Life After Palmer: What's Next?

Wednesday, May 4, 2011 Opening General Session; 1:00 – 2:45 p.m.

Barbara Kautz, Goldfarb & Lipman

Notes . . .

League of California Cities
City Attorneys Department
Annual Conference
Yosemite Valley, California
May 4, 2011

Life After *Palmer:* What's Next?

Local Responses to Palmer and Patterson

Presented by:

Barbara Kautz
Goldfarb & Lipman LLP
1300 Clay Street, Eleventh Floor
Oakland, CA 94612
510 836-6336
bkautz@goldfarblipman.com

I. Introduction

In 2009, two published Court of Appeal decisions, *Building Industry Ass'n of Cent. California v. City of Patterson ("Patterson")*[1] and *Palmer/Sixth Street Properties L.P. v. City of Los Angeles ("Palmer")*[2] together upended previous understandings about the validity of, and appropriate analysis applied to, inclusionary housing ordinances -- ordinances requiring that a portion of new homes in a development be affordable to lower or moderate-income households. While most communities in the state have adopted inclusionary ordinances as land use controls, *Patterson* found an inclusionary in-lieu fee to be a type of impact fee, and *Palmer* found that restricting rents in new developments violates State rent control laws. As a result, city attorneys are left wondering what, if anything, should be done about a city's inclusionary ordinance.

The cases, taken together, have these implications for inclusionary ordinances:

1. *Patterson* suggests that inclusionary housing ordinances should be viewed as "exactions" that must be justified by nexus studies, similar to studies prepared to justify impact fees.

2. *Palmer* does not allow inclusionary housing ordinances to limit rents unless public assistance is provided.

Because developers were successful in both challenges, the cases emboldened the development community and helped to revive, to some extent, political attacks on inclusionary ordinances, especially in an economy where the homebuilding industry, and housing prices, have collapsed and, as a practical matter, homes have become more affordable. The cases also led to

[1] 171 Cal. App. 4th 886 (2009).
[2] 175 Cal. App. 4th 1396 (2009).

an amped-up litigation strategy, at least in Santa Clara County, where one developer has filed at least five as-applied challenges to affordable housing conditions imposed on his projects; and the Building Industry Association (BIA) has filed facial challenges to the City of San Jose's inclusionary ordinance and to its affordable housing policies in redevelopment areas.[3] All the cases allege that affordable housing requirements are illegal "exactions" that must be justified by a nexus study. While this theory suffered a partial blow in the most recent published case, *Trinity Park LP v. City of Sunnyvale ("Trinity Park')*,[4] the issue has not yet been resolved by the courts.

This paper discusses the issues raised by *Patterson, Trinity Park*, *Palmer,* and other recent cases and their relation to existing inclusionary ordinances; reviews inclusionary nexus studies; describes how communities have responded to *Patterson* and *Palmer* to ensure that their ordinances and review of development applications can withstand legal attack; and concludes with some observations about other issues in relation to inclusionary ordinances.[5]

II. *Patterson:* What If Inclusionary Ordinances Are "Exactions"?

A. Background.

Home builders, developers, and, in particular, the Pacific Legal Foundation have brought a series of cases[6] in the United States attacking inclusionary ordinances on various grounds

[3] The lead attorney is all seven cases is David Lanferman of Sheppard Mullin.
[4] Sixth Appellate District, filed March 24, 2011.
[5] Two papers were presented at the League's September 2009 Annual Conference that explored the legal theories regarding inclusionary ordinances in more detail; this paper does not repeat much of that analysis, and those wanting additional detail are referred to: Barbara E. Kautz, *Inclusionary Ordinances after Palmer and Patterson;* Alan Selzer, *Home Sweet Home? Legal Challenges to Inclusionary Ordinances and Housing Elements: Action Apartment Association v. City of Santa Monica* (available from the authors or on the League's web site).
[6] *Home Builders Ass'n v. City of Napa* (2001) 90 Cal. App. 4th 188, and *Action Apartment Ass'n v. City of Santa Monica* (2008) 166 Cal. App. 4th 456, were both litigated by the Pacific Legal Foundation. *Mead v. City of Cotati*, 2008 U.S. Dist. LEXIS 94238, and *Kamaole Pointe Dev. L.P. v. County of Maui*, 573 F. Supp. 2d 1354 (Dist. Hawaii (2008)), also litigated by the PLF, have been appealed to the Ninth Circuit. Challenges brought by developers or the BIA to Palo

(including equal protection, substantive due process, etc.) but in particular designed to bring the ordinances under the intermediate scrutiny standard of review prescribed by the U.S. Supreme Court's *Nollan/Dolan* decisions,[7] which require that there be an "essential nexus" between the specific impact of the project and a required land dedication,[8] and place the burden of proof on the local agency to demonstrate that the "nature and extent" of the dedication is "roughly proportional" to the project's impact.[9] In California, there has also been a companion effort to bring inclusionary requirements (particularly in-lieu fees) under the purview of the Mitigation Fee Act.

