How to Undermine Tax Increment Financing: The Lessons of *City of Chicago v ProLogis*

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This Article examines the appropriate level of constitutional protection against outside governments that condemn property located within a given local municipality that uses tax increment financing (TIF) to fund local improvements. The standard TIF arrangement does not provide the TIF lenders with liens against any particular asset, because to do so would be to abandon the tax-exempt status of the municipal bonds that are issued. Yet these agreements guarantee that the local government that issued the bonds will take no steps to compromise their repayment from (incremental) tax dollars. These protections allow TIF bonds to trade in ordinary financial markets. The bonds may, however, prove vulnerable to loss when the private and public property within the local municipal district is condemned by an outside government, as happened in City of Chicago v ProLogis*, where the Illinois Supreme Court denied the bondholders claim. I believe that these TIF bonds should have been treated as property under the Takings Clause and not as a mere "expectation" devoid of constitutional protection. This topic opens the way for a larger consideration of how to value divided interests in real property under the Takings Clause as a matter of modern finance theory in light of the powerful public choice issues that lurk in the background of this, and all other, takings disputes.*

I. THE LOGIC OF TAX INCREMENT FINANCING

In most municipalities today, the revenues to fund local governments are largely raised from real estate taxes.[1] Most commonly, these taxes are keyed to the value of the taxed property. These taxes are levied without respect to the income or wealth of the property owner, and are used to discharge the general expenses of the community. The competition between nearby localities imposes an important constraint on both the form and the amount of the taxes levied.[2] The exit option is more credible with local governments than with either states or nations. Regardless, there is little doubt that real estate taxes will

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In the interests of full disclosure, I advised ProLogis on some of the legal and economic issues connected with its brief. The opinions expressed here are of course my own.

1 Richard Briffault, *The Most Popular Tool: Tax Increment Financing and Local Government*, 77 U Chi L Rev 65, 76 (2010) (describing property taxes as the "heart of the tax base for most cities").

2 For the now-obligatory citation, see generally Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J Pol Econ 416 (1956) (explaining that public expenditures may be efficiently allocated through competition between localities).

continue to serve as the dominant source of local taxation revenues. But not the only source. One limitation of general real estate taxes is that they preclude extensive localized investment in infrastructure that will provide a unique benefit to some fraction of the municipal tax district. At this juncture, the use of general real estate revenues draws resistance from those property owners who do not lie within that district. In the long run, no system of local taxation is politically stable if some significant fraction of property owners systematically pays more in taxes than they receive in benefits.

The most common device to respond to this challenge of differential local needs is the special assessment of old,[3] which has morphed into the more flexible tax increment financing (TIF) of today. The creation of TIF districts within local communities allows a local government to impose additional taxes on some properties within a particular district without burdening other property owners who do not benefit from the expenditures within that district. Properly constructed, these taxes could create infrastructure improvements to landowners within the narrow TIF district that justify the increment over normal real estate tax rates. The program can gain added legitimacy if it must be approved only by a supermajority of real estate owners within that district. Essentially, the two-tier system of taxation seeks to match benefits with burdens, albeit at different levels, in both the entire community and the TIF district.

There is an extensive literature that debates the desirability of creating TIF districts, which are now authorized in forty-nine states and the District of Columbia.[4] Many commentators fear that TIFs will be used to spark eminent domain projects for essentially private purposes.[5] Others think that TIFs can siphon off resources that are better devoted to schools and other community projects.[6] Still others think that TIFs impose rigid restrictions on the effective use of local funds. And still others could raise large-scale objections to the tax-exempt status of TIF bonds.

This Article shall not address any of these issues, but shall assume that these devices form an appropriate part of the local government toolkit, only to ask the instrumental question of how they best work. On this score, it is evident that most TIF districts require extensive

3 See generally Stephen Diamond, *The Death and Transfiguration of Benefit Taxation: Special Assessments in Nineteenth-Century America*, 12 J Legal Stud 201 (1983).

4 See Briffault, 77 U Chi L Rev at 72–74 (cited in note 1).

5 Id at 68.

6 Id at 68–69. See also Sterling Levy, *Financing Panel Reduces Scope of Development Plan*, St Louis Post-Dispatch A1 (Jan 18, 1996) (describing a TIF project that diverted money from a school district).

front-end expenditures that need third-party financing. TIF financing can only work by making sure that the private lenders who fund these projects will be repaid. But how? One possibility is to grant the lenders a direct lien on the public properties created with TIF money. But unfortunately, lenders cannot foreclose on public improvements that have no value in private hands. Nor is it possible to impose liens on the many private properties that benefit from TIF dollars. Not only is foreclosure still an issue, but, worse, this alternative founders because any revenue derived from secured obligations is not entitled to the tax exemption that is generally available for municipal bonds. Making TIF repayment a general obligation of the local government also fails. The whole point of TIF financing is to remove the additional cost from the community at large and to place it on the group of local property owners who derive the direct benefit from it.

To avoid these clear perils of public and private collateral, the common practice is to secure TIF bonds out of additional real estate tax revenues that can be raised from the local landowners whose property has increased in value from the expenditure on public improvements.[7] To make this work, the TIF bonds adopt a form of nonrecourse financing. The local government is not liable to repay these bonds from its general revenues. The lenders can look only to the additional tax revenues on the real estate within the TIF district. The local government collects the added revenues through its tax system, and then places them into a segregated fund for the benefit of the TIF bondholders. If that government refuses to collect, segregate, or turn over the money, the TIF bondholders could obtain an order requiring it to discharge its obligations. In practice, the underlying arrangements are so clear that local governments do not default on their key service obligations. Embedding the TIF bond in the real estate tax has the added advantage of conferring on TIF bondholders the same priority that all real estate taxes have over private liens held by lenders and materialmen.[8] To make sure there is no hanky-panky, the local government warrants that it will pay the fair market value for the bonds in the event that it condemns the private property that is used to secure the payments. In addition, it is common for these governments to covenant that they will not make zoning changes that reduce the value of the property within the TIF zones. Given these constraints, TIF bonds trade in orderly markets whereby their value is determined by two key components: fluctuation in general

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7 See Council of Development Finance Agencies and International Council of Shopping Centers, *Tax Increment Finance: Best Practices Reference Guide* 34 (2007), online at http://www.mrsc.org/artdocmisc/CDFA.pdf (visited Oct 22, 2009).

