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**Home Sweet Home? Legal Challenges to Inclusionary Ordinances
and Housing Elements**

Inclusionary Ordinances after Palmer and Patterson

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I. Introduction

Two published Court of Appeal decisions in the past six months, *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 have together upended previous understandings about the validity of, and appropriate analysis applied to, inclusionary housing ordinances. For the 170 communities in the State (nearly one-third of all cities) that had adopted inclusionary ordinances of some type by 2007,³ complying with *Patterson* and *Palmer* while still producing affordable housing has become more difficult.

As a means to understand the issues raised in *Patterson* and *Palmer* and to develop a coherent response, this paper initially discusses the various characterizations of inclusionary ordinances as either exactions, rent and price controls, or police power land use ordinances. 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, even though the Los Angeles plan at issue was adopted as a land use control. (Both cases are discussed in detail in the companion paper presented by Alan Seltzer, and so not all of the facts and holdings are repeated here.) This paper finally discusses alternative strategies for modifying inclusionary ordinances to meet the current legal landscape and the numerous associated issues raised by the cases.

Palmer was decided less than a week before this paper was drafted, and the conclusions reached here should be considered preliminary. In particular, it is to be hoped that the California

¹ 171 Cal. App. 4th 886 (2009).

² 2009 Cal. App. LEXIS 1186 (B206102, Second Appellate District, Div. 4, filed July 22, 2009)

³ Non-Profit Housing Association of Northern California, *Affordable by Choice: Trends in California Inclusionary Housing Programs* at 5 (2007) (hereinafter “NPH 2007”).

Supreme Court will accept review and engage in a far more robust analysis of the underlying issues than occurred in *Palmer*.

II. The Characterization of Inclusionary Ordinances

Since the first inclusionary ordinances were adopted in the early 1970s, legal analysts have variously characterized the ordinances as run-of-the-mill land use controls (like zoning ordinances), as rent and price controls, and as “exactions” more akin to impact fees and land dedications.⁴ Nationally, courts have taken all three positions. The *Palmer* case is the first where a California court has taken a definitive position (although still leaving unresolved the issue of whether the base inclusionary requirement is a land use control or an exaction).

A. Inclusionary Ordinances as Land Use Controls.

From a city standpoint, it is most advantageous if inclusionary ordinances can be characterized as land use controls. As land use ordinances, they can then be enacted pursuant to ordinary state zoning legislation, and courts will apply the deferential rational basis test for local

⁴ See Thomas Kleven, Inclusionary Ordinances - Policy and Legal Issues in Requiring Private Developers to Build Low Cost Housing, 21 *UCLA L. Rev.* 1432, 1490 (1974). See also Barbara Ehrlich Kautz, In Defense of Inclusionary Zoning: Successfully Creating Affordable Housing, 36 *USF L.Rev.* 971, 975 (2002); Fred P. Bosselman et al., Panel Comments, in Inclusionary Zoning Moves Downtown 41-54 (Dwight Merriam et al. eds., 1985); Daniel R. Mandelker, The Constitutionality of Inclusionary Zoning: An Overview, in Inclusionary Zoning Moves Downtown 31, 35-36; William W. Merrill III & Robert K. Lincoln, Linkage Fees and Fair Share Regulations: Law and Method, 25 *Urb. Law.* 223, 274 (1993). Many commentators simply assume that inclusionary housing is an exaction. See Mark Fenster, Takings Formalism and Regulatory Formulas: Exactions and the Consequences of Clarity, 92 *Calif. L. Rev.* 609, 657 (2004); Lawrence Berger, Inclusionary Zoning Devices as Takings: The Legacy of the Mount Laurel Cases, 70 *Neb. L. Rev.* 186, 221 (1991); Brian W. Blaesser, Inclusionary Housing: There's a Better Way, Inclusionary Zoning: Lessons learned in Massachusetts, 2 *NHC Affordable Housing Pol'y Rev.* 14, 15 (Jan. 2002); Susan M. Denbo, Development Exactions: A New Way to Fund State and Local Government Infrastructure Improvements and Affordable Housing, 23 *Real Estate L.J.* 7, 11 (1994); Robert C. Ellickson, The Irony of "Inclusionary" Zoning, 54 *S. Cal. L. Rev.* 1167, 1211 (1981). One recent author assumes that inclusionary zoning is a price control. See Benjamin Powell & Edward Stringham, "The Economics of Inclusionary Housing Reclaimed: How Effective Are Price Controls?" 33 *Fla. St. U. L. Rev.* 671, 672 (2005).

