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Owens-Brockway, *VWS*, and the Problem of 100% Clawbacks After Partial Performance of Economic Development Incentive Agreements

Economic development incentives are, at heart, contracts: a government offers to provide certain benefits—tax credits, grants, abatements, etc.—in exchange for a business creating jobs and investing capital. Agreements are often long-term, lasting a decade or more. Naturally, economic and political circumstances can change during such a length of time.

Two recent cases, *Owens-Brockway* and *VWS*, illustrate the unfairness if a company ceases performance of its agreement near the end of the term of its agreement, only to have the government claw back the entire value of the award. Businesses entering into incentive agreements should carefully consider these risks.

Sometimes a retrospective clawback is required by law and must be accepted as a condition to the award, but in other instances it may be negotiable. Additionally, if a business is facing a 100% clawback after partial performance, it should consider potential claims to challenge the 100% clawback or to receive compensation for the jobs and investment that it did create.

Enforcement of an unfair liquidated damages clause in *Owens-Brockway*. The Michigan Court of Appeals upheld a 100% "liquidated damages" clawback in *Owens-Brockway Glass Containers Inc. v. State Tax Commission*, No. 314190 (Oct. 24, 2014) (unpublished), despite the company's argument that the clause should be void as an unfair penalty. The case involved the partial closure of a glass plant more than 10 years into a 12-year tax abatement.

In 1999, Owens-Brockway had agreed to keep and expand its glass plant in exchange for the property tax abatement from the City of Charlotte. As part of the agreement, the taxpayer consented to a liquidated damages clause providing for a 100% clawback if the plant was closed during the term of the agreement. In 2010, the company ceased manufacturing operations, substantially reduced its payroll, and began removing equipment from the plant. The city sought to enforce its clawback and obtained a judgment from the trial court.

The Court of Appeals upheld the liquidated damages clause. It first disposed of a threshold issue as to whether the plant had "closed" within the meaning of the incentive agreement, where the company had argued that a property of sufficient value had remained at the plant to avoid a technical closing under the agreement. Concurring that the plant had closed, the court then turned to the validity of the liquidated damages clause. Reasoning that it would be difficult to determine the economic impact of the premature departure, the court connected the retrospective 100% clawback to the prospective loss of jobs and economic activity after the closure occurred.

The court's reasoning is troubling in that it failed to consider that the liquidated damages amount would tend to increase while the city's injury decreased. The greatest possible clawback would have been if the plant had closed a day before the end of the performance period, at which point the city's injury would have been minimal. The Court of Appeals decision allows the City of Charlotte a windfall: Enjoying approximately 85% of the benefit of its incentives agreement (more than 10 years of increased economic activity) while getting all of its abated taxes back from the business.

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Applying an ambiguous 100% clawback in *VWS*. The Ohio Court of Appeals imposed a 100% clawback for a "material breach" in *City of Westlake v. VWS, Inc.*, 2014 Ohio 1833 (Ohio Ct. App. May 1, 2014), reversing the trial court's finding that a different contractual clause had applied. Westlake had offered the business a 15-year tax abatement to in-

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duce the construction of a new facility in the municipality. Eleven years into the agreement, the business closed the facility and moved its headquarters out of Ohio.

Westlake sought to enforce a 100% clawback specified in the agreement for a "material breach." The trial court rejected the city's argument of a material breach, holding that the failure of the business to retain jobs prospectively was a condition precedent that excused the city from its performance but did not constitute a material breach triggering the clawback.

The Court of Appeals reversed and applied the clawback, concluding that the closure of the facility in fact had been a material breach. The court viewed the business's presence in the city throughout the 15-year term as "fundamental." It was the agreement's "essential purpose," and it could not be said that the business had "substantially performed." By abandoning its obligations, the business had materially breached the agreement and owed the city its 100% clawback. As in *Owens-Brockway*, the result effectively was a windfall to the municipality.

Strategies for avoiding the unfairness of a 100% clawback. There is something fundamentally unfair about a 100% clawback after a business is induced to commit to a jurisdiction but ultimately cannot or does not complete its performance over the entire term of the agreement. The benefits that an incentivized business brings—jobs, investment, economic activity—are incremental, not all-or-nothing. But a 100% clawback is effectively a rescission of the incentive.

