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OPINION NUMBER 2011-2

DATE: July 15, 2011

SUBJECT: Proposed Amendments to the Inclusionary Affordable Housing Ordinance, San Diego Municipal Code Chapter 14, Article 2, Division 13

REQUESTED BY: Council President Tony Young and Honorable Councilmembers

PREPARED BY: City Attorney

INTRODUCTION

On Monday, July 18, 2011, the City Council will consider amendments to the City's Affordable Inclusionary Housing Ordinance, found in San Diego Municipal Code Chapter 14, Article 2, Division 13, sections 142.1301-142.1312 (Inclusionary Housing Ordinance). These amendments are proposed in response to the court's decision in *Palmer/Sixth Street Properties, L.P. v. City of Los Angeles*, 175 Cal. App. 4th 1396 (2009), which interpreted the Costa-Hawkins Rental Housing Act (Cal. Civ. Code §§ 1954.50-1954.535)(Costa-Hawkins Act) to prohibit the requirement of on-site affordable rental housing as part of an inclusionary housing plan. Opposition to the amendments suggests that even with the proposed changes, the Inclusionary Housing Ordinance will violate the Costa-Hawkins Act. This opinion addresses that issue.

This opinion also discusses the nexus requirement that was established for inclusionary housing fees in *Building Industry Association of Central California v. City of Patterson*, 171 Cal. App. 4th 886 (2009) and how it relates to the fees proposed. Further, this opinion outlines the necessary standard of review for the fee imposed by the Inclusionary Housing Ordinance.

QUESTION PRESENTED

Do the proposed amendments to the Inclusionary Housing Ordinance contradict the ruling in *Palmer* or violate the Costa-Hawkins Act?

SHORT ANSWER

Because there is no case law further interpreting *Palmer* or the Costa-Hawkins Act and their applicability to inclusionary housing ordinances, it is difficult to predict with any certainty how a court would rule on this question. In view of this uncertainty, the Council's most legally prudent path would be to exclude any development of rental housing from application of the

Inclusionary Housing Ordinance. The Council could also consider the somewhat less cautious alternative of deleting the voluntary set-aside for rentals and apply only the inclusionary housing fee for development of rental housing. This Office believes an even less cautious alternative lies in the present form of the amendments — maintaining rental housing as a set-aside only in voluntary circumstances. There is simply no way to guaranty that a court would rule in favor of such an ordinance.

BACKGROUND

The City passed its current Inclusionary Housing Ordinance in 2003. Under the Inclusionary Housing Ordinance, a developer of market rate housing must set aside at least 10 percent of the units it develops as affordable, regardless of whether they are for-sale or for-rent units. SDMC 142.1306(a). This requirement is a condition of development that is enforced by the Housing Commission.

The developer may pay a fee in lieu of setting aside these units. The fee is based on a formula provided in the ordinance — essentially a dollar amount multiplied by the total square footage of the development. SDMC § 142.1310(b). Fees are paid into the Inclusionary Housing Fund, which is administered by the Housing Commission. SDMC § 142.1309(e)(4). The Inclusionary Housing Ordinance also provides for waivers and variances from the fee under certain circumstances. *See generally* SDMC §§ 142.1304 & 142.1305.

As is discussed further below, the Ordinance has come under some scrutiny due to the court's decision in *Palmer*. Since the court's decision in *Palmer*, the Housing Commission has not enforced that portion of the Inclusionary Housing Ordinance that requires a set-aside of rental housing and has commenced a study to determine whether the impact of developing market-rate housing causes a negative impact on the supply of affordable housing, and that the impact is related to the fees charged.