zoning established in *Euclid v. Ambler Realty Co.*⁵ and applied by the California Supreme Court in *Associated Home Builders etc., Inc. v. City of Livermore*.⁶

The land use ordinance position has been most clearly adopted by the New Jersey Supreme Court, in *Southern Burlington County NAACP v. Township of Mount Laurel*.⁷ The court rejected distinctions between socioeconomic and other zoning, noting that all zoning, such as that for "detached single family residential zones, high-rise multi-family zones of any kind, ... indeed[,] practically any significant kind of zoning" has inherent socioeconomic characteristics. The court held that, where a community's obligation to provide housing for all income groups could not be met by the removal of zoning restrictions, "inclusionary devices such as ... mandatory set-asides keyed to the construction of lower income housing, are constitutional and within the zoning power of a municipality...We know of no governmental purpose ... that is served by requiring a municipality to ingeniously design detailed land use regulations ... actually aimed at accommodating lower income families, while not allowing it directly to require developers to construct lower income units."⁸

In 1990, in *Holmdel Builders Ass'n v. Township of Holmdel*,⁹ the New Jersey Supreme Court revisited the issue while reviewing the constitutionality of affordable housing fees required by several New Jersey cities. The court explained that "inclusionary-zoning devices," including inclusionary in-lieu fees, are land use ordinances that bear a "real and substantial relationship to the regulation of land" because they are specifically designed to help create affordable housing

⁵ 272 U.S. 365 (1926).

⁶ 18 Cal.3d 582, 604–05 (1976).

⁷ 456 A.2d 390 (N.J. 1983).

⁸ *Id.* at 448-50.

⁹ 583 A.2d 277 (N.J. 1990)

and will therefore affect "the nature and extent of the uses of land and of buildings. . . ." ¹⁰ Further, the court held that inclusionary in-lieu fees are not exactions similar to impact fees, because the affordable housing requirements are not based on the impact of a project, but rather on the "the relationship that . . . development has on both the need for lower-income residential development and on the opportunity and capacity of municipalities to meet that need . . ." ¹¹

No court in California has resolved the issue or definitely characterized inclusionary ordinances as a land use control. In *Home Builders Ass'n v. City of Napa*¹² ("*Napa*"), the first published California case regarding inclusionary zoning, the City of Napa argued that its inclusionary ordinance was a land use ordinance that merely regulated the *use* of a small part of a development, and that inclusionary in-lieu fees were not impact fees because the underlying inclusionary requirement was not a monetary exaction, but rather a land use control, and fees were paid only at the election of the developer.¹³ The Court of Appeals did not reach this issue.

Nonetheless, the *Napa* court's generally favorable comments about inclusionary zoning led most California practitioners to assume that inclusionary ordinances could be considered to be land use ordinances and adopted them as such, most commonly including findings regarding the need for affordable housing in the community (as documented in its housing element) and the strong State interest in affordable housing.¹⁴ Certainly, the expansive interpretation of local police power and the State's interest in affordable housing appeared to support inclusionary housing as strongly in California as in New Jersey.

¹⁰ *Id.* at 286-97.

¹¹ *Id.* at 288.

¹² 108 Cal. Rptr. 2d 60 (2001).

¹³ See Brief of Amicus Curiae in Support of Respondent City of Napa at 9, *City of Napa* (Cal. Ct. App. 1st Dist.) (No. A090437); memorandum of Points & Authorities in Support of Defendant City of Napa's Demurrer at 17, *Home Builders Ass'n v. City of Napa* (Napa County Super. Ct.) (No. 26-07228).

¹⁴ See, e.g., Government Code Sections 65580, 65581, and 65582.1.