While a business should not receive a windfall for incomplete performance, nor should the governmental unit get "something for nothing" when a business misses its performance targets. When possible, the unfairness of 100% clawbacks should be avoided when negotiating incentive agreements. Additionally, businesses that have partially performed should consider potential contractual defenses to avoid a complete loss.

Clawback provisions are the "prenuptial" of an incentive arrangement: While no one wants to be the pessimist considering contingencies where the business cannot or does not perform for the entirety of its obligation, the realistic fact is that many projects do not proceed as originally expected. The economic situation may change, such that the envisioned project is no longer feasible. The political context can shift as elections are won and lost. A bureaucrat administering the award may take a narrow view of qualifying performance. Any of these contingencies can result in a clawback claim.

While in some cases 100% clawbacks are mandated by statute, in many cases they are not, as appears to have been the case in *Owens-Brockway* and *VWS*. In such situations, there may be room to negotiate more reasonable clawbacks or other remedies. Additionally, the clawback provision should be carefully drafted to reflect the parties' mutual understanding, so as to avoid conflicting interpretations as was the case in *VWS*.

Even in situations where the clawback is 100% and clearly applies, a business that missed its performance targets has several potential approaches to defeat or mitigate a contractual clawback:

Void as a penalty. Under general contract law, a liquidated damages clause is potentially void as contrary to public policy if it is really in the nature of a penalty rather than being a reasonable estimation of a party's damages.[1] As in *Owens-Brockway*, a business can challenge a contractual 100% clawback as a void penalty. While Owens-Brockway ultimately did not prevail, there are strong reasons to think that a 100% clawback late in a business's performance period does not provide a fair estimate of the government's damages. Liquidated damages should not increase as the government's actual damages decrease.

Substantial performance. The substantial performance doctrine is designed to avoid unfairness in situations where a party materially performs its part of the agreement but does not satisfy all of the requirements.[2] Substantial performance treats the contract as performed, but subject to a subtraction for the counterparty's damages due to the incomplete performance. In the incentives context, a business that performed for most of the period could make such a claim. It would be a particularly strong argument if the business had exceeded its targets in prior years such that it could be said that the government essentially had already received the benefits for which it contracted.

Quasi-contract unjust enrichment. A party that defaults on a contract after partial performance may in some instances recover compensation for the benefits conferred on the counterparty, so as to prevent the unjust enrichment of the non-defaulting party.[3] A business can argue that the government induced the business's location, expansion, or retention with an incentive package and would be unjustly enriched by the increased revenue once the incentive moneys are returned under a 100% clawback.

There are, however, significant challenges to recovering from a governmental unit for economic development benefits under a quasi-contract theory, including governmental immunity, government contracting rules, and the calculation of the benefits that the business had conferred. For example, in a case where a local incentive was voided because of the municipality's failure to follow the correct approval procedures, the court rejected the business's claim for recovery in quasi-contract.[4]

Conclusion In sum, the recent cases of *Owens-Brockway* and *VWS* demonstrate the unfairness of a 100% incentive clawback where the business has created a substantial portion of the promised jobs and investment but did not maintain its activity for the full performance period. The governmental unit essentially receives a windfall benefit from the jobs and investment that the business did create.

In situations where the 100% clawback is not required by law, this unfairness can be avoided upfront by proactive negotiation of the clawback at the outset of the agreement. Additionally, in a dispute over a contractual 100% clawback, a business should consider the potential for contract doctrines intended to avoid unfair or unjust results: void penalty clauses, substantial compliance, and quasi-contract unjust enrichment.

The benefits provided by a business in an economic development agreement are incremental, not all-or-nothing. Clawback provisions should be negotiated and interpreted, when possible, to mirror this reality instead of serving as 100% penalty clauses that effectively rescind the incentive. ■

1 *See generally*, WILLISTON ON CONTRACTS § 65:1 (4th ed.).

2 *See generally*, WILLISTON ON CONTRACTS § 44:54 *et seq.* (4th ed.).

3 *See generally* WILLISTON ON CONTRACTS § 68:30 (4th ed.).

4 *See D&W Development, Inc. v. City of Milford*, No. 3-207/12-0579 (Ia. Ct. App. May 15, 2013).