

The Use of Penalty Clauses in Location Incentive Agreements

MATTHEW T. FURTON*

INTRODUCTION

In October, 1980, the State of Tennessee provided Nissan Motor Manufacturing Company with \$33 million in financial incentives to induce the company to locate its first U.S.-based assembly plant in Smyrna, Tennessee.¹ The incentive package, valued at \$11,000 per Tennessean employed at the plant, included funds for worker training and road improvements.² In December, 1986, the State of Indiana offered more than \$86 million in financial incentives to Isuzu Motors Ltd. and Fuji Heavy Industries, Inc. as an inducement to locate their planned joint venture in Lafayette, Indiana.³ Indiana's incentive package, which included \$55 million directly from the state budget and \$5 million from the local city and county governments for infrastructure improvements, cost state taxpayers \$50,588 per worker employed at the Fuji-Isuzu plant.⁴ In October, 1993, the State of Alabama provided Mercedes-Benz AG ("Mercedes") with a package of financial incentives worth more than \$300 million.⁵ The package, valued at \$200,000 per job created at the plant, included an interest-free loan of more than \$42 million, construction of a \$35 million training center, and an agreement to purchase more than 2500 Mercedes vehicles for state use.⁶ Finally, Alabama agreed to pay the salaries of Mercedes employees during their training at the state-built training center.⁷

These direct financial incentives offered by state and local governments to attract and retain businesses are essentially *investments* in a speculative venture by the taxpayers of a community.⁸ Public officials anticipate that the investments they make on behalf of the local citizens eventually will cause the community to prosper due to the newly created jobs and the ripple effect on incomes, land values, and increased demand for goods and services. Public officials' willingness to gamble with public funds has caused an expensive bidding war pitting state against state, county against county, and township

* J.D. Candidate, 1995, Indiana University School of Law-Bloomington; B.S., 1992, University of Michigan. I wish to thank Professor Sarah Jane Hughes for her assistance and comments on earlier drafts of this Note.

1. H. Brinton Milward & Heidi H. Newman, *State Incentive Packages and the Industrial Location Decision*, 3 ECON. DEV. Q. 203, 211-13 (1989).

2. *Id.*

3. Susan Pastor, *Fuji, Isuzu Plan U.S. Auto Plant*, N.Y. TIMES, Dec. 3, 1986, at D1.

4. *Id.*; see also Milward & Newman, *supra* note 1, at 218.

5. E.S. Browning & Helene Cooper, *Ante Up; States' Bidding War Over Mercedes Plant Made for Costly Chase*, WALL ST. J., Nov. 24, 1993, at A1.

6. *Id.*

7. *Id.*

8. See, e.g., IND. CODE § 4-4-8-12 (1993) (labeling location incentive packages as "investments").

against township.⁹ Although most studies question whether these programs are cost justified,¹⁰ the dramatic escalation in the last decade in the quantity and the size of location incentive packages is a testament to their popularity with government officials.¹¹

Unfortunately, not all subsidized investments pan out. When a major employer receives public subsidies and subsequently discontinues operations in a community, the community's economy suffers, its image becomes tarnished, and the millions of dollars spent enticing the company to locate within its borders are lost.¹² Public resources that could have been allocated to more pressing needs, such as education or crime prevention, frequently are used to subsidize profitable corporations. Worse yet, if the corporation ceases operations, the community usually finds itself without recourse against the corporation. The corporation owes the community nothing and is free to leave at any time regardless of the devastation its exit might cause to the community.¹³

Ypsilanti, Michigan, experienced these difficulties when General Motors ("GM") announced on February 24, 1992, that its Willow Run assembly plant would close and that all operations would be transferred to a plant in Arlington, Texas.¹⁴ By some estimates, the closure of the Willow Run plant would cost the 60,000 residents of Ypsilanti not only the 2600 jobs at the plant, but also \$50 million in personal income, \$35 million in retail sales, and another 10,000 non-GM jobs in Michigan.¹⁵ The township sought to enjoin

9. PHILIP KOTLER ET AL., *MARKETING PLACES* 14-17, 242-46 (1993).

10. See *infra* part I.B.

11. See NATIONAL ASS'N OF STATE DEV. AGENCIES, *DIRECTORY OF INCENTIVES FOR BUSINESS INVESTMENT AND DEVELOPMENT IN THE UNITED STATES: A STATE-BY-STATE GUIDE* 2 (3d ed. 1991). According to this survey, every state and most larger local governments have an economic development agency charged with attracting and retaining job-creating industries. The average state economic development agency has more than 100 employees. See also Robert B. Reich, *Toward a New Economic Development*, *INDUS. WK.*, Oct. 5, 1992, at 37. Professor Reich estimated that in 1992, various state and local governments would provide location incentive packages worth more than \$30 billion. According to Professor Reich's estimates, New York City alone would forgo about \$700 million in tax revenues to induce about 4500 businesses to remain in the city. *Id.* at 39. Connecticut and New Jersey would respond to New York City's incentives by shelling out an estimated \$200 million in tax abatements. *Id.*

12. This is especially true when the financial incentives are firm-specific incentives such as grants, low interest loans, tax exemptions and abatements, and direct wage payments. These expenditures become valueless to the community if the company ceases operations. On the other hand, general financial incentives, such as road improvements and certain worker training programs, may provide value to the community regardless of a single company's operations. This Note deals primarily with firm-specific incentives, as these types of financial incentives involve a greater magnitude of risk.

13. See Joseph W. Singer, *The Reliance Interest in Property*, 40 *STAN. L. REV.* 614, 718 (1988). Professor Singer extensively documents the devastation that plant closings have on a community:

Many workers who lose jobs when a plant closes face long term unemployment and large losses in family income and depletion of family wealth. . . . Unemployment caused by plant closings is, moreover, associated with large adverse impacts on physical and emotional health. Statistics show increases in specific illnesses such as heart disease, ulcers, alcoholism, mental illness, and hypertension. There is also evidence of increases in suicide, homicide, and child and spouse abuse.

Id. at 718.

14. Warren Brown, *GM Loses Record \$4.5 Billion, Names 12 Plants to Be Closed*, *WASH. POST*, Feb. 25, 1992, at A1.

15. KOTLER ET AL., *supra* note 9, at 250.

the plant closure on the ground that, in return for \$13.5 million in property tax abatements, GM had promised to keep the plant open indefinitely.¹⁶ The trial court judge ruled in favor of Ypsilanti and enjoined the closing, but a Michigan state court of appeals unanimously overturned the trial court's decision¹⁷ and the Michigan Supreme Court refused to hear the township's appeal.¹⁸ General Motors was free to leave and Ypsilanti was powerless to recoup its investment.¹⁹

Ypsilanti is one of many communities that have suffered from the premature demise of a taxpayer-subsidized investment.²⁰ A major employer may discontinue operations for a number of reasons, including changes in market conditions, insolvency, or even the promise of better financial assistance from another community. These contingencies require public officials to account for, and control, the risk associated with the potential failure of direct financial incentives to corporations. More specifically, the local government needs recourse when the corporation fails to uphold its end of the bargain. Scholars and legislators, however, have been unsuccessful in developing a strategy for managing the risk of location incentive programs.

This Note proposes that government officials protect public investments in the form of direct financial incentives offered to attract and retain businesses by including a penalty clause in the location incentive agreement.²¹ This penalty clause would operate as a liquidated damages provision which would provide for a substantial penalty in the event that the company prematurely discontinued operations in the community. As enforcement of such clauses would require some reform in the prevailing contract jurisprudence, this Note also advocates revising the rule which precludes the enforcement of freely-negotiated penalty clauses in location incentive agreements. Part I of this Note examines the forces behind the proliferation of location incentives and evaluates the effectiveness of financial incentives as instruments for economic development. Part II proposes the use of penalty clauses as a new method for

16. See *Ypsilanti v. General Motors Corp.*, 506 N.W.2d 556, 557 (Mich. Ct. App. 1993).

17. *Id.*

18. *Ypsilanti v. General Motors Corp.*, 509 N.W.2d 152 (Mich. 1993) (mem.).

19. Benjamin Weiser, *Who Pays the Price When a Plant Closes? Workers, Towns Fight Uphill Battle to Regain Jobs, Factories*, WASH. POST, Nov. 29, 1993, at A1. The plant closed one month later. *Id.* Ypsilanti Township and General Motors eventually reached an agreement in April, 1994. Under the agreement, GM will invest \$80 million in a nearby powertrain plant and will attempt to sell the Willow Run plant. *Friday Ticker*, CHI. TRIB., Apr. 15, 1994, § 3, at 1.