ANALYSIS

I. Facts in *Palmer*

In *Palmer*, the City of Los Angeles conditionally approved a mixed-use rental project proposed for its Central City West neighborhood. *Palmer,* 175 Cal. App. 4th at 1399. That area was governed by a specific plan that required a development either to:

> "1) [d]ocument and replace, on a one-for-one basis in the form of new dwelling unit construction, Low and Very Low Income Dwelling Units and/or guest rooms demolished on the lot or lots on or after February 14, 1988; or
>
> 2) If no dwelling units were demolished on the lot or lots on or after February 14, 1988, a Project Applicant shall designate [and] reserve a total of 15% of the dwelling unit[]s within the Project as Low [I]ncome Dwelling Units."

Palmer, 175 Cal. App. 4th at 1400 (quoting City of Los Angeles Central City West Specific Plan, sec. 11.C (Plan)). In the alternative, a developer could pay an in lieu fee of $100,576.14 per very low income dwelling unit, or $78,883.41 per low income dwelling unit. *Id.*

Palmer applied for a waiver and upon its denial, filed a complaint against the City. Palmer argued that applying the Plan's section 11.C. violated the state's Costa-Hawkins Act. The Costa-Hawkins Act provides that "[n]otwithstanding any other provision of law," all residential landlords may, except in specified situations, "establish the initial rental rate for a dwelling or unit." Cal. Civ. Code § 1954.53(a). The court agreed that forcing Palmer to provide affordable housing rental units in order to obtain project approval violated the Costa-Hawkins Act.

The City of Los Angeles argued that the Plan's in lieu fee provision does not conflict with the Costa-Hawkins Act, because that statute makes no mention of fees. The court did not agree with this position either, finding that

> [t]he in lieu fee provision does not eliminate the conflict between the Costa-Hawkins Act and the Plan's affordable housing requirements. Although the fee option provides an alternative to the Plan's affordable housing requirements, *because the fee amount is based solely on the number of affordable housing units that a developer must provide under the Plan*, the Plan's affordable housing requirements and in lieu fee option are inextricably intertwined.

Palmer, 175 Cal. App. 4th at 1411 (emphasis added).

Therefore, the court found that application of the Plan's in lieu fee also violated the Costa-Hawkins Act.

II. City's Amendments to the Inclusionary Housing Ordinance

With some exceptions, the City's Inclusionary Housing Ordinance currently requires that development of market-rate housing, rental and for-sale, either set aside a certain amount of affordable units or pay a fee. To date, the Inclusionary Housing Ordinance has not been challenged under the Costa-Hawkins Act. The fee required does not equal the cost of developing the number of affordable units that would otherwise be set aside. Nevertheless, the Housing Commission seeks amendments to the Ordinance in order to guard against potential challenges of a nature similar to that in *Palmer*.

A. The City Will No Longer Require the Provision of on-site Affordable Rental Housing

The court in *Palmer* clearly stated that any requirement that a developer provide on-site affordable rental housing was a violation of the Costa-Hawkins Act. *Palmer*, 175 Cal. App. 4th at 1411. Therefore, the proposed amendments to the Inclusionary Housing Ordinance remove this requirement.

The amendments allow a developer voluntarily to provide on-site affordable rental housing. The Housing Commission proposes the voluntary provision is in conformance with the *Palmer* decision for two reasons. First, it is voluntary. The court in *Palmer* stated that "[*f*]*orcing* Palmer to provide affordable housing units" as a condition to allow development was inimical to the Costa-Hawkins Act. *Id.* (emphasis added).

Second, the Costa-Hawkins Act does not apply when "[t]he owner has otherwise agreed by contract with a public entity [to build affordable housing] in consideration for a direct financial contribution or any other forms of assistance specified in Chapter 4.3 (commencing with section 65915) of Division 1 of Title 7 of the Government Code." Cal. Civ. Code § 1954.53(a)(2). The amendments to the Inclusionary Housing Ordinance incorporate this language, and any voluntary provision of on-site rental will only be allowed under these circumstances.

The *Palmer* case has not been discussed in any subsequent court decisions. There is no additional interpretation that might support the provision of voluntary on-site housing. While the Housing Commission's position may withstand a court's scrutiny, the more cautious route would be to eliminate the option to provide on-site rental housing voluntarily as well.

