not illegal, the transactions resulted in a substantial cost to the City and its taxpayers, illustrating the need for the State to regulate municipal use of LLCs.

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## OSC Reform Proposals

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In 2010, Comptroller DiNapoli advanced a legislative proposal that would have given OSC explicit audit authority over any organization that is controlled by a municipality, industrial development agency, district or agency.<sup>9</sup> This proposal is being expanded to place restrictions on LDC activities pertaining to local government finances in order to address some of OSC's most egregious audit findings. The proposal also extends these restrictions to other not-for-profit corporations and limited liability companies to avoid a proliferation of these types of entities as means to avoid the limitations that would be placed upon LDC activities. These recommendations would limit the ability of local governments (or others) to create and utilize LLCs, LDCs, and other not-for-profit corporations to finance local government operations and the acquisition or improvement of their assets, and thereby circumvent the laws governing those types of financings when undertaken directly by local governments.

In addition to the enhanced audit authority for the Comptroller over organizations under the control of local government, the bill will include the following specific reform proposals:

- Restrict the purposes for which an LDC can be created by deleting "lessening the burdens of government and acting in the public interest" as a stand-alone purpose for which an LDC may be created. The primary purpose of the law allowing the establishment of LDCs was to promote economic development. However, this overly broad language in the law has been used to create LDCs that act as financing vehicles for local government projects or operations that do not fall under any of the economic development purposes stated in the law. In those instances when it is shown to be beneficial to a local government to establish an LDC to serve as a financing vehicle, the local government can seek special legislation, as is currently the case when a municipality seeks to form a public authority to assist in its functions.
- Prohibit the organization or use of LLCs by or for the benefit of local governments as a means to finance local government projects or operations. Such a prohibition will curb financing arrangements such as that between the City of Rochester and the Rochester Ferry Company. As in the case of LDCs, in those instances when it is shown to be beneficial to a local government to establish an LLC for such a purpose, the local government can seek special legislation.
- Require that any contract between a local government and an LDC must be for fair and adequate consideration and may be for a term no longer than five years, subject to periodic renewals for terms of up to five years each upon consent of both parties. This would address those instances where LDCs are utilized to avoid the constitutional gift prohibition, such as OSC found in the Town of Watertown audit, and align contract terms with the common law principle against binding successor governing boards.
- Prohibit LDCs incorporated by or at the behest of a municipality from providing compensation to any of its board members, officers and employees who serve as officers or employees of the municipality, or have done so in the previous two years.

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- Require that the public notice of sale or lease of municipally-owned real property to an LDC include a description of the property, the consideration to be received, the estimated fair market value of the asset, and a statement of the intended use or disposition of the property by the LDC.
  - Clarify that no municipality, school district, or district corporation may guarantee or assume the debt of any not-for-profit corporation or LLC formed by, on behalf of, for the benefit of, or under the control of the municipality, district, or district corporation. This would specifically overcome the statement in the Rochester Fast Ferry decision and ensure that local governments cannot be the guarantors of the debt issued by private entities, including an LLC, LDC, or other not-for-profit corporation, even if the entity was formed by or for the benefit of the local government or is under the control of the local government. This provision would correspond with the literal language of the prohibition against loans of credit by local governments in Article VIII, Section 1 of the State Constitution.
  - Provide that the Local Finance Law (LFL) is the exclusive law governing the manner in which municipalities, school districts, and district corporations finance their operations and the acquisition or improvement of their assets over time, unless otherwise expressly provided by law. This would clarify that the underlying purpose of Local Finance Law Section 176.00 is to make the LFL the sole means of financing operations and capital purposes over time, unless the Legislature expressly or specifically provides otherwise. This clarifying amendment would help avoid back-door financing schemes, designed to circumvent the requirements of the LFL.

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## Notes

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- <sup>1</sup> The increase of 20 LDCs only includes those that are “local authorities” subject to the Public Authority Accountability Act of 2005 (PAAA) and therefore report to the ABO.
- <sup>2</sup> It is not entirely clear that the quoted language was intended to be read as a completely separate corporate purpose of an LDC, not tied to the economic development purposes of LDCs (see generally, Bill Jacket, L 1962, ch 502).
- <sup>3</sup> Lackawanna Community Development Corporation v Krakowski, 12 NY3d 578 (2009).
- <sup>4</sup> Ibid.
- <sup>5</sup> The PAAA (L 2005 ch 766), as amended, defines the term “local authority” as: (a) a public authority or public benefit corporation created by or existing under any State law whose members do not hold a civil office of the State, are not appointed by the governor or are appointed by the governor specifically upon the recommendation of the local government or governments; (b) a not-for-profit corporation affiliated with, sponsored by, or created by a county, city, town or village government; (c) a local industrial developmental agency or authority or other local public benefit corporation; or (d) an affiliate of such local authority. The ABO’s determination to apply the term “local authority” to at least one entity has been challenged. There is presently pending before the Appellate Division an appeal from a decision upholding the ABO’s determination that the Griffiss Local Development Corporation, an LDC formed to deal with the closure of Griffiss Air force base in Oneida County, is a “local authority” within the meaning of the PAAA (Griffiss v State of New York Authority Budget Office, 26 Misc3d 815 [2009]). Moreover, recent newspaper accounts indicate that similar litigation is being commenced by one or more “economic development corporations” (most likely LDCs) in Fulton County.
- <sup>6</sup> Matter of Buffalo News v Buffalo Enterprise Development Corp., 84 NY2d 488 (1994); compare Matter of Farms First v Saratoga Economic Development Corp., 222 AD2d 861(1995) and Matter of Ervin v Southern Tier Economic Development Corp., 26 AD3d 633 (2006).
- <sup>7</sup> See, e.g., New York State Department of State, Committee on Open Government, Open Meetings Law Advisory Opinion OML-AO-4267.
- <sup>8</sup> 60 AD3d 1271 (2009), the Appellate Division, Fourth Department, in dicta.
- <sup>9</sup> S. 7907/A. 11088 of 2010. Such an organization would be deemed to be controlled by one of these entities if, among other similar scenarios; one or more officers or employees of the local government entity select a majority or quorum of the organization’s governing body or the CEO of the organization.

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