20. See KOTLER ET AL., *supra* note 9, at 243. For example, in 1978, the State of Pennsylvania provided more than \$78 million to Volkswagen of America to induce the company to build a new manufacturing facility for the popular Rabbit. *Id.* at 244. Despite slow sales of the Rabbit caused by design defects and an economic recession, state officials continued to invest in the company. *Id.* "Pennsylvania officials did not believe that Volkswagen, a worldwide corporate giant, would walk away from a half billion dollar investment." Andrew L. Kolesar, Note, *Can State and Local Tax Incentives and Other Contributions Stimulate Economic Development*, 44 TAX LAW. 285, 305 (1990). Much to the chagrin of Pennsylvania officials and taxpayers, the plant closed only 10 years after it opened, and the state never recovered its investment. *Id.* at 304.

21. This Note focuses on financial incentives provided through a contracting process. Although many location incentive programs operate through an application and approval process, see, e.g., IND. CODE § 4-4-8-5(b)(2) (1993), the largest inducement packages are usually provided for in a formal contract.

state and local governments to assess and reduce the risk involved in financial incentives offered to attract and retain businesses. To make this tool useful, Part III advocates reforming the current rule regarding "excessive" liquidated damages clauses in the context of location incentive agreements.

I. THE FORCES BEHIND, AND THE EFFICACY OF, LOCATION INCENTIVES

An investigation into the forces behind the popular practice of providing financial incentives to induce companies to locate or to remain located within a particular community reveals the need for a new legal mechanism to manage the risks inherent in such public investments. An examination of the effectiveness of these investments in promoting job creation and economic growth also reveals the necessity for better risk management in the administration of location incentive packages.

A. The Forces Behind Location Incentives

Political, historical, and market forces, as well as federal policies, have all contributed to the recent expansion in the size and quantity of direct financial incentives. The combined effect of these forces has created the current bidding war between localities.

Political forces play the largest role in the escalation of location incentives.²² Civic pride, survival instincts of political incumbents, and campaign promises of job creation lead many communities to offer incentive packages that are not cost-justified.²³ Politicians' desire to cultivate a positive business climate in their communities results in decisions based on appearances rather than rational economic analysis. No elected representative wants his or her district to appear uncompetitive or unfriendly to prestigious industries such as high-tech manufacturing. Moreover, elected representatives perceive financial inducements to be a low-cost method of job creation, at least when compared to public works programs.²⁴ Politicians' short-term orientation (caused by frequent elections) and voters' short memories also contribute to the political motivations behind location incentives.

Political forces worked behind the scenes when Toyota Motor Manufacturing USA, Inc. ("Toyota") selected Scott County, Kentucky, as the site for its new U.S. facility. Although more than thirty states tried to lure Toyota, Kentucky prevailed by providing the company with roughly \$149.7 million in location incentives.²⁵ Because Kentucky had lost a bidding war for the

22. KOTLER ET AL., *supra* note 9, at 242-46.

23. *See id.* at 249.

24. *See id.* at 243-44.

25. Milward & Newman, *supra* note 1, at 217-18. The incentive package included funds for purchasing the land, site preparation, road improvements, and worker training; a 20-year commitment to provide a Saturday school program for the children of Toyota employees; and a 10-year commitment to provide Toyota's employees and their families with English language classes. *Id.*

Saturn Project to Tennessee only a few months earlier, "Kentucky's state pride and mounting political pressure on the governor for an industrial 'success' were definitely contributing factors" to the size of the incentive package.²⁶

The political motivation behind providing financial incentives finds its origins in historical traditions. States' practice of using economic incentives to attract businesses predates the Constitution. Before the Union was formed, individual states levied tariffs on other states' goods to encourage local manufacturing.²⁷ This economic warfare was soon reflected in the pro-management policies of many states' corporate governance laws.²⁸ These "race to the bottom" tactics persist today and thereby cultivate an expectation of advantageous treatment within many companies. Although one term for these packages—municipal inducements—suggests that communities are the offerors, companies frequently approach municipalities seeking financial incentives.²⁹

Similarly, market forces encourage states to offer increasingly larger incentive packages. Regardless of whether location incentives actually lead to economic growth and job creation (the issue addressed in Part I.B), the popularity and the expansion of these public investments suggest that most public officials *believe* that public subsidies encourage economic development. It follows that these public officials also believe that states which fail to entice companies with public subsidies will be at a competitive disadvantage vis-à-vis those states which do provide location incentives. Although most state officials would prefer not to provide location incentives, they perceive no benefit from unilaterally refraining from granting such financial assistance.³⁰ Thus, market dynamics assure the continuation of this interstate economic warfare.

Competition as a driving force behind financial incentives is evident in the New York metropolitan region. In late 1991, New Jersey, Connecticut, New York State, and New York City signed a "non-aggression" pact designed to reduce the public subsidies each offered to attract and retain businesses.³¹

26. *Id.* at 218.

27. JOHN FISKE, *THE CRITICAL PERIOD OF AMERICAN HISTORY* 144-45 (2d ed. 1916).

28. William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *YALE L.J.* 663, 666 (1974).

29. One survey of business executives concluded that firms typically determine the location of their facilities and then look to the local government for subsidies, realizing, in essence, a windfall. Larry Kramer, *Business Lures Useless, Nader Says*, *WASH. POST*, Aug. 2, 1979, at D2; *see infra* part I.B.

30. One commentator compared this situation to the famous Tragedy of the Commons. *See* William J. Barrett VII, Note, *Problems with State Aid to New or Expanding Businesses*, 58 *S. CAL. L. REV.* 1019, 1027-28 (1985). According to Barrett, state officials, similar to the herdsman sending too many cows to graze on the commons, continue to give away public resources because they internalize all the benefits of their activity, including jobs and increased land values. Yet the officials bear only a fraction of the burdeus (the higher "market price" for job providers). State officials, therefore, have insufficient incentive to voluntarily reduce their consumption for some remote or theoretical gain from controlled consumption. *Id.* at 1028. For background information on the Tragedy of the Commons, *see* Garrett Hardin, *The Tragedy of the Commons*, in *ECONOMIC FOUNDATIONS OF PROPERTY LAW* 2, 4 (Bruce A. Ackerman ed., 1975).

31. KOTLER ET AL., *supra* note 9, at 258-59.

Within twelve months, all four governmental entities had essentially disregarded the voluntary agreement and returned to their earlier practice of raiding each others' businesses.³² In fact, the incentives offered after the non-aggression pact were more elaborate than those which preceded the agreement.³³

Federal policies also motivate the escalation of location incentives. The Federal Government has contributed to this increase in two ways. First, Congress drastically reduced the amount of direct financial assistance provided to state and local governments, thereby forcing these governments to look to the private sector for funding.³⁴ Second, through the adoption of several programs, the Federal Government has endorsed the concept of financial incentives as a means of achieving economic development, and occasionally mandates cooperation from state and local governments. For instance, Congress recently enacted the Revenue Reconciliation Act of 1993 (the "Act"),³⁵ which provides for direct financial incentives to businesses locating in targeted economically depressed areas.³⁶ More specifically, the Act provides employment credits,³⁷ increased expensing,³⁸ and facility bonds for businesses located in areas designated as empowerment zones or enterprise communities.³⁹ In addition to the intrinsic endorsement effect in this federal program, the legislation also explicitly requires a "strategic plan" by state and local governments to promote economic development in the targeted areas.⁴⁰

32. *Id.* at 259.

33. *Id.*

34. Reich, *supra* note 11, at 42 (estimating that the federal contribution to the operating budgets of the nation's cities declined from nearly 18% of total expenditures in 1980 to about 6% in 1992).

35. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13301(a), 107 Stat. 416, 543-555 (codified at 26 U.S.C. §§ 1391-1397D (Supp. V 1993)).

36. 26 U.S.C. § 1392.

37. *Id.* § 1396.

38. *Id.* § 1397A.

39. *Id.* § 1394.