The goal has been to treat inclusionary requirements as "exactions" like impact fees and parkland dedication requirements and to require a nexus-type study to justify them, in order to make it more difficult for jurisdictions to impose these requirements. As stated in one law review article:

> If the exactions rules did apply to [inclusionary] programs, . . . jurisdictions would have to make difficult, individualized demonstrations of the connection between the proposed project and an increase in the affordable housing shortage, and demonstrate proportionality with the percentage of affordable units or fees required. Demonstrating nexus and proportionality would not be impossible insofar as each new unit of market-priced housing in an expensive region boosts the need for service workers who cannot afford to pay market prices in such an area. Nevertheless, a burden of showing nexus and proportionality would raise the costs and risks for local governments that rely on inclusionary zoning as a tool for addressing affordable housing crises.[10]

In California, the issue was presented to the Court of Appeal as a claim that the *Nollan/Dolan* standard should be applied to inclusionary ordinances. In both *Home Builders*

Alto, Mountain View, and San Jose requirements are outstanding. Other challenges settled prior to a published decision have been filed against Sacramento County and the City of San Diego by the BIA or developers.

[7] *See Nollan v. California Coastal Commission*, 483 U.S. 825 (1987); *Dolan v. City of Tigard*, 512 U.S. 374 (1994).

[8] *Nollan*, 483 U.S. at 837.

[9] *Dolan*, 512 U.S. at 391.

[10] *See* Mark Fenster, Takings Formalism and Regulatory Formulas: Exactions and the Consequences of Clarity, 92 Calif. L. Rev. 609, 657 (2004).

Ass'n v. City of Napa (*"Napa"*)[11], the first published California case regarding inclusionary zoning, and *Action Apartment Ass'n v. City of Santa Monica ("Action Apt."),*[12] the plaintiffs claimed that inclusionary ordinances were exactions that should be subject to intermediate scrutiny under *Nollan/Dolan*. Since the California Supreme Court has limited *Nollan/Dolan* to exactions required on an *individualized* basis as a condition for development,[13] and the inclusionary requirements being challenged were instead generally applicable ordinances, the Court of Appeal consistently rejected the effort to apply *Nollan/Dolan* to inclusionary requirements.[14] In both *Napa* and *Action Apt.*, the Court of Appeal did not reach the issue (which had been briefed) of whether inclusionary ordinances were land use controls or exactions because the cases could be decided on the narrow issue of the inapplicability of *Nollan* and *Dolan.*

B. *Patterson* Holding.

In *BIA v. City of Patterson*, however, the Court of Appeal considered only an affordable housing in-lieu *fee*, not a requirement for affordable units to be built. Patterson's in-lieu fee had increased from $734 per market-rate unit to $20,946 per unit after a developer had entered into a development agreement with the City; the agreement specifically allowed the fee to be increased if it was "reasonably justified." Patterson's fee was calculated based on the cost of subsidizing the City's *entire* regional housing need, not just the affordable housing that would otherwise have been included in the project (the typical way that in-lieu fees are calculated).[15]

---

[11] 90 Cal. App. 4th 188 (2001).
[12] 166 Cal. App. 4th 456 (2008).
[13] *See San Remo Hotel v. City & County of San Francisco* (2002) 27 Cal. 4th 643, 670-71; *Santa Monica Beach, Ltd. v. Superior Court* (1999) 19 Cal. 4th 952, 966-67.
[14] *See Napa,* 90 Cal. App. 4th at 196-97; *Action Apt.,* 166 Cal. App. 4th at 469-471.
[15] *See Patterson*, 171 Cal. App. 4th at 890-93.

While again rejecting the *Nollan/Dolan* standard for this generally applicable fee,[16] the Court of Appeal found that the fee was not substantively different from an affordable housing fee reviewed in *San Remo Hotel v. City and County of San Francisco ("San Remo"),*[17] where San Francisco had required payment of a in-lieu fee to mitigate the loss of affordable residential hotels. Consequently, the Court held that the fee was subject to *San Remo's* requirement that there be a reasonable relationship between the amount of the fee and the "deleterious public impact of the development."[18] Effectively, the Court viewed the City of Patterson's fee as an impact fee.

Developers viewed *Patterson* as a significant victory. ("[T]he *Patterson* decision provides a powerful new tool for developers to use in challenging affordable housing in lieu fees…cities or counties must show that the fees are reasonably related to impacts being created by the new market rate development."[19]). *Patterson* has also served as the primary support for the seven recent lawsuits challenging inclusionary requirements as exactions.