8 See James J. Kelly, Jr, *Bringing Clarity to Title Clearing: Tax Foreclosure and Due Process in the Internet Age*, 77 U Cin L Rev 63, 73 (2008).

interest rates and changes in the value of the security. The former variable can move in any direction at any time. But as the riskiness of the local improvements falls, the TIF bonds increase in value. Typically, therefore, TIF bonds have a stable legal framework that calls little attention to itself. The less said about it the better.

It is here that the plot thickens. Even if the local issuer of TIF bonds can take no steps to undermine their worth, *other* government entities are not subject to the same constraints because they have not made the same contractual undertakings. In particular, the local government that issued the TIF bonds is not the only entity that can exercise the power of condemnation in any given community. State and federal agencies can condemn land, both private and public, for their projects, and states can authorize other municipal governments to condemn land outside their own territories for projects deemed to have regional or national importance.[9] These federal, state, and local condemners have not entered into any agreements to pay the fair market value of the TIF bonds upon condemnation, and the question arises both as a matter of statutory and common law whether they are required to make the bondholders whole when they condemn the private property that is used to secure the TIF financing.

II. UPSETTING TIF FINANCING: *CITY OF CHICAGO V PROLOGIS*

This question is now up for consideration in the Illinois Supreme Court in the case of *City of Chicago v ProLogis*.[10] The case arose in connection with some $7 million in TIF bonds issued in 1996 by the Village of Bensenville, pursuant to the Tax Increment Allocation Redevelopment Act.[11] Bensenville is located near O'Hare Airport. Its public improvements created the infrastructure that allowed the private landowners in a rundown portion of Bensenville to develop a high-class air cargo distribution center to serve the freight traffic in and out of O'Hare. The bonds in question were for a twenty-year term and carried an interest rate of 10 percent per annum.[12] Both the public and private parts of the overall project were successfully completed,

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9 But see *Mayor of Baltimore v Baltimore Football Club, Inc*, 624 F Supp 278, 284 (D Md 1985) (refusing to allow a city to exercise this authority over an entity in another state).

10 890 NE2d 639 (Ill App 2008), affd, 2010 WL 200015 (Ill).

11 See Tax Increment Allocation Redevelopment Act, 65 ILCS 5/11-74.4-4(a) (West):

> A municipality may . . . [b]y ordinance . . . approve redevelopment plans and redevelopment projects, and designate redevelopment project areas . . . . No redevelopment project area shall be designated unless a plan and project are approved prior to the designation of such area and such area shall include only those contiguous parcels of real property and improvements thereon substantially benefited by the proposed redevelopment project improvements.

12 *ProLogis*, 890 NE2d at 642.

so that the bonds traded at a premium before the City of Chicago condemned the entire project area, both public and private, to build an extension of O'Hare Airport in April 2006.[13] At the time of condemnation, the bondholders had received in interest payments of over $2.3 million in cash on their bonds, which were then trading at a premium over face value. In its condemnation papers, the city included compensation for all the real property located in the district, but made no allocation for the TIF bondholders. As is customary, these TIF bonds contained a covenant that indicated the limited sources of income available for the repayment of the bonds:

> The Bonds, together with the interest * * * if any, thereon, are limited obligations of the Village, payable solely and only from the Pledged Taxes. * * * No holder of any Bond shall have the right to compel the exercise of any taxing power of the Village for payment of principal thereof or interest * * * if any, thereon. THE BONDS DO NOT CONSTITUTE AN INDEBTEDNESS OF THE VILLAGE OR A LOAN OF CREDIT THEREOF WITHIN THE MEANING OF ANY STATUTORY OR CONSTITUTIONAL PROVISION.[14]

The question raised by this provision is simple to state but difficult to answer. Does the obligation to repay the TIF bonds survive the condemnation of the real estate to which the tax liens attached? In dealing with this question, both the Illinois Appellate Court and the Supreme Court sided with the City of Chicago by taking the view that the tax liens in question died when the property to which they were attached was transferred into public hands.[15] Since everyone agreed that these bonds were never general obligations of the Village of Bensenville, any source of repayment was gone. The city claimed that the risk of loss on these bonds had to be borne by the bondholders and not by the City of Chicago.[16] One critical irony in this case was that 60 percent of the TIF bonds had been issued to the original developers of the real estate within the TIF district, who well understood the synergies between the public and private improvements.[17] The remainder went to ProLogis, which at the time of the condemnation was also the landlord to the new private buildings on the site, all of which were leased out to paying te-

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13 See Virginia Groark, *Bensenville Offers O'Hare-Fight Help*, Chi Trib M3 (Feb 7, 2006).

14 *ProLogis*, 890 NE2d at 642 (recognizing that the bonds were "considered investments, subject to known risk").

15 Id at 647–48; 2010 WL 200015 at *5.

16 *ProLogis*, 800 NE2d at 642; 2010 WL 200015 at *4–5.

17 *ProLogis*, 800 NE2d at 641–42.

nants.[18] Subsequently, ProLogis took an assignment of the developer's interest so that it owned all the property that was the source of the TIF repayments.[19] There was a perfect concordance between the owners of the real property and the holders of the bonds.

The Illinois Supreme Court affirmed the decision of the Illinois Appellate Court, which denied ProLogis's claim for compensation for the now worthless bonds.[20] The claims in question rested on the Takings Clauses of both the United States and the Illinois Constitutions and the intermediate appellate court's ingenious arguments used to deflect important questions that relate to the nature of property and the proper scope of the state's eminent domain authority. In general, I think that its decision is wrong as a matter of first principle and that the errors it made call into question some of the basics of property theory and takings law alike. I shall examine these two points in order.