40. *Id.* § 1391. Sections 1391(e) and (f) provide in relevant part:

(e) Limitations on Designations.—No area may be designated under subsection (a) unless—

(1) the area is nominated by 1 or more local governments and the State or States in which it is located for designation under this section,

(f) Application.—No area may be designated under subsection (a) unless the application for such designation—

(2) includes a strategic plan for accomplishing the purposes of this subchapter that—
(A) describes the coordinated economic, human, community, and physical development plan and related activities proposed for the nominated area,

(B) describes the process by which the affected community is a full partner in the process of developing and implementing the plan and the extent to which local institutions and organizations have contributed to the planning process,

(C) identifies the amount of State, local, and private resources that will be available in the nominated area and the private/public partnerships to be used, which may include participation by, and cooperation with, universities, medical centers, and other private and public entities,

In sum, political, historical, and market forces, combined with the influence of federal policies, have caused the proliferation and the expansion of financial incentive packages designed to attract and retain businesses. In the face of these powerful forces, rational arguments over whether these programs are cost-justified or actually promote economic development are likely to fall on deaf ears; location incentive programs are remarkably resilient. Nonetheless, the effectiveness of these programs is an essential consideration in determining how location incentive programs should be administered.

B. The Effectiveness of Location Incentives

“When industries consider relocation or expansion, they consider a number of factors, including the cost and availability of raw materials, transportation, labor, energy, access to markets, access to credit, the general business climate, the cost of living, the quality of life, and available financial incentives.”⁴¹ The precise effect that financial incentives have on a particular company’s site-selection decision will, of course, vary depending on the individual circumstances. Numerous studies have attempted, however, to measure the overall effectiveness of location incentive packages as governmental tools to promote economic development and create employment opportunities.

The majority of academic studies condemn the practice of providing corporations with direct financial assistance, and argue that this type of government subsidy only encourages economic behavior that would have occurred anyway.⁴² For instance, a recent study of the Indiana Enterprise

Id. § 1391(e), (f); see also Adam M. Handler, *Empowerment Zones and Other Business Incentives May Provide Only Limited Benefits*, 79 J. TAX’N 274, 274 (1993) (listing the components of a strategic plan, including descriptions of the “state, local, community, and private plans for the area and the methodology and criteria to be used to measure progress”).

41. Oliver A. Houck, *This Side of Heresy: Conditioning Louisiana’s Ten-Year Industrial Tax Exemption upon Compliance with Environmental Laws*, 61 TUL. L. REV. 289, 300 (1986) (advocating that Louisiana should condition tax exemption under a location incentive program on compliance with environmental laws).

42. See Jack Lyne, *Incentives Are Important, Executives Say, But Business Concerns Drive the Location Process*, SITE SELECTION, Apr. 1992, at 282, 283 (noting that a survey conducted in December, 1991 and January, 1992 among corporate real estate executives revealed that only three percent of survey respondents said that a major incentive package could sway their firms’ location decisions, and that the overwhelming majority of location decisions are based in solid business considerations); see also NEW YORK LEGISLATIVE COMM’N ON THE MODERNIZATION AND SIMPLIFICATION OF TAX ADMIN. AND THE TAX LAW, INTERSTATE BUSINESS LOCATIONAL DECISIONS AND THE EFFECT OF THE STATE’S TAX STRUCTURE ON AFTER-TAX RATES-OF-RETURN OF MANUFACTURING FIRMS 7 (Prelim. Analysis, Dec. 31, 1984) (concluding that the overwhelming weight of empirical research indicates that state and local taxes generally have little if any effect on industrial location decisions); ROGER J. VAUGHAN, STATE TAXATION AND ECONOMIC DEVELOPMENT 95 (1979) (concluding that, “for the most part, firms are rewarded for doing what they would have done even in the absence of the incentive”) (emphasis in original); Houck, *supra* note 41, at 301 (concluding that “[s]tudies generally rank the influence of tax exemptions rather low”); Milward & Newman, *supra* note 1, at 207 (“The majority of published studies have minimized or dismissed the significance of tax differentials or tax incentives . . . on industrial development.”); Merrill Gozner, *A Relocation of Opinion on State Subsidies to Firms*, CHI. TRIB., July 16, 1989, § 7, at 1 (reporting that the Illinois Auditor General’s investigation of the Illinois Department of Commerce and Community Affairs concluded that the agency subsidized economic behavior that would have occurred in any case and gave an advantage to subsidized firms which resulted in the displacement of similar economic activity by unsubsidized firms). See generally Barrett, *supra* note 30, at 1041-49 (concluding that financial incentive programs may violate the dormant Commerce Clause).

Zone Program concluded with a particularly pessimistic analysis of the effectiveness of financial incentives as a method of promoting economic growth:⁴³ "EZ [Enterprise Zone] designation and implementation does not affect the level of inventories, employment, or depreciable property . . . [T]he tax concessions awarded EZ participating businesses are, in fact, 'gifts' or income transfers provided to participating businesses as compensation for the negative-profit characteristics of zone location."⁴⁴ The report also stated that any claims of linkage between the financial incentives and stimulation of investment or job creation "should be subject to serious skepticism and doubt."⁴⁵

In the studies that condemn the effectiveness of financial incentives, commentators criticize location incentives for a number of reasons. First, financial incentives are merely disguised government spending in which the decision frequently is made with neither a simple cost-benefit analysis nor much accountability.⁴⁶ Second, the provision of municipal incentives directly reduces the public resources available for education and infrastructure improvements—two traditional public expenditures universally acknowledged as essential to economic development.⁴⁷ Third, location incentives benefit new businesses over existing businesses.⁴⁸ Fourth, some companies threaten

43. JAMES A. PAPKE, *THE ROLE OF MARKET BASED PUBLIC POLICY IN ECONOMIC DEVELOPMENT AND URBAN REVITALIZATION: A RETROSPECTIVE ANALYSIS AND APPRAISAL OF THE INDIANA ENTERPRISE ZONE PROGRAM* (Aug. 31, 1990) (prepared for the Enterprise Zone Board, Indiana Department of Commerce). The Indiana Enterprise Zone Program promotes investment and job creation by the private sector. To accomplish this goal, the program targets economically depressed inner-city areas and provides participating businesses within the targeted areas with tax concessions and wage subsidies. *Id.* at ix.

44. *Id.* at 116.

45. *Id.*

46. See Richard D. Pomp et al., *Can Tax Policy Be Used to Stimulate Economic Development*, 29 AM. U. L. REV. 207, 218 (1980) (symposium comments by Roger Vaughan) (stating that tax incentives often are not considered expenditures and therefore are not budgeted or evaluated). Milward and Newman evaluated six inducement packages offered to automotive companies by different states. They note that "few states appear to have conducted an in-depth economic study of an automotive plant's impact after the inducement package was offered and the location decision announced." Milward & Newman, *supra* note 1, at 221.

The consultant who conducted an independent investigation into the efficacy of the State of Illinois' economic development agency was appalled at the absence of procedures used by the state to determine the credibility of a company's threat to leave the state. Gozner, *supra* note 42, at 5 ("If I'm going to give a company money for not leaving the state, I'd at least make an independent judgment whether that was, in fact, the case.").

Philip Kotler and his co-authors note that "cost-benefit ratios for places generally overstate immediate benefits and, depending on choice of economic multipliers used, often exaggerate the ripple effect of secondary benefits from business attraction or retention." KOTLER ET AL., *supra* note 9, at 258.

47. See Reich, *supra* note 11, at 42. Professor Reich, now Secretary of Labor, argues that only the promise of a good financial return on capital will attract and retain businesses in the long run. *Id.* at 40. After noting the limited number of methods available to a community that seeks to ensure a good return to local corporations, Reich argues that the most prudent course a community can follow is to ensure that its work force is well-educated and the community's infrastructure is sound. *Id.* at 41.

48. See Kolesar, *supra* note 20, at 296 (discussing the fundamental unfairness which results when government aids new businesses but not established ones). At least one commentator suggests that the converse situation—providing financial assistance to existing businesses—is also inequitable and inefficient. See KOTLER ET AL., *supra* note 9, at 250 ("By subsidizing inefficient, technologically laggard, noncompetitive businesses in the name of business retention, states and localities simply delay the inevitable—plant closings, business failures, and job loss.").

to relocate simply to take advantage of financial incentives.⁴⁹ Fifth, localities which are in the worst economic condition are more likely to grant financial incentives.⁵⁰ Sixth, location incentives encourage corporations to change their location frequently without regard for the disruption of employees' lives.⁵¹ Finally, some forms of direct financial incentives, such as tax increment financing, increase a community's level of debt.⁵²

On the other hand, a few commentators insist that location incentives which provide direct financial assistance are vital to the creation of new jobs.⁵³ The proponents of direct financial assistance programs cite a need to be competitive with surrounding states and to appear attractive to companies which are considering future location within the state.⁵⁴ Public officials also may believe that retaining a particular company is essential to maintaining a favorable image.⁵⁵ Commentators further argue that, to the extent that

49. See KOTLER ET AL., *supra* note 9, at 244-45 (noting that "footloose" firms shop for the best inducements and tend to move again whenever firm-specific benefits are exhausted). For example, in 1979, General Motors requested tax breaks from Lansing, Michigan, intimating that the tax breaks were necessary to expand operations at its plant in the area. Lansing refused the request, but GM stayed anyway. See Kolesar, *supra* note 20, at 308 & n.167; Mary McAleer Vizard, *How David (Westchester) Beat Goliath (Connecticut)*, N.Y. TIMES, July 12, 1992, § 10, at 11.