C. Local Responses.

Because of the odd facts, localities have been unsure how to respond to *Patterson.* Many practitioners have believed that *Patterson* could be distinguished from most inclusionary in-lieu fees in a properly briefed case, based on *Patterson's* unusual method of calculating the fee and the lack of any discussion in the opinion of the underlying inclusionary requirement as a land use requirement. Consequently, most communities did not see a need to amend ordinances in response. In addition, because a facial challenge to an inclusionary ordinance must be filed

[16]. *See id.* at 897-99.
[17] 27 Cal. 4th at 670-71.
[18] *See Patterson,* 171 Cal. App. 4th at 898-99.
[19] Cox Castle Nicholson, "Court Holds that Affordable Housing In Lieu Fees Must be Reasonably Related to the 'Deleterious Impact' Caused by New Market Rate Housing" (March 3, 2009).

within 90 days after the ordinance becomes effective, existing ordinances could not be challenged. Cities that had already adopted inclusionary ordinances have been free to wait for an as-applied challenge in the context of a particular application before deciding how, or whether, to respond.

However, when communities have decided to amend their inclusionary ordinances for other policy reasons, in our experience they have, for the most part, responded to *Patterson* by completing a nexus study to show that there is a "reasonable relationship" between the affordable housing requirements and the "deleterious public impact of the development": demonstrating how the construction of market-rate housing creates a need for affordable housing. Even when communities do not believe that inclusionary requirements are exactions, they have prepared such studies to protect themselves from a facial challenge or at least to provide a credible defense.

D. Does the Mitigation Fee Act Apply?

Once communities began to complete nexus studies and to examine affordable housing in-lieu fees as impact fees, they often then sought to further protect their ordinances by attempting to comply with the Mitigation Fee Act ("MFA")[20] without acknowledging that their fees were subject to the Act. There have been repeated claims (beginning with *Napa*) that the imposition of in lieu fees or even inclusionary requirements must comply with the MFA. However, the issue was never resolved in a published case.[21] Fees covered by the MFA are for "public facilities" (defined as "public improvements, public services, and community

[20] Gov't Code Section 66000 *et seq.*

[21] In *Mead v. City of Cotati*, 2008 U.S. Dist. LEXIS 94238, the U.S. District Court did hold that inclusionary in-lieu fees were not subject to the MFA. However, the case was not published.

amenities")[22] and must be justified by a study showing that there is a "reasonable relationship" between the need for the public facility and the development project on which the fee is imposed;[23] typical MFA fees contribute to the costs of such public facilities such as traffic and transit improvements. Affordable housing does not seem to be a "public facility" as defined in the MFA. And, because affordable housing projects are almost always proposed by private parties on an ad hoc basis, rather than – as in the case of other public facilities – being built by the public entity pursuant to an adopted capital improvements plan, even communities that wished to adopt the fees pursuant to the MFA found it difficult to identify the "public facilities" that the fee was to pay for..

In *Trinity Park L.P. v. City of Sunnyvale ("Trinity Park"),*[24] a developer's effort to use the MFA to avoid statutes of limitations may have resolved this issue. *Trinity Park* involved a subdivision initially approved in 2007 where the developer had proposed to provide five affordable homes in a 42-home subdivision to meet Sunnyvale's affordable housing requirements. By the time the developer filed suit in December 2009, the project was nearly complete, almost all units had been sold, and the 90-day statutes of limitations for challenges to conditions of approval under either the Subdivision Map Act[25] or Planning and Zoning Law[26] had long since expired.[27] Instead, the developer attempted to protest the conditions using Sections 66020 and 66021 of the MFA, which allow protests to any "fees, dedications, reservations, or *other exactions…*"[28] if the protest is filed within 90 days of the date the

[22] Gov't Code Section 66000(d).
[23] Gov't Code Section 66001(a).
[24] Sixth Appellate District, filed March 24, 2011.
[25] Gov't Code section 66497.37,
[26] Gov't Code Section 65009(c)
[27] Four of the seven cases filed in Santa Clara County involve projects where the 90-day statute of limitations had expired.
[28] Gov't Code Section 66020(a).

developer receives written notice that an exaction has been imposed and that a 90-day protest period has begun. The developer claimed that because the affordable housing requirements were "other exactions," and he had not received notice of the protest period, he could utilize the protest procedures under the MFA even after the project was almost completed and sold.