B. All Residential Development Will Be Required to Pay An Affordable Housing Inclusionary Fee

Instead of requiring on-site affordable rental housing, the amendments to the Ordinance will now require that all residential housing development pay an Affordable Housing Inclusionary Fee. The Housing Commission proposes that this fee differs from the fee in *Palmer* because it is not (and has never been) based on the cost of providing on-site units, but on the cost necessary to mitigate the negative impact of market-rate development on the supply of affordable housing.

In *Palmer*, the in lieu fee charged was the direct cost of providing the required affordable units under the Plan — between approximately $70,000 and $100,000 per unit required. The City's inclusionary housing fee is the product of the applicable per square foot charge multiplied by the aggregate gross floor area of the units within the development.

In correspondence dated May 19, 2011, the Building Industry Association of San Diego, Inc. (BIASD) argues that there is no distinction between charging the cost of developing an entire affordable unit and the City's proposal to charge a fee intended to place a dollar amount on the cost of mitigating development's impacts on the supply of affordable housing. *See* Letter to Hon. Council President Tony Young and Members of the Council and Hon. Mayor Jerry Sanders from Richard A. Schulman, May 19, 2011 (Schulman Letter). While not explicit, the Schulman Letter suggests that any fee, impact or otherwise, on the development of rental housing violates the Costa-Hawkins Act. Given the dearth of cases directly on point and the well-established

body of law on impact fees, it is unclear whether such an interpretation would withstand judicial challenge.[1] The most cautious approach would be to eliminate the fee as to all rental units.

The Schulman Letter further suggests the Housing Commission is trying to "get around" state law by providing an exemption from the inclusionary fee for those who provide on-site rental units and receive a financial incentive. This provision of the proposed amendments is taken directly from *Palmer*, where the court noted the Costa-Hawkins Act does not apply to those projects that receive financial incentives. The proposed amendments might be clarified to reflect this option more clearly, or the Council may choose to eliminate the voluntary provision of on-site rental units altogether.

III. Nexus Requirement

In *Building Industry Association of Central California v. City of Patterson,* the court rejected the application of an inclusionary housing fee where the fee was not based on causation — as fees of this nature should be — but on need. In *Patterson*, the developer entered into a development agreement with the City of Patterson and obtained a tentative map for the development of two residential subdivisions. The development agreement included a requirement that the developer pay no less that $734 per unit in affordable housing fees, but that the amount would be revised to reflect the result of an updated analysis of those fees and provided the updated fee was "reasonably justified." *Patterson*, 171 Cal. App. 4th at 890. The adjusted fee came to $20,946 per unit. The developer challenged the fee, the trial court rejected the challenge, and the developer appealed.

The court's analysis focused on the meaning of the development agreement term, "reasonably justified." The court found that interpretation of this term was a matter of law, not fact. *Patterson*, 171 Cal. App. 4th at 895-96. Therefore, the court looked to case law to determine what standard should be applied to reviewing the fee:

> "[I]t appears that the affordable housing in-lieu fee challenged here is not substantively different than the replacement in-lieu fee considered in *San Remo*. Both are formulaic, legislatively mandated fees imposed as a condition to developing property, not discretionary ad hoc exactions. [citations omitted]. We conclude, for this reason, that the level of constitutional scrutiny applied by the Court in *San Remo* must be applied to City's affordable housing in-lieu fee . . ."

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[1] Case law has long held that regulation of land that requires fees for negative impacts caused by development does not impose an unconstitutional taking on the developer. *See San Remo Hotel v. City and County of San Francisco,* 27 Cal. 4th 643 (2002)(approving mitigation fee measured by resulting loss of housing units for market rate development); *Home Builders Assoc. of Northern California v. City of Napa,* 90 Cal. App. 4th 188 (2001)(approving impact fees and other elements of inclusionary housing ordinance required by generally applicable legislation); and *Ehrlich v. City of Culver City,* 12 Cal. 4th 854 (1996)(finding a recreational mitigation fee acceptable in principle, but returning the matter to the lower court for correct calculation of the fee).