50. ANN O'M. BOWMAN, TOOLS AND TARGETS: THE MECHANICS OF CITY ECONOMIC DEVELOPMENT at vi (1987) (finding that in 1986, 37% of cities with poor economic conditions used tax abatements, while no cities with strong economic conditions used tax abatements extensively).

51. See *infra* note 69 (detailing the adverse impact plant closings have on individual workers and their families); cf. Goozner, *supra* note 42, at 5 (noting that one survey found that a large majority of the corporate headquarters relocations wound up within a ten-minute drive of the home of the executive who ordered the move).

52. For example, the State of Illinois and Hoffman Estates, a suburb of Chicago, provided Sears, Roebuck & Co. ("Sears") with an incentive package worth more than \$178 million to keep the company's headquarters in the Chicago area. The deal included grants for site development and infrastructure improvements, loans, and reduced sales, income, and property taxes. Most significantly, the Illinois Legislature passed legislation authorizing certain communities, including Hoffman Estates, to create special Tax Increment Financing ("TIF") districts. This legislation allows Hoffman Estates to sell tax-exempt bonds to acquire land, which it will subsequently turn over to Sears. Over a 20-year period, Sears will then pay off the bonds from a fund consisting of 80% of the property taxes generated by the development. Merrill Goozner, *Sears Picks Hoffman Estates: Deal Hinges on Approval of Tax Breaks*, CHI. TRIB., June 26, 1989, § 1, at 1.

53. See John P. Blair & Robert Premus, *Major Factors in Industrial Location: A Review*, 1 ECON. DEV. Q. 72 (1987); Roger W. Schmerrer et al., *Geographical Differences and the Location of New Manufacturing Facilities*, 21 J. URB. ECON. 83 (1987) (concluding that the location decision is made in stages, and the effect of location incentives increases in later stages); Steve Bergsman, *Incentives, Location, Quality of Life: All Figure into the Site Selection Equation*, NAT'L REAL EST. INVESTOR, Oct. 1993, at 158 (citing a recent survey by the Deloitte & Touche Realty Consulting Group and the International Association of Corporate Real Estate Executives which found that 82% of the corporate respondents said that incentives were important considerations at later stages in the decision-making process); see also Edward P. Lazarus, Note, *The Commerce Clause Limitation on the Power to Condemn a Relocating Business*, 96 YALE L.J. 1343, 1361 n.91 (1987) (arguing that competition with location incentives will lead to a site selection decision which is most economically efficient). Lazarus created an algebraic formula to show that in an efficient model, businesses will locate wherever the value of the business to the state plus the value of the business in that state is greater than these two values in any other state. *Id.*

54. Vizard, *supra* note 49, at 11.

55. During the bidding war preceding the eventual Sears deal with the State of Illinois, a state official remarked, "We think it's important for the city's image to keep an important corporate citizen." Lindsey Tanner, *Illinois Scrambles to Keep the Sears Address in Chicago*, WASH. POST, Feb. 21, 1989, at D1.

financial incentives encourage new industry, the multiplier effect on the surrounding community—in terms of employment, income, land values, and increased demand for goods and services—outweighs the direct cost to the public.⁵⁶

Although most researchers criticize the effectiveness of location incentives, the widespread use and the trend toward escalation of these programs illustrates a belief by public administrators that they are sound public policy. Given the ironic combination of the dubious effectiveness and the remarkable resiliency of location incentives, the necessity for prudent administration is apparent.

II. THE PROPOSAL: INCLUSION OF PENALTY CLAUSES IN LOCATION INCENTIVE AGREEMENTS

Public officials need a new technique to manage the risk inherent in location incentive packages. To this end, states and municipalities should enter into a contractual relationship—similar to a partnership agreement—with the company receiving a location incentive. This agreement would define the rights and obligations of both parties, as well as their remedial rights in the event that one of the “partners” cannot, or will not, perform. The government should ensure that its remedial rights include a liquidated damages clause that is of such magnitude that it would deter the company from abandoning the community, or at least fully compensate the taxpayers for the real value of their investment in the event of a breach. Although such a liquidated damages clause may be classified as a “penalty” and thus be unenforceable under current law,⁵⁷ the unique context of location incentive agreements presents a good argument for a change in existing law.⁵⁸

A. The Advantages of Penalty Clauses

Stipulating in advance the sum due in the event that the company discontinues operations has several advantages.⁵⁹ First, if the sum is substantial enough, it may deter the company from abandoning the community. Second, setting a sum certain at the drafting stage will facilitate the calculation of risks by both parties. Third, the government as the non-breaching party will

It is interesting to note that when asked about the magnitude of the incentive package offered to Sears, local officials in surrounding communities sounded gravely concerned. Aurora Mayor David Pierce questioned, “Is the state putting itself in a situation where companies can hold the state hostage and demand a ransom?” Bolingbrook Mayor Roger Claar added, “I often wonder if the state will see anything from these incentives if these companies leave after three or four years.” Nancy Ryan, *Suburbs See Sears Deal as Expensive Precedent*, CHI. TRIB., July 7, 1989, § I, at 1.

56. See Note, *Municipal Inducements to Private Industry*, 40 MINN. L. REV. 681, 681 (1956).

57. See *infra* notes 93-100 and accompanying text.

58. For an alternative characterization of liquidated damages clauses, see DAN B. DOBBS, *LAW OF REMEDIES* § 12.9(4), at 815-17 (2d ed. 1993).

59. Note that the liquidated damages clause need not be expressed by a liquidated sum. A formula for calculation of damages in the event of a breach is sufficient. JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* § 14-31(c), at 643 (3d ed. 1987).

be able to recover losses that are difficult to prove. Fourth, these provisions would allow the parties to convey messages about their credibility.⁶⁰

The first advantage of penalty clauses is that the potential liability incurred in the event of plant closure may deter a subsidized company from abandoning a community for all but the most serious financial considerations. Communities invest in a company anticipating job creation, increased land values, and general economic prosperity. Communities forgo other expenditures and make unique investments to attract and retain businesses.⁶¹ Communities primarily desire performance; they want the business to remain within their borders. The use of a penalty clause in a location incentive agreement can help avert the devastating consequences that occur when a major employer discontinues operations.

The city of Detroit would have been served well by such a penalty clause when it provided non-traditional, yet still financial, assistance to General Motors in the mid-1980's. The city condemned an entire neighborhood mostly comprised of elderly Polish-Americans so that GM could build an automotive assembly plant. The incentive package went forward despite the Poletown residents' strenuous objection that the condemnation was really a taking for private use rather than for public use.⁶² Once the condemnation was approved and the neighborhood razed, the public expected GM to perform its end of the bargain by alleviating unemployment and providing tax revenues. The public for whose benefit this land was taken, however, retained no control over its investment. General Motors had, and continues to have, the unfettered discretion to discontinue operations at the Poletown plant. The "investment" made by the displaced residents of Poletown could have been protected by a penalty clause which would have deterred GM from abandoning the community that it devastated in the name of economic development.

The second advantage of penalty clauses is that they encourage a community to calculate risks in advance of extending a location incentive agreement. As pointed out earlier, the process of approving financial incentives is frequently haphazard, uninformed, and often initiated by the beneficiary.⁶³ The inclusion of a penalty clause would force public officials to perform a cost-benefit analysis before making any investment on behalf of the citizens they represent. In this way, a liquidated damages clause would perform the

60. *Id.* Another advantage of liquidated damages clauses for both the parties and society is a reduction in litigation expenses. E. ALLAN FARNSWORTH, *CONTRACTS* § 12.18, at 935 (2d ed. 1990).

61. *See, e.g., infra* text accompanying notes 70-74.