The Court of Appeal held that a requirement or condition constitutes an "other exaction" for purposes of the MFA *only* where it is: "(1) imposed by a local agency as a condition of approval of a development project; and (2) for the purpose of 'defraying all or a portion of the cost of *public facilities* related to the development project.' " (citations omitted; emphasis added).[29] The Court of Appeal further determined that the City of Sunnyvale's requirement that Trinity sell five houses at below market rates as a condition of subdivision approval was for the purpose of creating affordable housing units and *not* to defray the cost of "public facilities"; since the requirement did not defray the cost of "public facilities," it could *not* be an "other exaction" under the MFA.[30]

While Sunnyvale's ordinance did not either require or allow the developer to pay in-lieu fees rather than build affordable homes, the holding appears to be applicable as well to fees – whether in-lieu fees or impact fees -- used for affordable housing, since the Court determined that "affordable housing" is not a "public facility." A Palo Alto case in the same appellate district involving in-lieu fees may definitively resolve this issue.[31] If the Court follows the same reasoning as in *Trinity Park* in its review of Palo Alto's fees, cities will not need to follow the procedures identified in the MFA for the adoption of affordable housing fees or other affordable

[29] Slip. Op. at 25-26.
[30] *Id.* at 27-29.
[31] *Sterling Park v. City of Palo Alto,* Case No. H036663, Sixth District Court of Appeal.

housing requirements, nor will cities need to allow developers to use the procedures in Section 66020 and 66021 to pay such fees under protest.

E. *Trinity Park* Did Not Modify *Patterson*.

The Court of Appeal determined *only* that the MFA did not apply to affordable housing requirements. It did not determine what evidence is needed to justify such requirements. In fact, the *Trinity Park* Court quoted (but did not discuss) *Patterson's* holding that such fees must be "reasonably related" to the project's deleterious impact -- simply to note that *Patterson* did not determine whether Patterson's fees were subject to the MFA.[32] Hence the case does not disapprove the holding in *Patterson,* and practitioners are left to decide whether *Patterson* in fact requires a nexus study to justify affordable housing in-lieu fees and other affordable housing requirements.

III. *Palmer:* Inclusionary Ordinances Impermissibly Impose Rent Control

While the decision in *Patterson* was arguably ambiguous, the Court of Appeal's decision in *Palmer/Sixth Street Properties L.P. v. City of Los Angeles ("Palmer")*[33] was clear: inclusionary ordinances violate the Costa-Hawkins Act when they require affordable housing in rental developments.

Palmer arose out of the City of Los Angeles' specific plan for Central City West, which required developers to provide units for low-income households. As part of his 350-unit

[32] *See Trinity Park*, Slip. Op. at 31,The Court similarly discussed the art-in-public places fee examined in *Ehrlich v. City of Culver City* (1996) 12 Cal. 4th 854, 866, 886 as evidence that not all fees or exactions are subject to review under the MFA. The California Supreme Court in *Ehrlich* determined that that in-lieu fee was "more akin to traditional land use regulations" and did not require a nexus study to justify the fee. But the *Trinity Park* court cited the case only to show that many so-called "exactions" are not subject to the MFA. *See id.* at 26-27.

[33] 175 Cal. App. 4th 1396 (2009).

development, developer Geoffrey Palmer was required to replace 60 low-income units that had been previously demolished on the site or, alternatively, to pay an in-lieu fee of approximately $96,200 per low-income unit, equal to the cost to the City of replacing the affordable units.

The Costa-Hawkins Act provides that, barring an exception, for any building completed after February 1, 1995, "an owner of residential real property may establish the initial and all subsequent rental rates for a dwelling or unit."[34] The *Palmer* court held that the language of the statute was "clear and unambiguous" and that forcing Palmer to provide affordable housing at regulated rents was "clearly hostile" to his right under Costa-Hawkins to establish the initial rental rate for the dwelling unit. Further, the Court found that because the objective of the Specific Plan was to impose affordable housing requirements and the amount of the fee was based on the number of affordable units required, the in-lieu fee option was "inextricably intertwined" with the preempted rent control option and similarly preempted. The Court even stated in a footnote that if the base requirement had been a fee, with voluntary provision of rental affordable units as an alternative, both the fee and the *voluntary* provision of units would be part of "an overall plan that is preempted by [Costa Hawkins]" and illegal.[35]

For cities, there is now only one exception to Costa Hawkins that is relevant to local inclusionary requirements: Limitations on rents may be applied when "[t]he owner has otherwise agreed by contract with a public entity in consideration for a direct financial contribution or any

---

[34] Civ. Code Section 1954.52(a)(1). There is a fair amount of evidence that Costa-Hawkins was never intended to apply to inclusionary ordinances. Mike Rawson of the California Affordable Housing Law Project stated in an interview that Costa-Hawkins proponents specifically asserted that the bill would not cover inclusionary units. However, he acknowledges that no such agreement is reflected in the legislative history. (Telephone Interview with Michael Rawson, Nov. 12, 2001.) See also Mallakh, *supra* note 28, at 1870-72. Mallakh also discusses the numerous statements of the bill's authors that Costa-Hawkins would affect only the five California cities that did not permit vacancy decontrol (Berkeley, Santa Monica, West Hollywood, Cotati, and East Palo Alto), see *id.* at 1870 n.149, although 64 cities at the time had inclusionary programs, and notes that nowhere in the legislative history was the act described as having a "prohibitive effect" on inclusionary programs. See *id.* at 1871 n.154.

