INCLUSIONARY ZONING REVITALIZED

INCLUSIONARY ZONING FOR RENTAL HOUSING RESTORED

AB 1505 Overturns *Palmer/Sixth Street Properties L.P. v. City of Los Angeles*

OVERVIEW

A constitutional and legislative struggle that began in 2009 ended this year with the reinstatement of the authority of California communities to apply inclusionary housing laws applicable to rental housing. The Legislature adopted and Governor Brown signed AB 1505 (Bloom) (*AB-1505*) overturning *Palmer/Sixth Street Properties L.P. v. City of Los Angeles,* 175 Cal. App. 4th 1396 (2009). *Palmer* held that inclusionary housing requirements on new rental housing amounted to rent control in violation of the Costa Hawkins Act (Civ. Code §1954.50 *et seq.*), which permits developers to set initial rents on newly constructed units.[1] Since *Palmer,* almost all of the 170 localities with inclusionary laws had suspended application of inclusionary to new rental housing. With a few limitations, described in this memorandum, the bill restores the right to apply inclusionary housing laws to rental housing and allows HCD to review inclusionary ordinances in very limited and particular circumstances.

AB 1505's legislative "fix" was a long time coming, affordable housing advocates having tried twice before tried to obtain legislation to overturn *Palmer*.[2] The enactment of the bill

[1] The court also had found that the exception in the Act (Civ. Code §1954.52(b)), which allows rent restrictions on units developed pursuant to a contract with local government to provide incentives and concessions similar to those in the state Density Bonus Law (Gov. C. §65915), does not apply when the developer is mandated by local law to enter into a contract to provide the affordable units.

[2] Assembly Bill 2502 was rejected by the Legislature in 2016. Assembly Bill 1229 was adopted by the Legislature in 2013, but vetoed by Governor Brown. The Governor gave as a reason for his veto the then pending constitutional attack on San José's inclusionary zoning ordinance. Subsequently, of course, the California Supreme Court decided

completed a legal struggle on two-fronts to preserve the legal validity of inclusionary zoning as a critical tool to ensure that below-market rate housing is an integral part of residential development in the state.

The battle had been joined in 2009 with the decisions in the *Palmer* case and *Building Industry Assn. of Central California v. City of Patterson,* 171 Cal. App. 4th 886 (2009). *Patterson* held that the City's unconventional in lieu fee lacked reasonable basis. Unlike most inclusionary in-lieu fees, which are based on the cost of developing the affordable housing required by the inclusionary program, Patterson's fee was ostensibly based on the impact of new market rate development on the need for affordable housing. The court found the calculation of the fee was not reasonably related to the affordable housing need created by new development. The California Building Industry Association seized upon the *Patterson* holding to argue that inclusionary requirements are valid only if based solely on the need for affordable housing *caused* by residential development. It then filed constitutional attacks against inclusionary zoning laws in Sunnyvale, Palo Alto[3] and San Josè.

The constitutional fight was finally concluded in 2016 with the U. S. Supreme Court refusing to take *California Building Industry Assn. v. City of San José,* 61 Cal. 4th 435 (2015), *cert denied* 577 U. S.___; 136 S.Ct. 928 (2016) (*"CBIA"*) in which the California Supreme Court unanimously upheld San Jose's inclusionary zoning ordinance on constitutional grounds, rejecting CBIA's argument and disapproving the *Patterson* opinion. The Court found that "[r]ather than being an exaction, the ordinance falls within . . . municipalities' general broad discretion to regulate the use of real property to serve the legitimate interests of the general public and the community at large." *Id.* at 461.[4]

AB 1505 followed in 2017.

This memorandum briefly explains the scope of AB 1505 and the limited authority it grants the Department of Housing and Community Development (HCD) to review newly adopted rental housing development inclusionary requirements. It then considers:

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the case unanimously upholding the constitutionality of inclusionary laws, and the U.S. Supreme Court denied *CBIA's* petition for certiorari. *California Building Industry Assn. v. City of San José,* 61 Cal. 4th 435 (2015), *cert denied* 577 U. S.___; 136 S.Ct. 928 (2016).