A. Property, Guarantees, and Expectations in a World of Nonrecourse Debt

The core of the city's argument that the Appellate Court accepted runs as follows:

> Here, the contractual terms and the explicit language of the bonds provided that repayment was to be exclusively from incremental taxes, *if any*. As the City points out, the bondholders had no legitimate expectation of guaranteed repayment; in fact, as the language of the bonds makes clear, the bondholders do not have the right to compel the Village to exercise its taxing power to pay the bonds.[21]

Finally, it insisted that any harm to the TIF bondholders was noncompensable consequential damages and not direct losses from government actions.[22] The quoted passage is literally correct insofar as the entire power of TIF bonds is to insulate the general revenues of the Village from the claims of the bondholders. But otherwise the statement reveals

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18 Brief and Appendix of Defendant-Appellant ProLogis and Intervenors-Appellants, *City of Chicago v ProLogis*, No 1-07-0108, *8–9 (Ill App filed June 15, 2007) (available on Westlaw at 2007 WL 6848393) ("ProLogis Brief") (noting that by April 1996, over $2 million had been paid on the bonds to bondholders).

19 *ProLogis*, 890 NE2d at 641–42 (noting that just under $9 million of the redevelopment cost was available for TIF).

20 *ProLogis*, 2010 WL 200015, *1.

21 *ProLogis*, 890 NE2d at 647–48. This issue was not pursued in the Illinois Supreme Court, which contented itself with the observation that the sophisticated investors in the bonds had assumed the risk of default, *ProLogis*, 2010 WL 200015 at *3, 6, without asking which risks were assumed and which not. The more detailed analysis in the text addresses the issues of great public significance that the Illinois Supreme Court passed over.

22 *ProLogis*, 890 NE2d at 644–45.

major intellectual confusion about its three central terms—"legitimate expectations," "guaranteed repayment," and "if any."

Start with the words "guaranteed repayment." ProLogis's claim does not require that that payment be guaranteed against any and all contingencies. The simple analogy here is to the standard nonrecourse mortgage, which arises whenever the debtor pledges specific assets to the repayment of a claim, to the exclusion of all other wealth. Creditors who accept this sort of financing typically obtain additional protection by two other means, either alone or in combination. First, they could demand a larger value cushion than they would require from a well-heeled debtor who signed a recourse mortgage—that is, one that allows the creditor to get a deficiency judgment against the borrower. Second, they could demand a higher interest rate to offset the risk. These nonrecourse arrangements are not limited to property transactions. They are implicit whenever corporations with limited liability borrow money from creditors who do not obtain guarantees from their shareholders. Here, in addition to the two protections just mentioned, creditors can insist on covenants that prevent the distribution of dividends or other payments to shareholders that could diminish the pool of wealth available to repay the loan.

The use of these nonrecourse arrangements is what marks the TIF bonds as distinctive financial instruments. It is for just that reason that the words "if any" were included in the bond covenants, to make it clear that if these funds failed, no money would be owing. The words were not added in order to excuse Bensenville from paying off those obligations when money from the designated sources was available. The two phrases in question point to a complex distribution of the residual risks of nonpayment, which makes it wholly inappropriate to write as though we live in a dichotomous universe in which repayment is either guaranteed or not guaranteed. The true situation is that there is a guarantee that all payments from the designated source be turned over to the creditor. There is no guarantee that additional monies be brought to the table, even if it is always open to the borrower to use outside revenues to forestall the foreclosure of the lien if it so desires. These nonrecourse instruments in any and all contexts provide rights to creditors and borrowers alike. It is a simple error to assume that the lender on a nonrecourse obligation trusts only to the good will of the borrower for repayment.

The first error in the Appellate Court's decision is only compounded by its incautious and inexact use of the phrase "legitimate expectations" in connection with these nonrecourse payments. These two words are fraught with difficulty, which can only be disentangled by dealing with two distinct but related situations. The first of these is the set of expectations between the two parties to the transaction. The second is the relationship that the two parties have to any third person whose actions disrupt or undermine their private relationship in question. In *ProLogis*, these two facets of the question arose in a constitutional context. But the only way to get purchase on the issue is to understand how these notions of legitimate expectations play out in the private law.[23] Takings law is parasitic upon the ordinary institutions of private property. As I have long argued, the entire field degenerates into ad hoc favoritism unless there is some external standard against which to judge the actions of government officials.[24] To be sure, these officials can take property in circumstances where private parties would be enjoined. But subject to that enduring difference, a solid signpost of private decisions is to ask this question: if the actions of the government were undertaken by a private party, would it have been subject to an obligation to compensate? If not, then the government is in the same position, as with its actions to enjoin traditional nuisances under the police power. It need not pay compensation. If yes, then the converse holds and compensation is now required, even if the private party is not allowed (when the taking is for public use, as is surely the case here) to ignore the government action. It follows, therefore, that we have to look first at the role of legitimate expectations as between the two parties to any relationship and thereafter turn to its role in cases when third persons become involved.

This inquiry is only needlessly complicated by the collateral point that these damages should not be allowed because they are only "consequential." The initial point is that they do not fall within the traditional categories of consequential damages, which cover such matters as relocation expenses, which are costs borne by the property owner that do not result in a gain to the property owner. Here there is an extinction of the set of rights in the very property that the government is taking. And even if these were consequential damages, why in principle should they not be recoverable when they amount to real losses from government actions that should be taken into account in order to prevent those excessive condemnations where the loss to private par-

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23 For an account of its use and misuse, see Richard A. Epstein, Lucas v. South Carolina Coastal Council*: A Tangled Web of Expectations*, 45 Stan L Rev 1369, 1379–85 (1993). See also Richard A. Epstein, *The Seven Deadly Sins of Takings Law: The Dissents in* Lucas v. South Carolina Coastal Council, 26 Loy LA L Rev 955, 962–63 (1993) (using public and private law to illustrate the difference between a loss of value attributable to competition and a loss of value attributable to a taking).