[35] *See Palmer*, 175 Cal. App. 4th at 1410-11; 1411 n.13.

other forms of assistance specified in [density bonus law, commencing with Gov't Code Section 65915]."[36] To meet the terms of this exception, there must be: (1) a contract with the developer; *and* 2) the developer must have received financial assistance or a regulatory incentive. If an agreement does not recite the financial assistance or other incentive provided, it is questionable whether a voluntary agreement to provide rent-controlled units could be enforced.[37]

In summary, *Palmer* has these implications for local inclusionary ordinances:

- A requirement for affordable *rental* housing in newly created rental developments receiving no governmental assistance is *no longer permitted*.

- Rents may be limited *if* the builder receives either a financial contribution or a type of assistance specified in density bonus law (which includes a wide variety of regulatory relief) *and* agrees by contract to restrict the rents.

- ***Affordable housing requirements imposed on for-sale housing are <u>not</u> affected by <u>Palmer</u>.***

As an alternative to an inclusionary requirement, a nexus study showing the impacts of new rental housing on the need for affordable housing may provide evidence to justify the imposition of an *impact fee* – rather than an in-lieu fee – on new rental housing.

[36] Civ. Code Section 1954.52(b).
[37] While it would normally be assumed that a developer could agree to provide affordable rental housing as part of a development agreement, communities may want to include a term in their development agreements expressly stating that developer has agreed to limit rents in exchange for the regulatory incentives included in the development agreement, one of which may be the development agreement itself.

IV. Local Responses in the Wake of *Palmer* and *Patterson*

By far the most common local response to these cases has been to do nothing. Most communities have not bothered to amend their inclusionary ordinances but simply do not enforce their affordable housing requirements on rental projects. Besides lack of time and staff, reasons vary:

- There has been so little residential development that there is no need to amend the ordinance;
- Amending the ordinance could permit a facial challenge to the amended ordinance;
- It is not certain that a nexus study is needed to justify inclusionary requirements;
- Most rental projects in the community request density bonuses or receive other city or redevelopment agency assistance and so are required to provide some affordable rental housing in any case; or
- The community wishes to encourage rental housing; or doesn't care if there are no affordable units in rentals.

Difficulties with this approach can occur, however, if a rental project is proposed that the community expects will contain affordable housing, but doesn't; if a developer raises an as-applied claim to an affordable housing requirement; or if a developer with a condominium map decides that he would like to rent the units for a time. Communities have completed nexus studies when they wish to impose affordable housing impact fees on rental housing or desire to

protect their ordinances from an as-applied challenge. Ordinance amendments in response to *Palmer* and *Patterson* have taken two forms:

- Maintaining the existing structure of the inclusionary program for for-sale units, while imposing impact fees on rental housing and adopting provisions to deal with condominium projects that are initially rented; or

- Converting the inclusionary requirement to an affordable housing fee, with provision of affordable units allowed only under specified conditions.

A. Nexus Studies and Rental Housing Impact Fees.

Affordable housing nexus studies seek to determine if a "reasonable relationship" exists between a community's affordable housing requirements and the deleterious effects of market-rate housing developments on the need for affordable housing. The studies, even when completed by different economic consultants, use the same basic methodology:

1. Based on the expected sales price of the homes, the income required to purchase the home and the homebuyer's expected disposable income are calculated. Buyers of more expensive homes have more disposable income.

2. Using economic surveys, the portion of the homebuyer's income that will be spent in each local-serving sector, such as retail stores, health care, schools, etc., is computed.

3. Based on the money to be spent in each local-serving sector, the number of new employees is calculated for each sector, as well as their expected wages (very low, low, moderate, or above).

4. The number of new employees is divided by workers/household to determine the number of new households at each affordability level (very low, low, and moderate).

5. The subsidy needed to create a new unit at each affordability level (very low, low, and moderate) is calculated.

6. The number of new worker households at each affordability level is multiplied by the subsidy needed at each affordability level to determine the maximum justified fee.

For instance, one recent study found that 100 units of single-family housing, requiring an average income of $155,000 per year, would generate 37.7 low-wage households who would require subsidies of $6.5 million to create 38 affordable units; while 100 garden apartments, requiring an average income of $68,300 per year, would generate only 17.7 low-wage households, who would require total subsidies of $3 million to create 18 affordable units. The results vary significantly by community, depending on typical market prices, the community's definition of "affordable," the income level served, and other program details.

Affordable housing advocates have long disfavored nexus studies because they fear that they will result in reduced affordable housing requirements, especially in less wealthy communities. In general, the wealthier the community, the higher the prices of new homes, and

the higher percentage of affordable housing that can be justified. In the seven studies we have been involved with to date, however:

- In *every* case, much higher fees could be charged based on the nexus study than were currently being charged by the community as in-lieu fees. Justified fees have ranged from about $18 per sq. ft. of new development to over $50 per sq. ft. – much higher than most in-lieu fees. While a few communities have raised fees, the studies have primarily been used either to justify existing fees; or to impose rental housing impact fees on market-rate rental housing.