Using the same logic adopted by the New Jersey courts and argued in *Napa*, in-lieu fees have usually been based on the dollar subsidy required to provide the same number of inclusionary units, at the same income levels, as would otherwise be constructed on the site. (In practice, most in-lieu fees have been set at a significantly lower amount than is actually needed to provide the same number of units.¹⁵) While this author has long been concerned that allowing an in-lieu fee alternative invites the courts to treat the entire inclusionary program as a development exaction rather than as a land use control (communities do not collect in-lieu fees as an alternative to setbacks and height limits), the California Supreme Court's approval of an art in public places fee provided at least some support for the concept that an in-lieu fee alternative would not automatically convert a zoning requirement to an exaction. In *Ehrlich v. City of Culver City*¹⁶ ("*Ehrlich*"), the Court reviewed a Culver City ordinance that required every development to include a piece of art equal to 1 percent of the building valuation or pay an equivalent fee to the City. The Court held unanimously that the fee was *not* a development exaction but rather an "aesthetic condition" akin to traditional land-use regulations such as setbacks, parking, lighting, and landscaping. While it might be questionable whether the Court would apply the same analysis to an inclusionary ordinance that restricts prices and rents and has no aesthetic component, the combination of *Napa* and the *Ehrlich* gave practitioners a fair amount of confidence in the strategy.

The inclusionary requirement and alternative in-lieu fee established in Los Angeles' Central City West Specific Plan and challenged in *Palmer* was adopted as a land use control: it was based on a study showing high rates of poverty, a need for affordable housing in the Specific

¹⁵ See Non-Profit Housing Association of Northern California and California Coalition for Rural Housing, *Inclusionary Housing in California: 30 Years of Innovation* at 17 – 19 (2003).

¹⁶ 12 Cal. 4th 854, 885-86 (1996). The case is discussed in depth in Alan Seltzer's paper.

Plan area, and development practices that had removed one-third of the affordable housing in the Plan area. The Specific Plan required that 15 percent of new units be affordable or that an in-lieu fee – calculated as the cost equivalent of building the units – be paid. Where low-income units had been demolished on the site, the Specific Plan alternatively required that they be replaced. In Palmer's case, this resulted in an inclusionary requirement of about 18 percent. The Plan offered density bonuses and other development incentives (not accepted by Palmer) in exchange for the affordable units. In *Palmer*, the City asserted that its inclusionary requirements were land use controls rather than rent controls governing the entire rental housing market – a defense rejected by the Court of Appeal. While not disagreeing that the requirements (imposed through a specific plan) were land use controls, the Court found that so long as the requirements restrict rents, they must comply with State rent control statutes.¹⁷

Since both the inclusionary requirement and the in-lieu fee were found in *Palmer* to be preempted by State law as applied to a *rental* project, clearly the "land use control" model can no longer be used to require affordable rental units. This will have a major impact on inclusionary housing practice, because of the inclusionary units surveyed in 2007, 71 percent were rentals.¹⁸ While the land-use theory may retain some validity for units offered for sale, the *Patterson* case (discussed in the next section) has made it questionable whether in-lieu fees can avoid analysis as impact fees.

B. Inclusionary Ordinances as Exactions

The development community and many published analyses of inclusionary zoning have

¹⁷ In particular, the Court held that the inclusionary provisions must comply with Civil Code Sections 1954.51 – 1954.535 (Costa Hawkins Act). The case is discussed in detail below.

¹⁸ NPH 2007, *supra* note 3, at 15.

simply *assumed* that inclusionary requirements are development exactions (see footnote 4 above). Home builders, developers, and, in particular the Pacific Legal Foundation, have brought a series of cases¹⁹ attacking inclusionary ordinances on various grounds (including equal protection, substantive due process, etc.) but in particular designed to bring the ordinances under the intermediate scrutiny prescribed by the U.S. Supreme Court's *Nollan/Dolan* decisions. In California, there has also been an effort to bring inclusionary requirements (particularly in-lieu fees) under the purview of the Mitigation Fee Act. (Alan Seltzer's companion paper provides an excellent analysis of these cases and issues.) The goal has been to treat inclusionary requirements as impact fees 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.²⁰

Until *Patterson*, these efforts were generally unsuccessful. That is in part because the litigants were somewhat entranced by *Nollan/Dolan* and based their litigation strategy (in *Napa* and in *Action Apartment Ass'n v. City of Santa Monica*,²¹ for example) on subjecting inclusionary ordinances to *Nollan/Dolan* rather on characterizing inclusionary requirements as

¹⁹ *Napa* and *Action Apartment Ass'n v. City of Santa Monica*, discussed in detail in Alan Seltzer's paper, 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. 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.