24 See, for example, Richard A. Epstein, *Takings: Private Property and the Power of Eminent Domain* 36 (Harvard 1985) (posing a straightforward test to determine whether there is a taking: "*Would the government action be treated as a taking of private property if it had been performed by some private party?*") (italics in original, thankfully).

ties exceeds the gain to the state?[25] Tort defendants who convert property can be held to pay consequential damages—why not the state?

B. Two-Party Relationships

In this area of the law, the distinction between (protected) property interests and (subjective) expectations occupies an enduring role.[26] The cases at the poles show why this distinction is so necessary. At one pole, a person is in possession of land in fee simple. In an everyday sense, we might say that this person has an expectation that the state will use its force to protect his exclusive possession of that property against strangers that might take it away from him. But the term "expectation" in this sense refers to the sound conviction that the owner's right to demand the state's cooperation in defending his property interest will, as expected, occur. Here the peculiar blend of normative and predictive elements lies behind the expectation, which is far more than a subjective hope or aspiration.[27] That type of expectation does not only apply to parties who are in possession of the fee simple, but also to persons who have more limited interests in land. The holder of a reversion over a lease has a property interest in land, which he expects the state to enforce in accordance with its terms both during the lease and at its expiration. Likewise, as regards our earlier discussion, a mortgagee has a lien over the land, which she also expects the state to enforce both during the pendency of the mortgage and at its expiration. The language of legitimate expectations works in sequence. The interest is valid on substantive grounds, which justifies calling expectations about its enforcement legitimate. Let the expectation of enforcement be shattered, and the lack of public confidence will lead to the disintegration of the system.

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25 See id at 51–56.

26 See, for example, John R. Cooke, Dames & Moore v. Regan—*Rights in Conflict: The Fifth Amendment Held Hostage*, 31 Am U L Rev 345, 351–54 (1982) (noting that the lack of a formula to determine when compensation is due for public takings has led to such cases being resolved through ad hoc, fact-specific inquiry).

27 For an interesting Roman law parallel on the relationship between an *emptio spei* and an *emptio rei speratae*, see Theodor Mommsen, Paul Krueger, and Alan Watson, eds, 2 *The Digest of Justinian* 18.1.8.1 at 515 (Pennsylvania 1985) ("Sometimes, indeed, there is held to be a sale even without a thing as where what is bought is, as it were, a chance."). Literally translated, the former means the purchase of an expectation and the latter means the purchase of the thing expected. But the former was not just hot air. The distinction was set in the context of a fisherman seeking a catch. The *emptio spei* meant that the net had to be cast, but the risk of coming up empty fell on the buyer. The *emptio rei speratae* meant a purchase of the expected thing, such that the buyer had only to pay for the catch that was realized. The difference was not between right and no right. It was over the allocation of risk over events that had to take place, given the seller's obligation to cast the nets. We have modern equivalents as well. In horseracing, the stud fee can be higher if the seller bears the risk it will not take and lower if that risk is on the buyer.

The second sense of the term "legitimate expectation" is at sharp variance with the first. A person could have a legitimate expectation that some property will come his way even though he has no entitlement to it. One obvious example of this type of unenforceable expectation is the interest that a named beneficiary under a will has in the property of a living person. I may draft a will that leaves my property in equal parts to my three children, and all of them may well expect that in the ordinary course they will receive that property at my death. But everyone understands that I may revoke or alter the will at any time. Thus, if I change my mind in the interim, the persons named as future beneficiaries have no enforceable claim to the property after my death. To be sure, their expectations may have been legitimate in the sense that it is rational for them to "count on" my leaving the will unchanged during my life. In addition, these beneficiaries can engage with any buyer or lender on the strength that this expectation will be met. But given the delineation of the legal entitlements, all these transactions are undertaken subject to the explicit risk that neither the named beneficiaries nor their creditors have any claim against the estate if the will is correctly changed. Indeed, this power to revoke can easily be retained over a trust fund from which the income has already been distributed on a timely basis to the named beneficiaries, whose future claims are precarious, even if they had received prior distributions from the trust.[28] It is for these reasons that we can talk about the sale or mortgage of an expectation when there is no vested interest. The price in question will reflect the risk of cancellation, which may well increase if the fact of sale or mortgage is known to the testator during life.

This second sense of expectation has an important role to play in public law contexts. To see why, we need only put the state in the shoes of a grantor (it cannot be a testator) who has reserved the explicit right to revoke a grant that has been made at will. Like any private grantor, the state can revoke for any reason and not pay damages for its action.[29] That simple point was the outcome of the decision in *United States v Fuller*.[30] There, the government under the provisions of the Taylor Grazing Act leased certain lands at below-market rates.[31] The

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28 See generally, for example, *Fischer v Union Trust Co*, 101 NW 852 (Mich 1904) (holding that gratuitous payments on mortgages for benefit of the plaintiff generated no obligation to continue payments). See also *Pitts v McGraw-Edison Co*, 329 F2d 412, 416 (6th Cir 1964) (holding that gratuitous retirement benefits paid to plaintiff generated no obligation to continue such payments).

29 I put aside here all the complications arising out of the doctrine of unconstitutional conditions used to control certain exercises of state monopoly power. See Richard A. Epstein, *Bargaining with the State* 226–27 (Princeton 1993).

30 409 US 488 (1973).