Patterson, 171 Cal. App. 4th at 898. In *San Remo,* the court mandated that the inclusionary fee in that case "must bear a reasonable relationship, in both intended use and amount, to the deleterious public impact of the development." *San Remo Hotel v. City and County of San Francisco*, 27 Cal. 4th 643, 671 (2002).

The standard for review for a formulaic, legislatively mandated fee imposed as a condition of property development is that the fee must bear a reasonable relationship to the negative impact the development has on the public. The Council must therefore determine that the Inclusionary Housing Fee bears a reasonable relationship to the negative impact of market-rate development on the supply of affordable housing. That is, the Council must determine market-rate development causes a negative impact on the need for affordable housing, and then look to whether the fee charged will mitigate those negative impacts. *See generally Patterson*, 171 Cal. App. 4th at 899.

In *Patterson*, the court found that the study commissioned by the city established a fee to satisfy that city's need to provide a certain amount of affordable housing, rather than how the development itself caused a need for affordable housing. *Patterson,* 171 Cal.App.4th at 899.

> No connection is shown, by the Fee Justification Study or by anything else in the record, between this [affordable housing] figure and the need for affordable housing associated with new market rate development. Accordingly, the fee calculations described in the Fee Justification Study and [the] declaration do not support a finding that the fees to be borne by Developer's project bore any reasonable relationship to any deleterious impact associated with the project.

Id. Therefore, the court found that the fees were not reasonably justified.

The Housing Commission commissioned a study by Keyser Marsten Associates to demonstrate that the fee charged under the Inclusionary Housing Ordinance is not based on citywide need, as in *Patterson*, but is rationally related to the impact caused by market-rate housing. The Keyser Marston Residential Nexus Analysis (Nexus Analysis) states that

> "[a]t its most simplified level, the underlying nexus concept is that the newly constructed units represent new households in San Diego. These households represent new income in San Diego that will consume goods and services, either through purchases of goods and services or by 'consuming' governmental services. New consumption translates to new jobs; a portion of the jobs are at loser compensation levels, low compensation jobs translate to lower income households that cannot afford market rate units in San Diego and therefore need affordable housing"

Residential Nexus Analysis, Keyser Marston Associates, Inc., p. 1 (November 2010). In addition, the Nexus Analysis explains that "[t]he IMPLAN model is a commercially available model developed over 30 years ago to quantify the impacts of changes in a local economy . . ." *Id.*

The Housing Commission's position is that the basis of the Keyser Marston study demonstrates causation between the development of market-rate housing and its deleterious impact on the supply of affordable housing. The Schulman Letter argues that the premise that new housing causes a need for more new housing is absurd, and that the IMPLAN model used by Keyser Marston is invalid. The Schulman letter provides no additional evidence to support its position, but it is imperative that the Council determine to its satisfaction that the Keyser Marston nexus study establishes a causation link between development of market-rate housing and the need for affordable housing in order to satisfy the standard established in *Patterson*.

CONCLUSION

In response to the court's decision in *Palmer*, the proposed amendments to the Inclusionary Housing Ordinance will eliminate the requirement of on-site affordable rental housing for market-rate development. Instead, the Inclusionary Housing Ordinance will charge a fee to all development. While the proposed amendments include a provision for voluntary on-site affordable rental units in limited circumstances, this Office advises that the most prudent route for the Council would be to eliminate any language in the proposed amendments that require fees or the provision of on-site units from rental housing development. In any event, the Council must review the inclusionary housing fee in light of the nexus requirement established in *Patterson* and be certain that the nexus study supporting the fee establishes how the fee is rationally related to the development's impact on the supply of affordable housing.

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