²⁰ Fenster, *supra* note 4, at 657.

²¹ 166 Cal. App. 4th 456 (2008).

exactions. Since the California Supreme Court has limited *Nollan/Dolan* to exactions required on an individualized basis as a condition for development,²² and the inclusionary requirements being challenged were generally applicable legislative enactments, the Court of Appeal consistently rejected the effort to apply *Nollan/Dolan*.

In *Patterson*, however, the Court of Appeal instead applied the more deferential "reasonable relationship" test to an inclusionary in-lieu fee, assuming that it was a generally applicable impact fee and without ever considering (at least in the published opinion) whether the underlying requirement was an exaction or a land use requirement. There are many odd facts about *Patterson* that have led practitioners to believe that it could be distinguished from most inclusionary in-lieu fees in a properly briefed case: the case arose in the context of interpreting a development agreement that required fees to be "reasonably justified;" the 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 argument was apparently never made that basic inclusionary requirement was similar to the art in public places requirement reviewed in *Ehrlich*.²³ Nonetheless, the language in *Patterson* characterizes the in-lieu fee as not substantively different from an affordable housing fee reviewed in *San Remo Hotel v. City and County of San Francisco* ("*San Remo*")²⁴ and subject to the requirement that there be a reasonable relationship between the amount of the fee and the "deleterious public impact of the development." The *San Remo* fee in fact *was* an impact fee: it was intended to mitigate the impact on the City's affordable housing supply caused by the conversion of residential hotels to tourist hotels. However, because the language in *Patterson* characterizes an

²² See *Santa Monica Beach, Ltd. v. Superior Court* (1999) 19 Cal. 4th 952, 966-67.

²³ However, this author has not reviewed the *Patterson* briefs.

²⁴ 27 Cal.4th 643, 670-71 (2002).

in-lieu fee as an impact fee, any community that wishes to continue to characterize its in-lieu fee as a land use control akin to the *Ehrlich* art in public places fee will need to be prepared to defend their fees against a challenge that their analysis does not comport with the language in *Patterson*, nor is it like the impact fee that was reviewed in *San Remo*. Developers have 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."²⁵).

The effort by the building industry to characterize inclusionary ordinances as exactions has been known for years, yet few communities have completed nexus studies to support their inclusionary and in-lieu fee requirements. In retrospect, this seems surprising, since cities are familiar with the procedural requirements for impact fees and exactions and this may be a “safer” alternative. There are several explanations:

- Affordable housing advocates have disfavored nexus studies because they often result in reduced affordable housing requirements, especially in less wealthy communities. (In general, the wealthier the community, the higher percentage of affordable housing that can be justified.)
- The methodology for completing these studies is not as developed as that for, say, traffic impact fees.²⁶

²⁵ 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).

²⁶ Nexus studies typically show that the construction of market-rate housing contributes to the need for affordable housing by increasing household spending in a community and so creating low-wage jobs – the kind of job creation that redevelopment plans anticipate when they facilitate downtown housing in order to create a market for local-

- Nexus studies are expensive.

Nonetheless, the relative simplicity of the exactions approach (see discussion below) and its ability to resolve both *Patterson* (by showing that the fee is related to the deleterious impact of the project) and *Palmer* (by replacing a requirement for on-site units with an impact fee) may make this the majority approach.

C. Inclusionary Ordinances as Rent or Price Control

A potential conflict between inclusionary zoning and rent control statutes – in particular, the Costa-Hawkins Act²⁷ – has been recognized for some time.²⁸ As early as 1998, a lawsuit claiming a conflict between inclusionary requirements and the State Costa-Hawkins Act was filed against the City of Santa Monica and settled by the City.²⁹ Nonetheless, based on the court decisions in New Jersey and the legislative history of the Costa-Hawkins Act, there was some hope that the California courts would agree that inclusionary controls on rents did not constitute rent control.