31 Id at 491–92. See Taylor Grazing Act, 48 Stat 1269, 1271 (1934), codified at 43 USC § 315 et seq. For discussion of its operation, see *Public Lands Council v Babbitt*, 529 US 728, 731–39

statute under which these permits were granted said explicitly that they did not "create any right, title, interest, or estate in or to the lands."[32] The genius of then-Justice William Rehnquist's opinion was that it took the statute at its word, even though the statutory permits were only given to individuals whose property lay near the government lands. The stable expectation that the government would not exercise its condemnation rights led in all private land sales to an increase in the value of the land to which those grazing rights were appurtenant. Nonetheless, when the United States decided to condemn Fuller's property, it first canceled the grazing rights, thereby depriving him of that extra increment of value, and its decision was upheld by a divided Court.[33]

That decision is correct, for it would be a mistake to instruct, as the district court did, that the permits could be taken into account in setting value by considering their "availability" to the permitee. There is, in these two-party situations, no reason to blur the line between rights and expectations of continued use by fudging the various valuation questions. If, therefore, the TIF bondholders in *ProLogis* had only this type of expectation, they should go home empty-handed. But that would have happened only if the Village of Bensenville had withdrawn the tax payments on its own motion under an agreement that was terminable at will. What happened, however, is that the security was lost through the condemnation of a third party, the City of Chicago. To see why this matters, we have to turn to the three-party situations.

C. Third-Party Interference with Expectations

The introduction of a third person always complicates the analysis. Starting with the private law, it is clear that the defendant party either can tamper with a vested right between the plaintiff and a third person, or can interfere with an expectation that the plaintiff has of continued relationships with the third party. The two cases play out in somewhat different fashion. Consider first the case where there are strong contractual ties between the parties, as when the third person is

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(2000). For an account of the cock-eyed subsidies built into the Act, see Michelle M. Campana, *Public Lands Grazing Fee Reform: Welfare Cowboys and Rolex Ranchers Wrangling with the New West*, 10 NYU Envir L J 403, 403–04 (2002) (decrying the below-market rates of interest).

32 43 USC § 315(b).

33 The conclusion of then-Justice Rehnquist's opinion read:

> The provisions of the Taylor Grazing Act . . . make clear the congressional intent that no compensable property might be created in the permit lands themselves as a result of the issuance of the permit. Given that intent, it would be unusual, we think, for Congress to have turned around and authorized compensation for the value added to fee lands by their potential use in connection with permit lands.

Fuller, 409 US at 494.

the landlord of the plaintiff. Here, the usual tort of inducement of breach of contract applies if the defendant, with knowledge of the contract, persuades the third person to remove the plaintiff from the property in order to lease or sell it to the defendant. Since *Lumley v Gye*,[34] the injured plaintiff has both an action against the third person on the lease and an action against the defendant who induced the breach. That situation did not arise here because there was no action by Bensenville that constituted a breach of its agreement with ProLogis, but it is important to keep *Lumley* in mind because it has been used to justify the proposition that the defendant's interference generates no obligation of compensation.

The more relevant line of cases deals with the interference of advantageous relationships. The hallmark of these cases is the deliberate interference by either force or fraud with the ongoing relationship between the plaintiff and the third party that has not been reduced to an enforceable contract so that only an expectation of future dealing is at stake.[35] As a tort matter, the force case involves a situation where the defendant shoots at a third party in order to induce him to steer clear of the plaintiff. Likewise, the situation with fraud involves the standard form of defamation in which the defendant knowingly lies to the third party about the plaintiff in order to dissuade that party from entering into or continuing any relationships with the plaintiff.

For these purposes, there is no need to examine the extent to which this interference tort rests on either negligence or strict liability because the public condemnation by the City of Chicago was deliberate. With these deliberate interferences, the action contains no requirement that the third person breach its relationship with the plaintiff.[36] What matters in these circumstances is the nature of the underlying expectations. Since we are in the three-party context, the correct procedure can no longer argue that since the third party is entitled to withdraw from the relationship at will, it should be treated, for the benefit of the defendant, as if it had *zero probability* of continuation.

That procedure is surely incorrect because it ignores the gains from continuation of that relationship to both the third person and the plaintiff in the ordinary course of events. What must be done, therefore, is to assess the likelihood that the relationship would be either formed or maintained in the absence of third-party force or fraud. This is no

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34 118 Eng Rep 749 (QB 1853).

35 See, for example, *Tarleton v M'Gawley*, 170 Eng Rep 153, 154 (KB 1793) (finding that shooting across the bow of boats to keep natives from trading is actionable when deliberate).

36 See Restatement (Second) of Torts § 766 (1979) ("One who intentionally and improperly interferes with the performance of a contract . . . between another and a third person . . . is subject to liability to the other.").

different from giving tort victims actions for lost income from future relationships. For newly formed relationships, that estimation procedure could prove uncertain, but in this case, we have no doubt whatsoever that the long history of compliance with the underlying deal meant that Bensenville would continue to play by the rules as long as the bonds were outstanding. So if there were a third person who blew up the houses to which the bonds were attached, he could be held to pay for the full value of the bonds.

To be sure, there is a wrinkle that will become indispensable for the overall analysis, namely, that the party in question would not have to pay twice for the same element in value. Thus, if the bonds were an asset in the hands of ProLogis, they were also a liability on the property that serviced them. So full compensation for the bonds requires an appropriate adjustment in the value owed to the property owner, to reflect the lien on the asset. Stated otherwise, the total amount owed by the defendant for the destruction of the real property to which the bonds attached should be *identical* whether or not the bonds are in place. If the bonds are in place, then less is paid for the loss of the real property if the bondholders are compensated in full. If not, then that value is paid to the landowners. The situation is but one application of the Modigliani-Miller Theorem that the value of an asset is independent of the capital structure superimposed on it.[37] It is commonly stated that this result holds only in the absence of taxes, bankruptcy, and informational asymmetries.[38] In this peculiar context of condemnation ex post, these assumptions fit quite well. It follows therefore that the existence of the complex arrangement between Bensenville and ProLogis determines *who* gets paid, not how much.