62. *Poletown Neighborhood Council v. City of Detroit*, 304 N.W.2d 455, 458 (Mich. 1981). The residents argued that the condemnation was a taking for private use because GM was the primary beneficiary and any benefits to the public in the form of employment and future tax revenues were only incidental. *Id.*

63. *See Kolesar, supra* note 20, at 301 (noting that the cost-benefit analysis undertaken by public officials is often a "back of an envelope" calculation); *see also* sources cited *supra* note 46 and accompanying text (discussing further the lack of detailed economic analysis in the granting of location incentives).

same deliberative function that the consideration requirement performs in all contracts.⁶⁴

Any mechanism that forces a state or municipality to conduct an explicit fiscal analysis would be in the best interests of taxpayers. This is especially true given that financial incentive packages are merely disguised government spending programs of uncertain amounts.⁶⁵ In this sense, location incentives are politically expedient because they appear to be less costly than other spending programs.⁶⁶ Although financial incentives in the form of tax abatements and exemptions appear to minimize public expenditures, these types of packages can be fiscally dangerous. For instance, with a tax abatement, the public investment is impossible to quantify as the extent of the expenditure is limited only by the degree of success attained by the business receiving the incentive.⁶⁷ This uncertainty may compound the difficulty in evaluating the success of these packages, and thus may act as a disincentive to post-hoc analysis as well. An explicit fiscal analysis of such a package may avert imprudent public investments, or at least ensure that investments are made on sensible terms.

The third advantage of penalty clauses is that they permit a community to recover damages which are difficult to prove. As a general rule, "[d]amages for breach of contract are recoverable only to the extent that the evidence permits the loss to be established to a reasonable degree of certainty."⁶⁸ In the event that a company receiving direct financial incentives prematurely

64. See Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 800 (1941): *The Cautionary Function*.—A formality may also perform a cautionary or deterrent function by acting as a check against inconsiderate action. The seal in its original form fulfilled this purpose remarkably well. The affixing and impressing of a wax wafer—symbol in the popular mind of legalism and weightiness—was an excellent device for inducing the circumspective frame of mind appropriate in one pledging his future. To a less extent any requirement of a writing, of course, serves the same purpose, as do requirements of attestation, notarization, etc.

65. See *supra* note 46 and accompanying text.

66. See Richard D. Pomp, *The Role of State Tax Incentives in Attracting and Retaining Business: A View From New York*, 29 TAX NOTES 521, 527 (1985); see also PAPKE, *supra* note 43 and accompanying text. Papke's study of Indiana's Enterprise Zone Program computed the cost to the State of Indiana for each new job created for zone residents in 1988 to be \$31,112. *Id.* at 53. By analyzing the amount of every financial incentive package provided through the program, the study also found that each job created in the machinery manufacturing industry cost Indiana taxpayers \$308,276. *Id.* at 54. Professor Papke remarked:

Whether an explicit State-local spending program to promote the employment of zone residents with this price tag would be adopted is unlikely. Tax expenditure policy, however, which is implemented through the tax system, has precisely the same budgetary impact as a conventional direct expenditure program. . . . If these [tax] credits were proposed in the form of an explicit expenditure program, would the legislature or city councils have appropriated \$1.3 million for these firms without requiring substantial accountability and specific performance targets in exchange for the public expenditure? However this question is answered, the point is that it is seldom if ever posed when entitlement-type spending programs are adopted and/or evaluated in the form of tax credits or exemptions.

Id.

67. Kolesar, *supra* note 20, at 296. See generally Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV. 679 (1976) (providing background information on tax expenditures).

68. *Thorpe Sales Corp. v. Gyuro Grading Co.*, 319 N.W.2d 879, 884 (Wis. Ct. App. 1982); see also CALAMARI & PERILLO, *supra* note 59, § 14-8 at 599-600.

discontinues operations, the community may not receive full compensation for its investment because it is likely to incur damages that are difficult, if not impossible, to quantify.⁶⁹

As two recent experiences with incentive packages demonstrate, unsuccessful public investments may result in idiosyncratic injuries to the community which escape concrete appraisal. In 1992, Bayerische Motoren Werke AG ("BMW") accepted an offer valued at more than \$130 million to build its first U.S. assembly plant in South Carolina.⁷⁰ The State of South Carolina paid the costs associated with moving 100 families out of their homes so that BMW could build on the exact site it desired.⁷¹ If BMW were to discontinue operations tomorrow, South Carolina could never recover damages for the human cost associated with needlessly moving families and destroying a neighborhood. Similarly, in the bidding war for the Mercedes plant,⁷² South Carolina had offered to move eight endangered red-cockaded woodpeckers in order to help the company comply with environmental regulations at the proposed site.⁷³ In the event that the company prematurely discontinued operations, the disruption of an ecosystem, like the uprooting of families, would be an unrecoverable loss in subsequent litigation because it would escape reasonably certain valuation.

Likewise, the value of forgone government expenditures, such as improvements to the local public transportation system or new programs in public schools, can never be valued with certainty. How does one calculate the loss to a community that hired fewer teachers or operated fewer bus routes because public funds were spent enticing businesses to locate in the area? Because location incentives directly reduce the public funds available for other activities,⁷⁴ public officials must determine that the benefits of the subsidized business in the community outweigh the deprivation of other government expenditures. If the business prematurely closes or relocates, the community will be unable to recoup its investment under traditional damage calculations,

69. See Singer, *supra* note 13, at 717-19. The external impacts of plant closings are difficult to value in the market and the judicial system. *Id.* at 719 n.359 (citing Richard Lewis, *Destruction of Community*, 35 BUFFALO L. REV. 365 (1986)). Professor Singer notes that difficult-to-value losses are visited on (1) individual workers and their families in the form of adverse impacts on physical and emotional health; (2) the city government in the form of lost tax revenues and increased demand for municipal services; (3) supporting businesses in the community; and (4) on the community at large. *Id.* at 718-19. As to the last of these, Professor Singer states:

Major plant closings change everything. When job losses are high, the loss to the community is so great that it is hard to calculate in dollar terms. Some losses are not amenable to easy monetization because there are no markets for them. How much do we value the loss of companionship of large groups of workers that have worked together for twenty years? How much do we value the loss of a healthy economic life in the community? How much do we value the sense of security, the sense of belonging to a productive enterprise, the sense of history? How much do we value the costs of alienation, of disillusionment, of the loss of dreams?

Id. at 718.

70. Browning & Cooper, *supra* note 5, at A1.

71. *Id.*

72. See *supra* notes 5-7 and accompanying text.

73. See Browning & Cooper, *supra* note 5, at A1.

74. See Reich, *supra* note 11.

because part of its "investment" in a company is the otherwise forgone public expenditures. Penalty clauses in location incentive agreements would permit communities to recover the idiosyncratic losses and the value of forgone government expenditures in the event that a subsidized business relocates.

The final advantage of penalty clauses arises from the informational role that they serve.⁷⁵ Penalty clauses allow both parties the opportunity to monetize their desires and demonstrate their commitment. Including a liquidated damages clause may be the most effective way for a company to persuade a community that it is willing and able to perform.⁷⁶ "[T]he willingness to agree to a penalty clause is a way of making the promisor and his promise credible and may therefore be essential to inducing some value-maximizing contracts to be made."⁷⁷

In a typical scenario, a penalty clause may be included for the purpose of inducing the state or municipality to grant financial incentives to a firm of uncertain reputation or to commit to a particular community. As stated earlier, companies frequently approach municipalities seeking financial incentives.⁷⁸ When a company seeking financial assistance approaches a community, the public officials' initial reactions are likely to include concern over the company's dedication to the area. In this situation, the company may lend credence to its claim that it will foster long-term economic growth by agreeing to be liable for a substantial penalty in the event that the company discontinues operations in the community. Moreover, the penalty clause allows public officials to communicate their desire for the company to remain in the community.

Ypsilanti Township officials and GM faced such a situation in 1988.⁷⁹ GM decided that it would retool the Willow Run plant to build a redesigned Chevrolet Caprice and sought a fifty-percent abatement of property taxes from Ypsilanti Township. If the Township had balked out of concern for GM's commitment to the community and the substantial sum the Township was being asked to invest, as some Township officials apparently did,⁸⁰ GM might

75. See David Brizzee, Note, *Liquidated Damages and the Penalty Rule: A Reassessment*, 1991 B.Y.U. L. REV. 1613, 1620.

76. ANTHONY T. KRONMAN & RICHARD A. POSNER, *THE ECONOMICS OF CONTRACT LAW* 224 (1979).

77. *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir. 1985).