Conflicts with State Statutes Regulating Rent Control. Rationales presented for distinguishing inclusionary ordinances from rent control statutes include inclusionary zoning's remedial character as a response to exclusionary zoning; its application to a small portion of new development *only* rather than to existing apartments; its inclusion of both rental and ownership

serving activities such as supermarkets. An alternative nexus theory, more difficult to quantify, is that market-rate projects use up land that would otherwise be available for affordable housing. In a case involving commercial linkage fees, the Ninth Circuit discussed the "indirectness of the connection between the creation of new jobs and the need for low-income housing," but ultimately concluded that the fees bore a "*rational relationship* to a public cost closely associated with" new development. *Commercial Builders of Northern California v City of Sacramento*, 941 F.2d 872, 874-76 (9th Cir. 1991).

²⁷ Civil Code Sections 1954.51 – 1954.535.

²⁸ See California Affordable Housing Law Project & Western Center on Law & Poverty, *Inclusionary Zoning: Legal Issues* at 24-29 (December 2002) (hereinafter "Legal Issues"); Kautz, *supra* note 4, at 1015-17; Nadia El Mallakh, *Does the Costa-Hawkins Act Prohibit Local Inclusionary Zoning Programs?* 89 Cal. L.Rev. 1847 (2001).

²⁹ See Mallakh, *id.*, at 1851.

housing; and its screening of owners and tenants (at least initially) to ensure that they are lower income households. In *Napa*, the plaintiffs had asserted that the City's ordinance was a rent control ordinance that violated the due process clause because it required the sale or rental of ten percent of housing units at a fixed price without any provision for a fair return on investment to the developer. While not resolving whether a fair rate of return was required, the Court of Appeal found that Napa's ordinance was not an ordinance that "require[d] property owners who develop residential housing to sell or rent 10 of their units [to low income individuals]," (i.e., was not a rent control ordinance) because any person who did not want to sell or rent a portion of his or her housing units to low income individuals could choose one of the numerous alternatives included in the ordinance, such as paying an in lieu fee or donating land.³⁰

In 2000, the Colorado Supreme Court found that a similar ordinance was, indeed, a rent control law.³¹ The Town of Telluride's ordinance required developers to create housing affordable to forty percent of the employees generated by the development. The developer could satisfy the requirement by constructing new housing with controlled rents, paying fees, or dedicating land. Even though the developer was not required to provide rent-controlled units, the Colorado court found that the Telluride ordinance set a base rent and strictly limited rent increases and that the "scheme as a whole operated to suppress rental values below their market values," violating the "plain language" of the Colorado statute prohibiting rent control. Similarly, in 2006 a Wisconsin appellate court found that an inclusionary ordinance adopted by the City of Madison violated the "plain language" of a Wisconsin statute prohibiting local rent control, despite state policies encouraging cities to provide housing affordable to all income levels. The

³⁰ *Napa* at 199.

³¹ See *Town of Telluride v. Lot Thirty-Four Venture L.L.C.*, 3 P. 3d 30, 35 (Colo. 2000).

court observed that, "local governments may not choose a means of achieving that goal that is prohibited."³²

The Court of Appeal's decision in *Palmer* uses language very similar to that in the Colorado and Wisconsin cases. The state 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."³³ 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, in an analysis similar to the Colorado court's treatment of Telluride's fee and dedication alternatives, and without any acknowledgement of the contrary language in *Napa*, 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 went even further and 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.

³² See *Apt. Ass'n of S. Cent. Wis., Inc. v. City of Madison*, 722 N.W.2d 614 (Wi. Ct. App. 2006).

³³ Cal. 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.

For cities, there is now only one relevant exception to Costa Hawkins, which does not apply when "[t]he owner has otherwise agreed by contract with a public entity in consideration for a direct financial contribution or any other forms of assistance specified in [density bonus law, commencing with Government Code Section 65915]." ³⁴ In the absence of financial assistance or another incentive, it is questionable whether a voluntary agreement to provide rent-controlled units could be enforced. ³⁵

Inclusionary Ordinances as Rent and Price Controls. The *Palmer* court's characterization of inclusionary zoning as a rent control could result in the characterization of controls on ownership units as price controls. If the courts begin to classify inclusionary ordinances as price controls, a different set of constitutional standards would prevail. The issue was raised in *Napa* but not resolved.