The notion of legitimate expectations carries with it different weight in the three-party context. Just that result is found in the takings cases on the same problem. The companion case to *Fuller* was *Almota Farmers Elevator & Warehouse Co v United States.*[39] In that situation, the United States condemned land on which Almota had constructed a

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37 Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of the Firm*, 48 Am Econ Rev 261, 268–69 (1958) (stating that the theorem is equivalent to the assertion that a dairy farmer cannot "earn more for the milk he produces by skimming some of the butter fat and selling it separately, even though butter fat per unit weight, sells for more than whole milk"). The shorthand version of this, which appeared recently in the Wall Street Journal, repeated a Yogi Berra joke of Merton Miller. "The pizza deliverer says to Yogi Berra: 'Do you want your pizza cut into quarters or eighths?' Yogi answers: 'Cut it into eight pieces. I'm feeling hungry tonight.'" Burton G. Malkiel, *The Price Is (Usually) Right*, Wall St J A13 (June 10, 2009) (describing the debate between efficient-market theorists and behavioral economists).

38 See Razeen Sappideen, *Imputation of the Corporate and Personal Income Tax: Is It Chasing One's Tail?*, 15 Am J Tax Pol 167, 172–74 (1998).

39 409 US 470 (1973).

grain elevator whose expected life was greater than the seven and one-half years left on the current lease.[40] Almota and its landlord had renewed leases on multiple occasions in the past, and there was every expectation that it would do so in the future.

The question in the case was whether Almota could recover for the value of the grain elevator attributable to the period after the expiration of the lease, which the Court allowed notwithstanding its general (and mistaken) rule that it offers no compensation for the disruption of ordinary commercial arrangements.[41] The ground for distinction was that Almota had already built the improvement in question.[42] But the answer should not turn on the existence of a physical asset. The reversionary interest in the grain elevator has value regardless of whether it is owned by Almota or its landlord. The transaction costs are sufficiently low, and the pattern of dealing sufficiently clear, that we know that absent the intervention, it would end up with Almota, who had the higher use value. As with the general analysis above, the government should pay the same amount either way, where the only question is how the proceeds are divvied up between the parties. Given the forcible disruption of their stable arrangement, that division of compensation should take place on the footing of a lease renewal on customary terms. Almota could keep the interest if it was paid or recover it from the government if not.

The pattern of argument here is in fact reflected in the customary terms found in many leases, whereby the lease is terminated between the parties when condemnation is at issue.[43] The efficiency advantage of this simplification is that it reduces the net costs of transacting with the government, as it is now possible to offer a valuation of the property as a whole without having to offer an evaluation of the divided interests in it. That task could be difficult because it is often unclear whether the tenant's leasehold estate is positive or negative in value, which depends on whether the rental value of the property exceeds its market value or the reverse. But working out those details is of no concern for the government because if the lease is at a premium, then it pays more to the tenant and less to the landlord. If it is not, the reverse is true. But once again the fundamental result is that the total

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40 Id at 471.

41 Id at 476 & n 3.

42 Id at 476.

43 For a discussion, see Victor P. Goldberg, Thomas W. Merrill, and Daniel Unumb, *Bargaining in the Shadow of Eminent Domain: Valuing and Apportioning Condemnation Awards between Landlord and Tenant*, 34 UCLA L Rev 1083, 1087 (1987) (showing how the allocation of condemnation awards can be determined by the lease).

amount paid is equal to the value of the underlying property when put to its best use, regardless of who owns what interest in it.[44]

These results cast a negative light on some of the constitutional cases relied on by both the Illinois Supreme and Appellate Courts. First among these is *Omnia Commercial Co v United States*,[45] which arose out of the following situation: The plaintiff had entered into a contract to purchase the entire year's output of steel from the Allegheny Steel Company at a price that was below its current market value.[46] The government then condemned the steel while in the hands of the seller,[47] agreeing to pay only the amount that the seller would have received had the deal gone through. The question was whether the government was obliged to compensate the plaintiff for the lost profits on the steel.[48] Justice George Sutherland answered in the negative on the ground that what was taken was the subject matter of the contract and not the contract itself.[49] In effect, that horrific decision announces that whenever there is a divided interest in property (here held subject to sale), the government gets to acquire it for the lower of cost or market. The result arises because the government receives a free option. Accordingly, if the price goes down, the government waits for the steel to be delivered and buys it at its lower market price. If, however, the price goes up, the government takes the steel at the contract price and leaves the buyer high and dry. But there is no reason to deviate from the rule that requires payment of the fair market value of the steel regardless of contract terms. The parties can divide the proceeds so that the seller gets the sale price and the buyer the gain. Under the Court's logic, once the government pays the seller the contract price, it is uncertain whether the seller will be exposed to a breach of damage suit, which reduces his total compensation, or whether the buyer forfeits his profit. But the basic theorem of takings law should govern the case. If a private party who takes the steel must answer for its market value in the face of divided ownership, so too must the government.

In the actual litigation, ProLogis distinguished *Omnia* on the ground that it involved a contract that was fully executory while ProLogis had fully performed its deal. The point is true, and the argument offers a convenient handhold for a state court that does not want to do battle

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44 Indeed, by this principle, Bensenville should be able to recover for the value of its public improvements, whether or not funded by the TIF bonds.

45 261 US 502 (1923), quoted extensively in *ProLogis*, 890 NE2d at 645. For a fuller criticism of the case, see Epstein, *Takings* at 90–92 (cited in note 24).

46 *Omnia*, 261 US at 507.

47 Id.

48 Id at 507–08.

49 Id at 510–11.

with an established, if erroneous, decision of the United States Supreme Court, which neither the Illinois Appellate or Supreme Court was prepared to do. But the Prologis logic concedes too much to the exercise of government power. In the law of contract, promises are enforceable whether the contract is executed or not. All that differs is the measure of damages. That said, the result in *ProLogis* is predetermined. Chicago must pay for the full value of the property taken, regardless of the capital structure superimposed on it. The enforceability of the bonds determines only who collects, not how much is paid.