78. See *supra* note 29 and accompanying text.

79. See *supra* notes 14-19 and accompanying text.

80. At the Ypsilanti Township meeting in November, 1988, the Chairman of the County Commissioners opposed a tax break for Willow Run "unless a commitment was made by General Motors to remain operating at the present facility in Ypsilanti Township for that period of time thereby securing employment for the community." At a meeting one month later, the same county commissioner reiterated his concerns about granting abatements to GM in the absence of any assurances of a commitment to Willow Run over time:

"The plant has not given us any commitments in any way that they will not "outsource" production, they will not tell you how long they are going to stay, they will not tell you that we only want it as long as we stay. Who knows, they might move tomorrow or two years from now and they will have been given three tax breaks with a hidden plan.

.....

have offered to include a penalty clause to prove the sincerity of its commitment. With a penalty clause assigning the risk of non-performance, GM could have received the financial assistance it desired, and Ypsilanti officials might have slept better, both before and after the announced plant closing.

B. Responses to Criticisms of Penalty Clauses

The use of penalty clauses may be criticized as impractical for a number of reasons. After dispassionate analysis, however, these obstacles are not as forbidding as they might at first appear.

One could argue that companies will object to penalty clauses in financial incentive agreements, and consequently will avoid localities that employ such clauses. Although the marketplace will be the ultimate arbiter of the effectiveness of penalty clauses, there are many reasons why the use of preemptory damage provisions will not dissuade many, if any, companies from establishing or continuing operations in communities that require such provisions.

First, penalty clauses are meaningless unless the corporation prematurely discontinues operations, and the net effect of a penalty clause is to reduce slightly the value of the inducement package. This diminution in the value of inducement packages will be compensated for in the other terms of the agreement. Companies with confidence in their ability to fulfill their obligations will benefit from the inclusion of a penalty clause because they will be able to extract more favorable substantive terms. Companies without confidence in their ability to perform their contractual obligations to a community, however, will avoid those that employ such clauses. Thus, localities that employ these clauses will be sought out by certain performers and avoided by uncertain performers. Penalty clauses, therefore, serve to prevent public subsidization of companies that are likely to abandon their community.

Second, penalty clauses are eminently adaptable, and can accommodate the needs, fears, and desires of the government and the company alike. Firms that find it difficult to quantify their confidence of performance in the face of marketplace uncertainty can negotiate the severity of the clause. Both the conditions precipitating liability under the penalty clause and the sum to be paid in the event liability is incurred can be adjusted to accommodate the needs of the parties.

The incentive package recently provided to United Airlines ("United") to induce the company to build its new aircraft maintenance facility in

If Georgia or Alabama gives them a hundred percent [tax abatement], don't we have a right to bid on it? Don't we have that right, or should they just say, we're closing the plant because we got a better deal. . . . I would like to be able for them to tell us how long are they going to stay."

Ypsilanti v. General Motors Corp., 506 N.W.2d 556, 561-62 (Mich. Ct. App. 1993) (omission in original) (alteration in original) (quoting Washtenaw County Commission Chairman Craiger).

Indianapolis, Indiana, provides an excellent illustration of the flexibility available to drafters of liquidated damages clauses.⁸¹ In 1991, the State of Indiana, Marion County, and the city of Indianapolis provided \$293.7 million in direct financial incentives to United to induce the company to locate a new \$1 billion maintenance facility in Indianapolis.⁸² The governmental bodies drafted the location incentive agreements to include two reimbursement provisions. The first employs a formula to establish liquidated damages in the event United spends less than \$800 million in the construction of the facility.⁸³ This provision does not mandate the return of all state money in the event that United does not perform. Rather, it calls for remitting a fraction of the public funding based upon any shortfall in construction costs. Similarly, the second reimbursement provision calls for a fraction of the money to be returned to both state and local governments if United employs fewer people at the facility than originally anticipated.⁸⁴

It is also interesting to note that some of the covenants to which United agreed are not subject to a preemptory remedy in the event of non-compliance. For example, the contract urges United to employ women and minorities, but failure to do so does not subject United to liability.⁸⁵

81. Agreement between the State of Indiana, the City of Indianapolis, the Indianapolis Airport Authority, and United Airlines, Inc. (Nov. 21, 1991) (copy on file with the *Indiana Law Journal*).

82. *Id.*

83. *Id.* § 6.02(a). This section states:

[T]he parties hereto agree that if any of such covenants are not fulfilled, the following provisions shall serve as the sole and exclusive remedy of the Governments

(i) In the event that on or before December 31, 2001, the aggregate Indiana Project Costs do not equal or exceed \$800 million (in actual dollars expended), United shall pay to the Governments an aggregate amount equal to the product of (A) a fraction, the numerator of which shall be \$800 million minus the actual Indiana Project Costs accrued or expended through December 31, 2001, and the denominator of which shall be \$800 million; times (B) a fraction, the numerator of which shall be \$297.7 million and the denominator of which shall be three.

Id.

84. *Id.* § 6.02(a)(ii). This section states:

In the event that during the calendar year ending December 31, 2004 (or any earlier calendar year selected by United in its sole discretion), there are not at least 6,300 Facility Employees, United shall pay to the Governments an aggregate amount equal to the product of (X) a fraction, the numerator of which shall be 6,300 minus the number of Facility Employees for the year ending December 31, 2004 (or such earlier year selected by United), and the denominator of which shall be 6,300; times (Y) a fraction, the numerator of which shall be the product of \$297.7 million multiplied by two and the denominator of which shall be three.

Id.

85. *Id.* § 6.03(a), (b). The provisions state in relevant part:

(a) United and the Governments acknowledge that Affirmative Action is an important objective in connection with public and public/private development projects. . . . United and the Governments recognize that within the total annual amount expended on the Project, the Governments' and United's goal is to attain a dollar amount at least equal to thirteen percent (13%) utilization of [Minority Business Enterprises] and two percent (2%) utilization of [Women Business Enterprises].

(b) United and the Governments acknowledge and agree, with respect to the construction and operation of the Facility, that they shall use reasonable efforts to engage the services of and procure goods and supplies from [Minority Business Enterprise] and [Women Business Enterprise] contractors, subcontractors, vendors, and suppliers which are certified by the Governments, and at a level consistent with the goals set forth above.

Id.

Speculating on the rationale behind this construction is unnecessary—although admittedly interesting—because one needs to know only that the agreement represents the allocation of risks most agreeable to the parties.

Finally, the terms of the United deal illustratively refute the notion that companies will avoid communities employing substantial liquidated damages clauses. United chose Indianapolis despite the preemptory remedy provisions discussed above. Moreover, other states offered inducement packages worth \$40 million more than the package United accepted from Indiana.⁸⁶ Apparently, the magnitude of the incentive and the terms of the preemptory remedy were not United's primary concerns.⁸⁷

Another criticism of substantial liquidated damages clauses is that they are useless if the recipient corporation files for protection under the federal bankruptcy laws.⁸⁸ Although there is some support for this criticism in that a liquidated damages clause is not applicable to an executory contract which the trustee in bankruptcy rejects,⁸⁹ some commentators have posited that valid liquidated damages clauses should be recognized in bankruptcy.⁹⁰ Yet, this point is immaterial because, either way, the government has not lost anything more by including the penalty clause than it would have lost without the clause.

Given the deterrent effect of penalty clauses, the paucity of reasoned analysis by government officials, the unlikelihood of true compensation from the legal system, and the value of the messaging function served by substantial liquidated damages clauses, citizens should insist on their use in these dubious government-giveaway programs. The only legitimate justification for shunning these useful devices is the fact that courts currently disfavor them. Nevertheless, bold and innovative public officials should bargain for penalty clauses in location incentive agreements and prepare to argue in favor of reforming the antiquated and anomalous "penalty rule."

86. *United Picks Indianapolis*, N.Y. TIMES, Oct. 24, 1991, at D4.

87. While providing a fine example of the flexibility of liquidated damages clauses, the United-Indiana agreement also illustrates the current paucity of effective risk management in location incentive packages. Indiana public officials should have negotiated a more substantial liquidated damages provision. The citizens of Indiana are subsidizing the operations of a profitable airline at the expense of public investment in improved schools, better roads, and safer streets. The provisions in the agreement are not severe enough to deter United from relocating to another community that offers even more lucrative financial incentives. Furthermore, if United were to move to Louisville, Kentucky, next month, the provisions in the contract would hardly compensate the people of Indiana for the value of forgone governmental services, disruption of local lives, and the tarnished image of the state.