A price control is considered constitutional so long as it is not "confiscatory, i.e., ... fails to permit a landlord a fair rate of return." ³⁶ However, prices for inclusionary units are not based on "fair return" concepts but on prices that are affordable to moderate and lower income families. The formulas used to set affordable prices have nothing to do with land costs, prices of market-rate units, financing, construction costs, or other factors that affect the developer's rate of return.

³⁴ Civil Code Section 1954.52(b).

³⁵ 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.

The case also raises the question of the validity of existing agreements requiring the provision of rent-controlled housing when no city incentives were provided. We will attempt to discuss this issue in our panel discussion, but there has not been time to address this issue in this paper.

³⁶ *Santa Monica Beach, Ltd. v. Superior Court*, [P 998]

In *Pennell v. City of San Jose*,³⁷ the U.S. Supreme Court reviewed a constitutional challenge to a San Jose rent control ordinance based on a provision that permitted the City to *consider* "hardship to a tenant" when setting rents but did not *require* a reduction. The Court held that the provision was not unconstitutional absent any evidence of its actual impact.

Pennell appears to stand for the proposition that price controls cannot be challenged on their face unless they actually deny an owner a fair return. However, inclusionary provisions could be subject to rate of return analysis if viewed as price controls. Whether a court would review the rate of return for only the inclusionary units (likely negative) or for the entire project (likely positive) is unknown, since no court in California has applied such an analysis to a development project.

Conflicts with Other Statutes. The *Palmer* decision potentially conflicts with the Mello Act,³⁸ 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.

In addition, 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:

³⁷ 485 U.S. 1 (1988).

³⁸ Government Code Section 65590-65590.1.

A local government which adopts a requirement in its housing element that a housing development contain a fixed percentage of affordable housing units, shall permit a developer to satisfy all or a portion of that requirement by constructing rental housing at *affordable monthly rents*, as determined by the local government.

Nothing in this section shall be construed to expand or contract the authority of a local government to adopt an ordinance, charter amendment, or policy requiring that any housing development contain a fixed percentage of affordable housing units. (emphasis added)

This statute was not cited in either the City's or the amicus brief, but would appear to have no meaning at all if – as concluded in *Palmer* – rent control is only permitted pursuant to a agreement in exchange for money or incentives.³⁹ Perhaps one way to reconcile the two statutes and the Court's holding is to classify the developer's ability to substitute rental units for ownership units as an *incentive* provided pursuant to density bonus law (see discussion below).

III. Options for a Defensible Inclusionary Ordinance

This section describes some initial ideas for creating a defensible inclusionary ordinance in the wake of *Palmer* and *Patterson* and discusses various associated issues. The discussion should be considered preliminary and subject to change.

A. Don'ts.

In light of *Palmer* and *Patterson*, some past inclusionary practices are no longer permitted:

³⁹ This provision would also appear to provide ammunition to the argument that Costa Hawkins was never intended to apply to inclusionary ordinances, since the wording of this provision does not contain any acknowledgement that rent control provisions might apply to inclusionary ordinances.

- *Don't* require affordable *rental* housing in any newly created units (but see below regarding impact fees for rental units and requirements when condominium maps have been recorded).
- *Don't* include new affordable rental housing in a menu of options to meet affordable housing requirements (except as described in the next bullet). Including price-restricted rental housing in the program risks having the entire inclusionary scheme deemed "an overall program preempted by" Costa Hawkins.
- *Don't* enter into a voluntary agreement to restrict rents *unless* the builder receives either money or an incentive provided in density bonus law, *and* agrees by contract to restrict rents. An agreement limiting rents without money or an incentive as consideration may not be enforceable, since it does not comport with the precise language of Costa Hawkins.
- *Don't* calculate inclusionary in-lieu fees by dividing the total cost of subsidizing the City's entire fair share (RHNA) housing obligation by the number of units remaining to be built in the City (as was done by the City of Patterson).