- Justified fees for rentals are usually significantly lower than for for-sale housing (renters on average have lower incomes).

- The *percentage* of inclusionary units required (where communities require a percentage of affordable units in each project) is usually close to the maximum justified by the nexus study; and in less wealthy communities, the current inclusionary percentage may not be supported by the nexus study. (Note that the studies have all been done after the steep drop in housing prices that began in 2008.)

While the methodology seems well established and is used by all the major economic consulting firms, the approach is, nonetheless, indirect, requiring multiple steps to determine the justified fee. In *Commercial Builders of Northern California v. City of Sacramento,*[38] the Ninth Circuit Court of Appeals considered a commercial linkage fee imposed by the City of Sacramento, which was based on a nexus study demonstrating that new commercial construction

[38] 941 F.2d 872 (9th Cir. 1991), *cert. denied* 504 U.S. 931 (1992).

created a new for affordable housing. The Court found the commercial linkage fee to be constitutional but discussed the "indirectness of the connection between the creation of new jobs and the need for low-income housing."[39] Ultimately the Ninth Circuit concluded that the fee "bears a *rational relationship* to a public cost closely associated with" new development, in part because the City designed the fee so that only nine percent of the justified costs were assessed against the developers.[40] Better practice is therefore not to charge the maximum amount supported by a residential nexus study.

Although the development community asked that nexus studies be completed, the results have been unexpected and not particularly favorable to the homebuilding community. Developers have variously argued that the analyses include the costs of correcting existing deficiencies; the connections are too indirect; fewer jobs are actually created because of 'slack in the labor market' (high unemployment); nexus studies do not account for available housing subsidies; most of the jobs will be created in other cities; and many of those working at the jobs created will not live in the city. Most recently, a competing economic report was submitted to a city by Gruen Gruen + Associates, asserting that a new 65-unit project would actually make 13 additional affordable units available due to a chain of move-ups (a version of the "trickle down" theory).

Because the burden of proof remains on a plaintiff to show that a city's own reports are not "substantial evidence" for the city's fees, the courts are likely to uphold the city's nexus report unless a strong case can be made that the methodology is not supportable. However, until the issue is resolved, we continue to advise clients to justify and defend their ordinances as land use

[39] *Id.* at 876.
[40] *Id.* at 873-74 (emphasis added).

controls that may be adopted based on the public health, safety, and welfare, with the nexus study providing only a backup to oppose a claim that the requirements must be justified by such a study.

B. Ordinance Amendments Related to Condominiums.

Most existing inclusionary ordinances and policies distinguish between units "offered" for rent and those "offered" for sale. To deal with condominiums that are initially rented, communities have modified their ordinances to define an ownership project as one with a condominium or other subdivision map allowing units to be sold individually. For instance, one ordinance now distinguishes ownership and rental units as follows:

> "Residential ownership project" means any residential project that includes the creation of one or more residential dwelling units that may be sold individually. A residential ownership project also includes the conversion of apartments to condominiums.
>
> "Residential rental project" means any residential project that creates residential dwelling units that cannot be sold individually.

The ordinance goes on to require payment of an impact fee for "residential rental projects" unless the project is receiving financial or regulatory assistance from the city; and to require that 20 percent of all new dwelling units in a "residential ownership project" be made available at an affordable sales price to moderate-income households.

However, Government Code Section 65589.8 *specifically* allows developers who are required to provide inclusionary units to use rentals to provide all or some of the units. To achieve consistency between this provision and Costa-Hawkins, ordinances need to allow the affordable units to be rentals, but *only if* the developer enters into an agreement with the locality

that meets the requirement of the Costa Hawkins exception. For instance, the ordinance above allows the units in "residential ownership projects" to be rented as follows:

> As an alternative to providing affordable ownership dwelling units on-site, an applicant may propose to provide twelve percent of the dwelling units in the residential project as rental dwelling units affordable to low income households. To ensure compliance with the Costa-Hawkins Act (Chapter 2.7 of Title 5 or Part 4 of Division 3 of the Civil Code), the city may only approve such a proposal if the applicant agrees in a rent regulatory agreement with the city to limit rents in consideration for a direct financial contribution or a form of assistance specified in Chapter 4.3 (commencing with Section 65915) of Division 1 of Title 7 of the Government Code. The affordable housing agreement with the city shall include provisions for sale of affordable units and relocation benefits for tenants of the affordable units if the owner of the residential project later determines to offer any dwelling units in the residential project for sale.

A similar requirement withstood a challenge in *Action Apt*. (although the challenge was not based on Costa Hawkins). Since the City of Santa Monica automatically waives two taxes for required affordable housing units so that each project receives an incentive;[41] any development providing affordable housing has received an incentive, complying with the Costa Hawkins Act so long as the developer has agreed to the restrictions.