88. 11 U.S.C. §§ 101-1330 (1988 & Supp. V. 1993). The bankruptcy law is silent as to such clauses.

89. *In re TransAmerica Natural Gas Corp.*, 79 B.R. 663, 667 (Bankr. S.D. Tex. 1987) (stating that "[i]f any executory contract is rejected, the damages clause is also rejected").

90. DAVID G. EPSTEIN ET AL., *BANKRUPTCY* § 5-7(f), at 242 (1993). The Bankruptcy Code describes rejection of a contract by the trustee as a "breach" rather than a "rescission," thus resulting in the creation of an unsecured claim. 11 U.S.C. § 365(g) (1988). These commentators, however, presumably limit their arguments to liquidated damages clauses which are enforceable under the current rule. The effect that the liberalization of the penalty rule, as advocated by this Note, would have on their opinions is unknown.

III. THE ENFORCEABILITY OF PENALTY CLAUSES IN LOCATION INCENTIVE AGREEMENTS

Contract provisions stipulating a predetermined remedy in the event that the promisee fails to perform are enforceable under the Uniform Commercial Code⁹¹ and the Restatement of Contracts.⁹² Courts draw a line, however, between those clauses that are enforceable as liquidated damages and those which are void as a penalty on grounds of public policy.⁹³ The line that separates valid liquidated damages clauses from invalid penalty clauses is usually defined by three factors.⁹⁴ First, the anticipated injury resulting from a breach must be either uncertain or difficult to quantify. Second, the parties must have intended to provide for damages in the event of a breach. Third, the amount stipulated must be a reasonable estimate at the time the contract was drafted of the probable loss.

It is the third of these criteria that is most troublesome. If the amount stipulated exceeds an amount which is reasonable in light of the anticipated or the actual loss, the clause will be void as a penalty.⁹⁵ Judicial hostility to "excessive" liquidated damages clauses is premised on the fact that such clauses compel performance by deterring breach,⁹⁶ exploit man's overconfident tendencies,⁹⁷ inject punitive notions into contractual relationships,⁹⁸

91. The Uniform Commercial Code states:

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

U.C.C. § 2-718(1) (1994). The commentary to section 2-718 further states: "Under subsection (1) liquidated damage clauses are allowed where the amount involved is reasonable in the light of the circumstances of the case." *Id.* cmt. 1.

92. The Restatement of Contracts provides:

Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.

RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981).

93. *Id.* § 356 cmt. a (1981). Louisiana is the only state that deviates from this general rule. See *Pembroke v. Gulf Oil Corp.*, 454 F.2d 606 (5th Cir. 1971). Under Louisiana law, parties to a contract generally have the right to stipulate to any amount of liquidated damages in the event of a breach, and Louisiana courts will not inquire into whether the actual damages suffered equal or approximate the stipulated amount. Louisiana will, however, set aside these clauses when fraud, error, mistake, or a violation of good morals, public policy, or a statutory provision is present. *Id.* at 611-12.

94. CALAMARI & PERILLO, *supra* note 59, § 14-31, at 640-41; FARNSWORTH, *supra* note 60, § 12.18, at 937; see also RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (1981).

In cases where the clause is ambiguous as to whether it is a valid liquidated damages clause or a penalty, earlier courts tended to assume the clause to be a penalty. Since the turn of the century, however, courts have tended to characterize ambiguous clauses as valid liquidated damages clauses. See *United States v. Bethlehem Steel Co.*, 205 U.S. 105, 119 (1907).

95. Note that the other provisions of the contract are still enforceable and that the courts will not deny the injured party redress, but will apply the conventional damage remedy. FARNSWORTH, *supra* note 60, § 12.18, at 936-37.

96. *Id.* at 935-36.

97. CHARLES T. MCCORMICK, *HANDBOOK ON THE LAW OF DAMAGES*, § 147, at 601 (1935).

98. Brizze, *supra* note 75, at 1624-25.

raise the cost of efficient breach,⁹⁹ and encourage overreaching.¹⁰⁰ The justifications for the penalty rule, however, are unsupportable in the context of location incentive agreements for three reasons: (1) the rule violates the basic tenets of freedom of contract; (2) the rule prevents injured parties from receiving proper compensation; and (3) the rule is unnecessary in light of other contract doctrines.¹⁰¹

A. The Penalty Rule is Paternalistic

The penalty rule should be reformed because it contravenes the usual rule that "the law will not be wiser than the parties themselves."¹⁰² Perhaps the most fundamental economic principle of contract law is that when voluntary exchanges are permitted, resources will gravitate toward their most valuable uses.¹⁰³ As only the parties themselves can assign proper values to different commodities, a fairly bargained exchange serves as the best evidence of the most valuable use of a commodity. When two sophisticated parties stipulate to a remedy that appears to be excessive, they have very likely assigned the cost of contractual failure according to the value that they place on completing their contractual obligations. When courts refuse to enforce freely negotiated terms, they frustrate the efficient private allocation of resources.¹⁰⁴

Each party was willing to exchange on the designated terms; each therefore thought he would profit. Refusal to enforce deprives each of that profit. It does *not*, however, modify their bargaining power. If we refuse to enforce a particular term, they will readjust the rest of the bargain, and the stronger will exact in the form of a higher price, or whatever, the advantage that can no longer express itself in an allocation of a risk.¹⁰⁵

The prohibition on penalty clauses is justified by supposed "information barriers" that prevent parties from making rational assessments of the nature and extent of the risk allocations produced by the agreement.¹⁰⁶ In his seminal treatise on damages, Professor McCormick described this information barrier:

It is characteristic of men, however, that they are likely to be beguiled by "illusions of hope," and to feel so certain of their ability to carry out their engagements in the future, that their confidence leads them to be willing

99. *Id.* at 1625-26.

100. *Id.* at 1626-28.

101. In addition, even liquidated damage clauses that are "excessive" will reduce the expense of litigation.

102. MCCORMICK, *supra* note 97, § 147, at 600.

103. See KRONMAN & POSNER, *supra* note 76, at 1-2.

104. See Brizzee, *supra* note 75, at 1614-15 ("Perhaps the most compelling reason for allowing a freely bargained penalty provision to remain in a contract is the concept of contractual freedom.")

105. Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1746 (1976) (emphasis in original).

106. MCCORMICK, *supra* note 97, § 146, at 601; see also Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 594 (1977).

to make extravagant promises and commitments as to what they are willing to suffer if they fail.¹⁰⁷

In the context of financial incentive agreements, the government and a company negotiate the terms of assistance that the public sector will provide. It is a safe assumption that both parties are sophisticated and that "the parties will, in deciding whether to include a penalty clause in their contract weigh the gains against the costs . . . and will include the clause only if the benefits exceed those costs."¹⁰⁸ If a corporation's site-selection decision involves making a commitment that includes potential liability for failure to perform, it is reasonable to assume that the company accounted for that contingency. If both of the sophisticated parties believed that they would profit from an agreement that compelled performance by deterring breach, why should a court void the provision? It is difficult to justify a legal rule that protects corporations, such as General Motors and United Airlines, from information barriers caused by the "delusive effect of hope and confidence in the future."¹⁰⁹

As stated by the Seventh Circuit Court of Appeals: "The refusal to enforce penalty clauses is (at best) paternalistic."¹¹⁰ The most fundamental tenet of a capitalistic society—that freely bargained exchanges promote wealth—is undermined by paternalistic rules such as the penalty rule. When applied to the area of economic development, it is anomalous to promote a rule that frustrates the development of wealth.

B. The Penalty Rule Prevents Full Compensation

The penalty rule also should be reformed because it prevents even sophisticated parties from assigning values to the performance of the contractual obligations that would fully compensate the non-breaching party in the event of a breach. "[A] penal clause may be useful to a buyer who has reason to believe that his normal money damages remedy will be inadequate and who wants to force his seller to buy his way out of the contract before breaching."¹¹¹ Normal money damages often will not adequately compensate a community that suffers idiosyncratic losses and forgoes other public expenditures.¹¹²

For example, a penalty clause can protect the interests of a community when the community's interests will not be vindicated via a traditional damages remedy. Recall South Carolina's relocation of 100 families and its offer to

107. MCCORMICK, *supra* note 97, § 147, at 601.

108. *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir. 1985).

109. MCCORMICK, *supra* note 97, § 147, at 601.

110. *Lake River Corp.*, 769 F.2d at 1289; *see also* KRONMAN & POSNER, *supra* note 76, at 261 (calling the penalty rule the least defensible paternalistic limitation in contract law today).