B. The Pure Exactions Approach

The option that is conceptually the easiest to understand would treat all inclusionary requirements as exactions and/or impact fees. This would resolve the issues raised in *Patterson* and would convert all requirements for rental housing to an impact fee in response to *Palmer*. In this model, communities would:

- Complete a nexus study showing how the construction of market-rate housing contributes to the need for affordable housing. Generally such a study looks at the need created by different housing types (single-family homes, medium- and high-density multifamily, rentals v. ownership housing).
- Impose a housing impact fee on new rentals (usually a dollar amount per sq. ft.).
- Allow rental developments to provide on-site affordable housing only pursuant to a contract reciting financial or other incentives provided to the development.
- Determine an inclusionary percentage for ownership housing based on the nexus study. If it is desired to have an impact fee as an alternative, also determine the fee based on the nexus study.

Such an ordinance would be very similar to existing inclusionary ordinances, except that only an impact fee would be required for new rental housing.

C. The Mixed Exactions/Land Use Approach

Another approach uses the exactions approach for rentals and the land use control approach for ownership housing. Its treatment of rental housing is identical to that in the previous option.

- Complete a nexus study for rental housing only.
- Impose a housing impact fee on new rentals (usually a dollar amount per sq. ft.).

- Allow rental developments to provide on-site affordable housing only pursuant to a contract reciting financial or other incentives provided to the development.
- Retain existing on-site inclusionary requirements for ownership units as land use controls, with any in-lieu fee equal to the cost of providing the units elsewhere and with language stating clearly that the fee is not an impact fee. However, the in-lieu fees would remain subject to attack under *Patterson* and would need to be differentiated from the affordable housing in-lieu fees analyzed in *San Remo*. An option is to simply require that the units be provided on site and not include an in-lieu fee option.

One advantage of this structure may be that the city can amend only those portions of its ordinance related to rental housing, saving its existing provisions for ownership housing from a facial attack.⁴⁰ In addition, if the courts agree that the on-site requirements are land use controls, they will be subject only to the highly deferential “rational basis” test. However, as Alan Seltzer's paper states, once a nexus study is completed, it would be hard to avoid its conclusions regarding the justification for the fee in-lieu of producing housing on-site. As a final variation, this result can be avoided by removing rental housing without recorded condominium maps from all affordable housing requirements and retaining only provisions for ownership housing.

D. Random Considerations

⁴⁰See *Buena Park Motel Assn. v. City of Buena Park* (2003) 109 Cal. App. 4th 302, 308, holding that plaintiffs were precluded from challenging portions of a later-adopted ordinance that were "not altered" from an earlier ordinance.

Based on our review to date of *Palmer's* implications, here are additional thoughts on issues raised by the case. Because of the many issues, the discussion in most instances is cursory and intended primarily to alert practitioners to the issue.

Projects with Condominium Maps that Are Initially Rented. Developers of rental housing often record a condominium map at the time of construction so that they may be able to avoid the terms of a condominium conversion ordinance when and if they decide to sell the units. Even if the developer at the time of approval intended to sell the units, market conditions may require developers to rent for a time. The issue is whether these units could be subject to a local inclusionary ordinance.

There does not seem to be an obstacle to requiring as a condition of map approval that the developer provide a proportion of the units as ownership affordable units (assuming that this requirement is contained in the General Plan, zoning ordinance, or other generally applicable ordinance). As an option, the developer could be permitted to provide the units as rentals by entering into an agreement that meets the requirement of the Costa Hawkins exception (including City provision of a financial or regulatory incentive). This requirement withstood a challenge in the *Action Apartment Assoc. v. City of Santa Monica* case discussed in Alan Seltzer's accompanying paper.⁴¹ Santa Monica automatically waives two taxes for required affordable housing units so that each project receives an incentive and also allows affordable units to receive density bonuses and incentives pursuant to State density bonus law (Section 65915). The rental option itself could also be defined as an incentive in an effort to reconcile Costa-Hawkins (which does not allow rent control unless the developer has received an incentive) and

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

Government Code Section 65589.8 (which allows the developer to provide rentals as inclusionary units).

Limited Discretion to Avoid *Nollan/Dolan*. The deferential “reasonable relationship” test for impact fees and other exactions applies only to “legislatively mandated, formulaic mitigation fees” and not to ad hoc individualized exactions, which are subject to *Nollan/Dolan* scrutiny.⁴² Consequently, an 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 will transform the inclusionary requirements into ad hoc exactions, which will make them more vulnerable to attack and transfer the burden of proof to the City.