[3] *Sterling Park, L.P. v. City of Palo Alto,* 57 Cal.4th 1193 (holding that the statute of limitations provided in the Mitigation Fee Act applied to the developer's challenge of Palo Alto's inclusionary housing law.)

[4] "[S]o long as a land use restriction or regulation bears a reasonable relationship to the public welfare, the restriction or regulation is constitutionally permissible." *Id.* at 454. And it easily concluded that inclusionary housing requirements are land use restrictions that bear a reasonable relationship to their public purposes. *Id.* at 457.

1) How communities with existing inclusionary requirements can transition to restarting application inclusionary to rental housing;
2) Steps communities with new or amended ordinances should take to ensure their ordinances will pass muster in the event circumstances trigger HCD's authority to review them, and HCD elects to review.
3) The requirement that all inclusionary ordinances covering rental housing must now provide for alternative means of compliance if they do not already;
4) Options for communities that adopted housing impact fee ordinances to provide resources for rental housing production as a work-around for *Palmer*.

Finally, the memorandum briefly reviews new judicial developments that touch on the law affecting inclusionary housing programs. The legal foundation of inclusionary housing remains very solid. But as with any law that furthers social and economic equality, opponents continue to sift through the barest legal threads for new legal strategies, hoping for a misguided change in the views of some courts.

AB 1505

The Legislation amended Government Code § 65850[5] and added § 65850.01 to permit any city or county to adopt inclusionary housing requirements as a condition of development of rental units, expressly superseding *Palmer* "to the extent that decision conflicts with a local jurisdiction's authority to impose inclusionary housing ordinances…." (Uncodified legislative findings [Stats. 2017, ch. 376, § 3]) It allows the community to require a percentage of new rental units to be affordable to, and occupied by, extremely low, very low, low or moderate income households, subject to specified restrictions and, in some cases, review by the Department of Housing and Community Development (HCD).

SUMMARY

- **Authorizes on-site inclusionary for rental housing.** Local governments may now adopt inclusionary housing ordinances that require residential rental housing developments to include a percentage of units affordable to lower or moderate income households, including units affordable to extremely low income households.

- **Mandates rental IZ ordinances provide alternatives to on-site inclusionary.** Inclusionary ordinances covering rental housing must provide alternative means of compliance that may include in-lieu fees, land dedication, off-site construction or acquisition and rehabilitation.

- **Permits, *but does not require,* HCD to review rental housing IZ ordinances adopted or amended after September 15, 2017, *but only if*:**
    1) The ordinance requires more than 15% of the units to be affordable to lower income households, *and*
    2) The locality has either:
        a. Failed to meet 75% of its share of the *above moderate income* Regional Housing Need Allocation (RHNA) prorated over *five years*, or
        b. Failed to submit its annual housing element report (required by §65400) for the last *two years*.

- **Limits HCD review to:**
    1) Requesting that the locality provide an "*economic feasibility study"* within 180 days, and
    2) Determining whether the study meets the standards set out in the legislation:

[5] All citations are to the Government Code unless otherwise indicated.

a. Contains evidence that the rental housing requirement does not "unduly constrain" housing development;
b. Prepared by a qualified entity with demonstrated expertise in feasibility studies;
c. Made available to the public on the internet for 30 days and placed on the agenda of the legislative body;
d. Methodology follows "best professional practices" for assessing whether the rental requirement is economically feasible.

3) Jurisdictions may appeal the determination to HCD's director.

- **Communities with inadequate feasibility studies must limit rental IZ to no more than 15% until it prepares an adequate study.** If HCD finds an economic feasibility study inadequate, lower income rental housing inclusionary requirement are limited to no more than 15% until the jurisdiction submits an adequate study.

- **Expressly overturns *Palmer*.**

DETAILS

Authority to Apply Inclusionary Housing Requirement to Rental Housing Development.