C. Converting the Inclusionary Requirement to a Fee.

The most radical response to *Palmer* and *Patterson* has been to convert the inclusionary requirement to a fee. Based on a nexus study, the City & County of San Francisco now requires payment of an "Affordable Housing Fee." If a developer instead wishes to provide actual affordable units, either on- or off-site, the developer must submit an affidavit to the City *and* either:

- Sell affordable units as ownership units;

[41] *See* Santa Monica Municipal Code Sections 9.56.050(a) and (b) and 9.56.090 (fee waivers).

- Submit a contract demonstrating that affordable rental units are not subject to Costa Hawkins because the developer has entered into an agreement with a public entity agreeing to provide the units in exchange for financial assistance or a regulatory incentive; or

- Apply to enter into a development agreement with the City to provide affordable rentals.[42]

Similarly, in considering a mixed income ordinance in early 2010, the City of Los Angeles concluded that a fee-based approach would be easier to administer and could be more broadly applied to both residential and commercial developments.

A fee-based approach seems suitable for larger cities that can collect enough fees to build housing and that have a staff experienced in developing affordable housing. In addition, many developers would rather pay fees than have to deal with selling or managing affordable housing, and many housing advocates believe that collecting fees to support lower income housing better meets housing needs than requiring developers to provide moderate-income units on site. While not all communities will wish to switch to a fee-based approach, there has been a trend of allowing more developers to pay fees than requiring them to build units on-site.

D. Summary.

Cities have developed effective ways to respond to *Palmer* and *Patterson.* Where they desire to impose impact fees on rental units; to modify their inclusionary ordinances for other policy reasons; or to provide a defense in the event of an as-applied challenge, they have

[42] San Francisco, California, Planning Code Section 415.5.

completed nexus studies. Where there is not a concern about imposing affordable housing requirements on rental housing, most communities have taken a 'wait and see' attitude, intending to modify their ordinances eventually once the issues raised in *Patterson* are resolved. As the economy improves and residential development applications increase, more developers may challenge affordable housing requirements, and more cities may complete nexus studies to provide a defense against these challenges.

V. Unresolved Issues

This section reviews other issues that have been raised regarding affordable housing requirements.

A. Redevelopment Affordable Housing Requirements.

State law requires that 15 percent of housing produced in redevelopment areas be affordable (6 percent to very low income households, 9 percent to moderate-income households). If future deposits of tax increment into the Low and Moderate Income Housing Fund are eliminated, as currently proposed, and this requirement remains in place, communities may be forced to rely upon inclusionary ordinances to meet the requirement; many communities already use inclusionary units to satisfy some of their redevelopment obligations.

Redevelopment law provides that the requirements for affordable housing "shall apply, in the aggregate, to [housing constructed in the project area] and not to each individual case of rehabilitation, development, or construction of dwelling units, *unless an agency determines otherwise."*[43] At issue is whether an agency's adoption of a provision requiring *each project* in

[43] Health & Safety Code Section 33413(b)(3).

the redevelopment area to have 15 percent inclusionary units could provide sufficient authority for the redevelopment agency to reject a rental project that did not provide 15 percent affordable housing. This is an issue that is likely to be resolved only through litigation, since there is no clear answer from the face of the statutes.

B. Conflict with Mello Act.

Palmer potentially conflicts with the Mello Act,[44] which requires that every new housing development in the coastal zone, "where feasible," provide housing affordable to low and moderate income households and also requires that all housing demolished in the coastal zone and formerly occupied by low and moderate income households be replaced within three years (subject to certain exceptions) or that the developer pay an in-lieu fee. Developers of new rental housing in the coastal zone will certainly argue that, given *Palmer*, it is no longer "feasible" for them to be required to provide affordable housing, and those who need to pay an in-lieu fee may argue that it is tainted by an on-site rent-controlled alternative. Although the issue was raised in the briefs, the *Palmer* court ignored it.

C. Regulatory Incentives and Density Bonus law.

Rental affordable units can now *only* be required if the project receives either money or "any other forms of assistance specified in [density bonus law]." The "forms of assistance" specified in the relevant code sections include density bonuses, "incentives and concessions" (regulatory concessions), waivers of development standards, and reduced parking requirements. Almost all communities now give regulatory incentives for residential projects through mechanisms that are distinct from density bonus law, such as approval of code exceptions

[44] Gov't Code Section 65590-65590.1.

through approval of a planned development or variance, or through a development agreement. Any agreement with a developer to provide affordable rental housing should specify that these types of regulatory waivers are a "form of assistance" specified by state density bonus law, to ensure that all of these incentives can be recognized in an agreement requiring the provision of affordable rental housing.