In response, it could be argued that there is no reason to distinguish this case from the customary situation with real estate taxes. When the state takes real property for its own use, it need not compensate the city for the loss of its tax revenues.[50] That result is in general correct, even though the city has a tax lien in its own right for unpaid taxes. The key point here is that ordinary real estate taxation is used to fund current expenditures. The taking of the property by the government thus has two effects. It reduces the revenue to the local government, and it also decreases the expenses that it has to incur, and the two are a wash. This need not always be the case, for the state government (like private charities) may be tax exempt even if it continues to receive the same services as before. That vexing situation could not have arisen in *ProLogis,* however, because the covenants between the bondholders and Bensenville prohibited the village from rezoning the property for tax-exempt use, which is consistent with the paramount effort of both parties to the transaction to secure the tax base needed for repayment of the TIF bonds. In some instances, the covenants would be of no effect, as when the federal government takes the land. Yet even here, there is good reason to think that real property in general should not receive tax-exempt status given the additional burdens it would throw on everyone else.[51] That larger question has to wait for another day, even if it is presumptively troubling to grant a tax exemption for parties who receive current administrative services. But even if that inequity is not corrected, the situation with TIF bonds is different. There the taking occurs as in other taxation contexts, but in this situation neither the local government nor real estate owner is relieved of any service obligation that it would otherwise incur. So the conclusion continues to hold. The City of Chicago may quarrel over who gets the value of the bonds, not whether that value should be included.

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50 See, for example, *Public Water Supply District No 3 v United States*, 135 F Supp 887, 890 (Ct Cl 1955) ("While . . . ownership of tangible property is not always essential to the establishment of a taking under the Fifth Amendment, the interest must be more than a mere right to tax.").

51 See the discussion of *United States v Aho* and *United States v Florea* in text accompanying notes 62–63.

This basic approach helps explain the second Supreme Court case on which both the Illinois Appellate and Supreme Courts relied—*Mullen Benevolent Corp v United States*.[52] In *Mullen*, the local improvement district funded improvements by issuing bonds, secured by assessments of the local real property, which were supposed to be sufficient to pay them off in full.[53] In this instance, the United States acquired the properties and contributed to a fund equal to the amount needed to pay the assessments that had already been imposed on the land.[54] But after the bonds were acquired, a shortfall in the tax revenues was discovered, and the government resisted any fresh assessment on its properties to make up its share of the shortfall.[55] Justice Owen Roberts sustained the government's refusal to pay on the authority of *Omnia,* holding that the bonds were not taken: "By purchase of the lands the United States at most frustrated action by the city to replenish the assessment fund to which alone the bondholder must look for payment of his bonds. But this was not a taking of the bondholder's property."[56] The point seems wrong when the supposed act of "frustration" is the conscious taking of the underlying property interest. If a private party took the land, he would have to compensate both the holder of the equity and the mortgagee to the extent of their respective interests. The same logic should apply here.

In any event, *Mullen* supports ProLogis because the government conceded that it had to make good on all unpaid assessments *prior* to the takeover. The government only resisted the *new* assessment by asserting in effect the defense of sovereign immunity against the payments. But that result runs against the grain in eminent domain cases. The most famous maxim in modern eminent domain law comes from the Supreme Court's decision in *Armstrong v United States*,[57] which held that the overarching purpose of the Takings Clause is "to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[58]

At the most general level this decision is inconsistent with the overall approach in *Mullen*. Although the point is not explicit, it appears that the government continues to enjoy the benefit of the local improvements, as did its predecessor in title. Why force other lan-

52 290 US 89 (1933), discussed in *ProLogis,* 690 NE2d at 645–46.
53 290 US at 90.
54 Id at 91.
55 Id at 91–92.
56 Id at 94–95.
57 364 US 40 (1960).
58 Id at 48–49 (holding that compensation was required for liens on uncompleted boat hulls that were taken for use of the US Navy).

downers to bear what should be a public cost? More strikingly, *Armstrong* involves the same problem raised in *Mullen* but in a different guise. There, the claimants were materialmen in the State of Maine who placed a lien on a United States vessel on which they had done work in Maine's territorial waters.[59] The lien was nonrecourse, much like the obligation in *ProLogis*, and the government sought to defeat its foreclosure by sailing the vessel out of state waters so that the lien was effectively dissolved.[60] It would be perfectly easy to say that this was not a taking of the lien, but simply a way to "frustrate" its collection. But the point makes no sense, for why should these materialmen have to eat the cost of improvements whose benefits are shared equally by all American citizens? Just that result applies in *Mullen*, and it hardly matters that the source of the immunity from collection is sovereign immunity, not the physical removal of property from the jurisdiction. That defense works uneasily, to be sure, against ordinary tort actions, but it has never been held to apply to cases where property is taken instead of destroyed by tort action.[61] *Mullen* therefore is both distinguishable on the one hand and wrong on the other.

The weaknesses of that decision, moreover, are revealed by the way in which it has been ignored in subsequent cases. Both *United States v Aho*[62] and *United States v Florea*[63] involved patterns similar to those in *Mullen*. In both these cases, drainage districts issued improvement bonds for the long-term maintenance of the drainage system that worked a benefit for each parcel contained within the region.[64] The United States acquired several of these parcels through condemnation and sought thereafter to rid itself of the obligation to contribute its pro rata share for the upkeep of the district.[65] Prior to the condemnation there was a perfect matching of benefit and burden across all parcels.[66] The government's refusal to pay would necessarily

59 Id at 41.

60 Id at 41–42.

61 See, for example, *Keokuk & Hamilton Bridge Co v United States*, 260 US 125, 127 (1922) (applying sovereign immunity and finding there was no taking because the damage done by the government "might be a tort but which could be nothing else" if done by a private party).

62 68 F Supp 358, 366 (D Or 1945) (refusing to allow the government to take improved property without accepting "the burden of the taxes specifically imposed by legislation to pay for the benefit").