The bill first added subsection (g) to § 65850, which authorizes local governments to enact specified local requirements:

> 65850. The legislative body of any county or city may, pursuant to this chapter, adopt ordinances that do any of the following:
>
> (g) Require, as a condition of the development of residential rental units, that the development include a certain percentage of residential rental units affordable to, and occupied by, households with incomes that do not exceed the limits for moderate-income, lower income, very low income, or extremely low income households specified in Sections 50079.5, 50093, 50105, and 50106 of the Health and Safety Code….
>
> [Stats. 2017, ch. 376, § 1]

Requirement to Provide Alternative Methods of Compliance.

The authority to apply inclusionary to rental development also requires that any inclusionary law applied to rental projects must "provide alternative means of compliance that may include, but are not limited to, in-lieu fees, land dedication, off-site construction, or

acquisition and rehabilitation of existing units." (§ 65850(g)) Accordingly, all inclusionary ordinances covering rental housing must now provide alternatives to on-site production requirement if they do not already do so

Limited Authority for HCD to Review Newly Adopted Rental Housing Inclusionary Laws (§65850.01(a) & (d))

Next, the legislation added § 65850.01, which provides limited authority to the Department of Housing and Community Development to review an inclusionary ordinance adopted or amended after September 15, 2017 if the ordinance requires more than 15% of the total number of units "rented in a development be affordable to, and occupied by, households at 80 percent or less of the area median income…." ***The department is not required to review the ordinance*** **and the statute only authorizes review if *either* of these applies**:

- The local government has failed to meet 75% of its share of the housing element Regional Housing Needs Allocation (RHNA) for the *above-moderate income* category (greater than 120% of median) based on:
    1) Calculating the number of units developed over at least five years as reported in the annual housing element report submitted to HCD pursuant to § 65400, and
    2) Prorating the number of units based on the length of time of the housing element planning period (generally eight years, but sometimes five—see § 65583(c) and 65588(e) and (f)); *or*
- The department finds that the jurisdiction has not submitted the annual housing element report as required by paragraph (2) of subdivision (a) of Section 65400 for at least two consecutive years.

(§ 65850.01(a))

HCD also may not request an economic feasibility study for an ordinance more than ten years from the date of adoption or amendment. (d)

HCD's Limited Scope of Review, Should It Elect to An Ordinance (§ 65850.01(b))

If HCD chooses to review an ordinance upon finding that either of the conditions described in subdivision (a) exist, it *may* require that the local government provide evidence that the ordinance "does not unduly constrain the production of housing by submitting an *economic feasibility study*." *The term is vaguely defined and the legislation does not require that a jurisdiction have prepared a formal economic feasibility study prior to adopting or amending an inclusionary ordinance covering rental housing or applying an existing inclusionary ordinance to rental housing.*

The study, if requested, must meet these standards:

1) A "qualified entity with demonstrated expertise" must prepare the study
2) A study prepared after September 15, 2017 must first be made available for 30 days in the local government's website and then placed on the agenda of the local legislative body for approval. This requirement applies whether the jurisdiction elects to prepare a formal study on its own or the study is requested by HCD.
3) "The study methodology followed best professional practices and was sufficiently rigorous to allow assessment of whether the rental inclusionary requirement, in combination with other factors that influence feasibility, is economically feasible."

The first and third standards are quite vague, lacking sufficient definition or precision to facilitate determination or analysis of economic feasibility. HCD will likely issue further guidance, but it does not have much to work with.

Comments on the "Economic Feasibility Study" Standards

"*Unduly constrain*" is undefined and the statute provides no standard for HCD to use to make this assessment. The phrase lends itself to many interpretations even among developers, economists and planners. HCD may or may not provide guidance to local governments should it decide to ask for an economic feasibility study from a particular jurisdiction. Because the question is whether the ordinance unduly constrains housing development generally, anecdotal examples of constraints or lack of constraints are insufficient to establish the general effect of an ordinance. Indeed, the requirement to include affordable housing in a development may *increase feasibility* because it opens the development up to sources of affordable housing funding or because a jurisdiction may have reserved certain sites for developments that include affordable housing.