Compliance with the Mitigation Fee Act. There have been repeated claims (beginning with *Napa*) that the imposition of in lieu fees or even inclusionary requirements must comply with the Mitigation Fee Act (“MFA”).⁴³ Alan Seltzer reviews these claims in detail in his companion paper.

If cities adopt any part of their inclusionary requirements as exactions or impact fees, they may want to follow MFA procedures to protect against a future challenge, even if not acknowledging that the fees are subject to the Act. A difficulty in complying completely with the MFA is the need to identify precisely the “public facilities” that the fee is to pay for. Affordable housing projects funded with impact or in lieu fees are typically proposed by private parties on an ad hoc basis, rather than – as in the case of other public facilities – being built by the public

⁴² See *San Remo* at 670-71.

⁴³ Government Code Section 66000 *et seq.*

entity pursuant to an adopted capital improvements plan. This difference may help convince a court that affordable housing is not a “public facility” and hence is not subject to the MFA (even if it is ultimately defined as an exaction). However, following the MFA procedures in *adopting* an ordinance may at least protect the adoption against a facial challenge (as was the case in Santa Monica).⁴⁴

Takings and Price Control Issues. Clearly an impact fee and inclusionary requirement cannot be so confiscatory as to deprive an owner of "all economically beneficial use" of the property. The issue is whether, as price controls, they must also give owners a reasonable rate of return.

From a practical viewpoint, the requirement of the Department of Housing and Community Development (“HCD”) that cities demonstrate their inclusionary ordinances do not pose a “constraint” on housing has resulted in communities’ preparing economic studies to show that housing development remains feasible even after adoption of an inclusionary ordinance. Some of these studies have been based on a rate of return analysis. For instance, one study we reviewed looked at whether an inclusionary requirement would provide developers with a 12 percent profit on cost, based on data from the National Association of Homebuilders. Communities may want to include a rate of return analysis in their economic feasibility studies to protect against future claims based on the characterization of inclusionary requirements as price controls.

Relation to Density Bonus Law. If *Palmer* remains good law, rental affordable units can be required *only* if the project receives either money or “any other forms of assistance specified

⁴⁴ Although a contrary argument may be made that, if the city follows MFA procedures, applicants may claim that the city has conceded the applicability of the MFA.

in [density bonus law].” The “forms of assistance” specified in the relevant code sections include density bonuses, “incentives and concessions” (almost any regulatory concession), waivers of development standards, and reduced parking requirements. Some communities now give incentives for inclusionary housing through mechanisms that are distinct from density bonus law. It may be prudent to specify that all forms of assistance granted to projects are being provided pursuant to state density bonus law, to ensure that all of these incentives can be recognized in an agreement requiring the provision of affordable rental housing.⁴⁵

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

Relation to Redevelopment Production 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). As the Housing Set Aside money used for this purpose has disappeared into the giant State maw, more communities have been relying upon inclusionary ordinances to ensure that each project in the redevelopment area meets its production requirement (i.e., includes 15 percent affordable housing). Communities that lose the ability to obtain this affordable housing may have few opportunities to meet their production requirements.

⁴⁵ However, at least one publication has opined that the “plain language” of the exception requires only that a *form* of assistance mentioned in density bonus law be provided, not that the incentive must actually be provided pursuant to density bonus law. See Legal Issues, *supra* note 28, at 27.

Some adopted redevelopment plans allow the redevelopment agency to adopt guidelines to ensure that the agency is meeting its affordable housing requirements. A question is whether such provisions could provide independent authority to reject a project that does not provide adequate affordable housing on site. Alternatively, a question is whether a nexus study would allow the city to charge a high enough fee to provide the required affordable housing elsewhere in the redevelopment area.

Conclusion

The implications of *Palmer* for the creation of affordable housing in the State of California may be profound. If the case is not depublished or accepted for review, it would be prudent for communities with inclusionary ordinances to amend them to avoid a facial conflict with State rent control provisions. While some of the changes suggested here may mitigate the effect of adverse court rulings, *Palmer* will likely require changes in affordable housing policies and practices in the State if it is not modified by the California Supreme Court.