111. KRONMAN & POSNER, *supra* note 76, at 260; *see also* HOWARD O. HUNTER, MODERN LAW OF CONTRACTS: BREACH AND REMEDIES § 11.01, at 11-2 (1986) ("[C]ompensatory damages may not actually compensate the plaintiff. He may be vindicated . . . but it is likely that the plaintiff will never be returned to the same economic position he would have enjoyed if the defendant had performed.")

112. *See supra* notes 68-74 and accompanying text.

relocate endangered animals to facilitate the construction of two automobile plants.¹¹³ If the plants closed soon after opening, the emotional losses suffered by the families that were forced to relocate and the idiosyncratic losses suffered by the state when an entire ecosystem was unnecessarily disrupted would be unrecoverable in subsequent litigation. Conventional damage calculation does not account for subjective values because of courts' inability to value these losses with certainty.¹¹⁴ Reform of the penalty rule would permit the parties to contract around the structural limitations of the legal system and make binding agreements which would ensure compensation of the parties' subjective values.¹¹⁵

One justification for the penalty rule, which forms a structural impediment to true compensation, is that the "central objective behind the system of contract remedies is compensatory, not punitive."¹¹⁶ Current law, however, already subverts this justification by enforcing liquidated damages clauses that are a reasonable *ex ante* estimate of the likely damages of breach, even if the actual damages are much less.¹¹⁷ Because the estimate of probable loss must be reasonable only at the time of contracting, the law already endorses contract remedies that compensate injured parties beyond their actual provable damages.¹¹⁸

A related and further justification for the current rule prohibiting penalty clauses is that they would raise the cost of an efficient breach. Contract law currently excuses failure to perform a contract if the breaching party finds it difficult or uneconomic to perform, as long as he or she is resigned to payment of compensatory damages.¹¹⁹ This has been called an "efficient" breach.

[A] party to a contract usually can predict the approximate cost of completing his obligation and can compare it with the potential gain or savings from a breach. It may make sense to go into default rather than to continue with what seems to be a losing deal. The general approach of contract law is to allow an "efficient" breach and not to punish the breaching party who makes a decision that is economically wise.¹²⁰

This justification is unsatisfactory for three reasons. First, efficient breaches significantly harm a non-breaching party that is not fully compensated under the traditional damage calculus.¹²¹ A legal rule allowing one party to benefit from behavior which injures another party is hardly justifiable. Second,

113. See *supra* notes 70-73 and accompanying text.

114. See RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981).

115. In addition, penalty clauses permit the idiosyncratic values to be insured by the lowest cost insurer—the potential contract breaker. See Goetz & Scott, *supra* note 106, at 578-93.

116. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (1981).

117. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 128 (3d ed. 1986).

118. MCCORMICK, *supra* note 97, § 150; see, e.g., *Equitable Lumber Corp. v. I.P.A. Land Dev. Corp.*, 38 N.Y.2d 516 (1976) (holding that a liquidated damages provision need only be reasonable in light of the *anticipated* harm so long as it is not grossly disproportionate to the *actual* damages incurred as a result of the breach).

119. See OLIVER W. HOLMES, *THE COMMON LAW* 233-38 (Mark D. Howe ed., 1963).

120. HUNTER, *supra* note 111, § 1.03, at 1-7.

121. See *supra* notes 68-74 and accompanying text.

assuming that a penalty clause does raise the cost of an efficient breach, the remedial clause would permit the non-breaching party to share in the efficiency gains.¹²² Finally, as long as a penalty clause is freely negotiated, the parties can adjust their expectations and behavior to account for that provision which raises the cost of an efficient breach.

In sum, penalty provisions ensure that a non-breaching party receives full compensation and shares the gains in the event of an efficient breach. Moreover, penalty clauses ensure that the breaching party suffers the freely negotiated consequences of its breach.

C. The Penalty Rule Is Unnecessary and Imprecise

Finally, the penalty rule should be reformed because the irrebuttable presumption of unfair bargaining that the rule establishes assumes more than is necessary to achieve its goal. "[T]he law's sole purpose in departing from its usual rule of enforcing agreements . . . is to avoid the extortion and injustice which a free power to stipulate damages would invite."¹²³ The penalty rule reflects fears that allowing penal clauses will give one party an incentive to induce a breach. This *in terrorem* effect—the advantage one party may gain by inducing a breach of contract if the penalty imposed on the breaching party is high enough to compensate the party inducing the breach—is a frequently recurring objection to penalty clauses. Although a penalty clause may provide this motivation in certain situations, there are numerous other contract principles, such as fraud, duress, and unconscionability, that courts can use to set aside private exchanges whenever unacceptable behavior is detected in the negotiating process. The penalty rule is thus superfluous since the evil it attempts to prevent, extortionary bargaining, is proscribed by other doctrines, particularly unconscionability.¹²⁴

Unconscionability is the contract doctrine that permits a court to set aside bargains whenever they "affront the sense of decency."¹²⁵ As stated by the drafters of the Uniform Commercial Code, "The principle is one of the prevention of oppression and unfair surprise . . . and not of disturbance of allocation of risks because of superior bargaining power."¹²⁶ Thus, the doctrine of unconscionability is judiciously circumscribed by the general rule of enforcing fairly negotiated agreements. Conversely, the penalty rule is a "per se" rule, invalidating every liquidated damages clause deemed "unreasonably large" without inquiry into the fairness of the negotiating process. Consequently, the rule is both underinclusive and overinclusive. That is, some bargains that are infected by unfairness are not proscribed, while others are

122. See Brizzee, *supra* note 75, at 1624.

123. MCCORMICK, *supra* note 97, § 149, at 606.

124. See POSNER, *supra* note 117, at 115-17; Goetz & Scott, *supra* note 106, at 594; Brizzee, *supra* note 75, at 1629-31.

125. CALAMARI & PERILLO, *supra* note 59, § 9-40, at 406.

126. U.C.C. § 2-302 cmt. 1 (1994).

invalidated in spite of a fairly-bargained exchange.¹²⁷ Contract law already polices the bargaining process without such an imprecise rule.

Granted, the technique advocated in this Note is currently disfavored by courts. The enforcement of substantial, freely negotiated liquidated damages clauses is not, however, a large departure from the norm. Courts are likely to uphold a liquidated damages clause when actual damages are very difficult to prove,¹²⁸ which will almost certainly be the case with location incentive agreements.¹²⁹ Therefore, a court would merely have to take one more step and approve an agreed-upon remedy which exceeds a reasonable pre-estimate of probable loss. This reform in the law would bring location incentive agreement remedies in line with traditional freedom-of-contract principles, ensure just compensation in the event of non-performance, and eliminate an unnecessary, overbroad rule.

CONCLUSION

In the relentless quest for job creation and economic development, state and local governments continue to provide questionably effective financial incentives to influence corporate site-selection decisions. Strong forces assure the continuation of this public policy which is rooted in fear and concern for appearances rather than sound government. If public funds must subsidize profitable corporations, taxpayers deserve at least minimal protection of their investments. States and municipalities could effectively manage the risk inherent in these taxpayer-subsidized investments by including a penalty clause in the location incentive agreement that penalizes the company and fully compensates the community in the event that the company prematurely discontinues operations. Although such clauses are unenforceable under present law, courts should apply the usual rule of deference to the parties' intentions and enforce any fairly negotiated penalty provision in a location incentive agreement.

127. David Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEG. STUD. 262-68 (1974). Compare the cases in which courts have upheld clauses that the parties labeled as penalties, *United States v. Bethlehem Steel Co.*, 205 U.S. 105 (1907); *Pierce v. Fuller*, 8 Mass. 223 (1811); *Tode v. Gross*, 28 N.E. 469 (N.Y.2d 1891) with cases in which courts have struck down clauses that the parties labeled as liquidated damages, *Caesar v. Rubinson*, 67 N.E. 58 (N.Y. 1903); *Seeman v. Biemann*, 84 N.W. 490 (Wis. 1900).

128. CALAMARI & PERILLO, *supra* note 59, § 14-31, at 642.

129. Calculating damages in the context of a breached financial incentive agreement is always difficult because courts look to the market to determine the value of the breached obligation. *Id.* § 14-14, at 609-10. Although the bidding wars may create the illusion of a market for attracting and retaining businesses, there really is no market in which a municipality can effect cover for a breaching corporation's failure to perform.