Some communities have adopted density bonus ordinances that provide bonuses and incentives only when the developer *voluntarily* agrees to construct affordable units and not when affordable units are *required* by an inclusionary ordinance. Practitioners should note that, pursuant to *Palmer*, because cities cannot require the provision of affordable rental housing, an argument could be made that any affordable rental unit provided in a new development is, by definition, provided *voluntarily* and hence is entitled to state density bonuses and incentives.

D. Ellis Act Problems.

The Ellis Act[45] does not allow any public entity to *compel* the owner of a rental property to continue to offer the property for rent. The owner may agree to waive the requirement in return for a "direct financial contribution," which is defined as an interest rate subsidy, tax abatement, cost of infrastructure, write-down of land costs, or construction subsidy.[46] In *Embassy LLC v. City of Santa Monica*,[47] the Court of Appeals held that an Ellis Act waiver cannot be waived, even voluntarily, unless waived pursuant to a contract providing a "direct financial contribution" as defined in the statute.[48]

[45] Gov't Code Section 7060 et seq.
[46] Gov't Code Section 7060.1(a); 65916.
[47] 185 Cal. App. 4th 771 (2010).
[48] *See id.* at 776-77.

Consequently, even if a city complies with the Costa Hawkins Act by entering into an agreement with a developer to provide *non-financial* regulatory incentives (such as reduced parking) in return for affordable rentals for, say, a 30-year period, *Embassy* raises the issue of whether a developer could simply leave the units vacant, or use "tenants in common" ownership to evict the tenants, even while the regulatory incentives remain in place.

E. Avoiding *Nollan/Dolan*.

The deferential "reasonable relationship" test applies only to "legislatively mandated, formulaic mitigation fees" and not to ad hoc individualized exactions, which are subject to *Nollan/Dolan* scrutiny.[49] Consequently, an inclusionary ordinance that has alternatives (such as dedication of land and off-site construction) needs to define them precisely so that the requirements are, in fact, "formulaic." There has been a tendency regarding inclusionary ordinances to provide more and more options with more and more "flexibility." At some point this could transform inclusionary requirements into ad hoc exactions, making them more vulnerable to attack and transferring the burden of proof to the City.

F. Challenges to Existing Conditions Requiring Rental Housing.

Given the holding in *Trinity Park,* inclusionary rental requirements imposed as conditions of approval should continue to be valid if 90 days have passed since the decision (Gov't Code §65009(c)(1) for zoning approvals; Gov't Code §66499.37 for subdivisions). Note, however, that the Court of Appeals in *Trinity Park* held that the 90-day limitations period started "*no later than*" the date that an agreement between the City and Trinity Park's developer, describing the sales prices and identifying which units would be affordable, was recorded – an event that

[49] See *San Remo,* 27 Cal. 4th at 670-71.

occurred in April 2008, over six months after the project was approved by the City Council in September 2007. In *Trinity Park*, the issue was immaterial, and use of the later date allowed the Court to dismiss the case without leave to amend, since it was clear that the lawsuit was time-barred even if the limitations period did not accrue until April 2008. However, if no agreement has yet been entered into between a city and a developer giving details of inclusionary rental units, an argument may be made that the statute has not yet begun to run. However, it would be our view that if the lawsuit is filed more than 90 days after the conditions were imposed, the only matters that could be addressed would be details not included in the original conditions of approval.

G. Palmer "Fix."

State Senator Mark Leno has introduced SB 184, which amends Gov't Code Section 65850 to state that local zoning ordinances may require rental housing for lower income tenants; and further states the Legislature's intent to supersede the holding in *Palmer*. It seems odd not to insert a specific exemption into the Costa Hawkins Act; however, advocates for the legislation apparently believe that it is more likely to be adopted if located in the Planning and Zoning Law. We have a concern that placing the amendment in this section, without an express exemption in Costa Hawkins, could permit continued challenges to inclusionary provisions for rental projects.

VI. Conclusion.

As housing prices and housing construction have collapsed in California, homebuilders have attempted to have inclusionary requirements reduced or eliminated. Some communities have reduced their in-lieu fees or on-site requirements; temporarily suspended their inclusionary requirements; or allowed in-lieu fees to be paid when homes are sold rather than at issuance of a

building permit. At least two communities (Oceanside and Folsom) have entirely repealed their inclusionary requirements. Other communities have let affordable units be sold at market prices without restrictions, because “affordable” prices have converged with fair market value.

However, given the breakdown in the housing market and substantial increases in affordability, it is surprising that there has not been a wholesale repeal of affordable housing requirements. In much of coastal California, of course, the median-priced home is still not affordable to the median household; and since household incomes have fallen along with prices, much housing remains unaffordable. Nonetheless, this would be an ideal time for cities to look at their affordable housing policies to determine how inclusionary housing policies would be most effective, including becoming more flexible to accommodate shifts in the market.