63 68 F Supp 367, 375 (D Or 1945) (describing the right to receive annual assessments from the improved property as a "property right").

64 See *Florea*, 68 F Supp at 367 (specifying an estimated improvement cost of $600,000, leaving unpaid bonds in the amount of $238,000); *Aho*, 68 F Supp at 358–62.

65 *Florea*, 68 F Supp at 368; *Aho*, 68 F Supp at 359.

66 See *Florea*, 68 F Supp at 369 ("[T]he benefit of the water received and the burden of the payments were more nearly equalized."); *Aho*, 68 F Supp at 360 ("[P]arcels of land not benefited cannot be subject to the burdens of contribution.").

force other parcels to bear these maintenance costs while giving the government a free ride.[67] Judge James Fee took pains to distinguish these assessments from the "unsecured levies of state, county and municipal taxes to liquidate general obligations of such bodies,"[68] and held in effect that this was a special assessment for a unique return benefit that the United States should pay.

His opinion thus makes a persuasive case that benefits and burdens should not be presumed equivalent on a priori grounds. But at no point did he apply the same analysis to ordinary real estate taxes. To be sure, many such expenditures will exhibit the rough proportionality that makes this assumption justifiable on administrative grounds. But it is easy to think of exceptions, especially for those portions of local real estate taxes that provide public goods for the community at large. Thus, let the federal government take over large swaths of a small community, and it will do little, if anything, to reduce the costs that it incurs in keeping open its courthouse, recording office, or power plants, whose total costs of operation are relatively insensitive to total population. In these cases, it perhaps would be wise to rethink the rule that allows the condemnor to force the local community to bear its losses. Indeed the Bensenville situation looks as though the remainder of the town suffered when it was denied its general revenues from the taxed property, which probably required fewer services than other portions of the town. The basic logic of *Armstrong* applies to a wide range of circumstances to which the narrower decision in *Mullen* does not. *Mullen* should yield to *Armstrong* with its superior logic.

These precedents thus raise many complex issues. Yet in dealing with the problem, however, the Illinois Supreme Court ignored every systematic distributional consequences of its decision. Instead it contented itself with distinguishing both *Aho* and *Flores* on superficial and inadequate grounds:

> In the case before us, the only security the bondholders had was the right to the incremental taxes, if any, which did not encumber the subject property. The security for the bonds is outlined in the bond ordinance and in the TIF bonds themselves. Additionally, each bondholder signed the certificate of purchase and, in doing so, confirmed they understood what secured the TIF bonds.[69]

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67 *Florea*, 68 F Supp at 369; *Aho*, 68 F Supp at 360.

68 *Florea*, 68 F Supp at 371 ("[T]he levying of assessments in a Drainage District . . . is a property right which belongs to the aggregate of the owners within the boundaries."); *Aho*, 68 F Supp at 359.

69 *ProLogis*, 2010 WL 200015 at *5.

The argument is, however, wholly unresponsive. It ignores the entire elaborate set of covenants and undertakings to say that the "only security of the bonders" lay in the incremental taxes, if any. The whole point of these arrangements was to make sure that the Bensenville could not ride roughshod over the transaction. The unconventional nature of the lien was driven by a variety of tax and business situations. Yet the implicit argument of the Illinois Supreme Court was that Bensenville could terminate the arrangement at will, which was manifestly not the case. It is therefore wholly indefensible to allow a third party to what Bensenville could not, and what Chicago would never dare try with its own TIF bonds. At this point, the last sentence only adds insult to injury. The bondholders knew precisely what risks they took—diminished revenues from the project. It was the Illinois Supreme Court that had no understanding of the complex arrangements that secured the bonds.

CONCLUSION

Tax increment financing devices have been in common use for many years now because they supply a sensible way in which local governments can differentiate in the level of services provided to different parts of the same municipal governments. It is of course possible to oppose the use of these devices on the ground that they misallocate the resources of local governments. But whether that attack succeeds or not, the one point that does seem clear is that once created, TIFs should be protected from subversion by other government entities that have eminent domain power over the territory of the local government that issued the TIF bonds. These local governments have taken every possible step to secure the bonds against their own machinations. Their agreements, however, are powerless to protect these bonds from the machinations of other governments who have not bound themselves by contract. The only protection for that source of abuse is to insist that these outside governments be forced to compensate these bondholders, either directly or indirectly, for the loss of value inherent in the bonds.

The basic logic of this position follows from general finance theory. The value of the real estate taken by the condemning government is independent of the capital structure imposed on it. All that is needed to get the right result is to require that the condemnor engage in consistent accounting. From a private law perspective, TIF bonds are liens, and hence liabilities, on the private property within the district. They are assets in the hands of the bondholders. Accordingly, there are only two consistent ways in which to do the accounting. One is to follow the property interests by valuing each separately, which is what the plaintiffs in *ProLogis* sought. The other approach is more adventurous, for it conscientiously ignores the capital structure, puts the money in a common pot, and lets the various claimants sort out their interests after the government leaves the scene. In this case, the two methods are the same since ProLogis is the sole bondholder and the sole owner of real estate. In other cases, the necessary allocation among multiple claimants will have to be made more explicitly. But no matter how we think about it, the one confident conclusion is that the decisions of the Illinois Appellate and Supreme Courts are wrong for the same reason that *Omnia* is wrong: They give a free option to the interloper, the City of Chicago, which gets the best of both worlds. It pays the property holders for the value of their property less the liens on it but does not compensate the bondholders when it wipes out their nonrecourse interest. The simple truth is that what counts as an asset to the bondholders is a liability to the real estate holder. The city cannot treat these complex instruments as though they are liabilities to the real estate owners but not assets to the bondholders. As usual, if the fundamentals of the transaction are well understood, the constitutional law will almost take care of itself. But if a court misunderstands slippery terms like "sophisticated investors," "legitimate expectations" and "guaranteed payments," it will surely go astray.