"*Economic feasibility study"* lacks definition as to "economic feasibility" and the requirement to determine adherence of the study methodology to "*best professional practices"* presumes that those standards exist. Development feasibility is based on a variety factors that will be different for each development. For example, land costs (if any), financing costs (if any), current market, projected market, and reasonable investment back expectations.

"Qualified entity with demonstrated expertise" does not preclude use of feasibility studies produced by community development or planning staff of local jurisdictions as is frequently the case. (In discussions about this phrase during negotiations over the legislation, the proponents of this language indicated that studies by local government staff could certainly qualify.)

Procedure, Should HCD Elect to Request or Review a Feasibility Study. (§ 65850.01 (c) & (d))

The locality must submit the study within 180 days of the request. (§ 65851.01(c)) Within 90 days of submission, HCD must make a finding *whether the feasibility study meets the standards* in subdivision (b). *HCD is not authorized to assess the conclusions of the study—only that the study meets the general standards discussed above*.

If HCD finds that the study does not meet the standards or the locality does not submit a study within 180 days, the jurisdiction must limit any inclusionary requirement to include rental housing affordable to lower income households (80% of median or less) "to no more than 15%..." until the locality submits a study that meets the standards.

HCD must report any findings made regarding local inclusionary ordinances to the Legislature annually. (65850.01(f))

IMPLEMENTATION OF AB 1505

Communities with Rental Inclusionary Laws in Place on September 15, 2017

After the *Palmer* decision was issued in 2009, most communities with inclusionary laws that covered rental housing development simply suspended application of the inclusionary requirements to new rental developments but continued to apply the requirements to for-sale housing. Those communities need only take whatever steps required by local procedures to undue the suspension. San José's ordinance, for example, expressly provided that it would apply to rental housing developments if *Palmer* was overturned by an appellate decision or statute. *CBIA* at 450, fn 6.

Depending on the local procedural requirements, that could involve adoption of a resolution or simply issuing an administrative notice pursuant to the local implementing regulations or guidelines. Because neither procedure involves amendment of the local inclusionary law, AB 1505's provisions allowing HCD to someday review the ordinance would not be triggered.

However, if a community responded to *Palmer* by amending its inclusionary ordinance to eliminate the application to rental housing development, it would have to amend its ordinance to apply to rental housing projects. And that would trigger the provisions of AB 1505 that impose the possibility of HCD review. The same would be true for communities that repealed their inclusionary ordinances after *Palmer*.

Communities with Rental Inclusionary Laws Adopted/Amended Post 9-15-17

- **Ordinances Subject to HCD's (Unlikely) Review**

Ordinances or amended ordinances will be subject to HCD review only if the criteria identified in the statute are met. (See discussion above of § 65850.01(a)):

- Ordinance requires over 15% of the units be affordable to low income households (80% of median or less) *and*
- a) Less than 75% percent of the locality's *above moderate* income (120% of median) regional housing needs has been constructed over a five year prorated period, *or* b) the locality has not submitted the annual § 65400 housing element report for two years.

For those few jurisdictions meeting the criteria, HCD may elect to review their ordinances, although at this point we do not anticipate more than a handful being tagged for review if that. Our view is partly based on the recognition that HCD *already* reviews all inclusionary zoning ordinances as part of its periodic review of all of the updated housing elements. The department

analyzes each ordinance to determine whether it presents a governmental constraint to the development of housing to meet the community's share of the regional need. See Gov. C. §65583(a)(5) and HCD's "Building Blocks: A Comprehensive Housing-Element Guide (http://www.hcd.ca.gov/community-development/building-blocks/index.shtml).

- **Safeguarding an Ordinance in Anticipation of HCD Review**

As explained above, if on the off chance HCD decides to review an ordinance, it will ask the community for an "economic feasibility study" demonstrating that the ordinance "does not unduly constrain the production of housing." But, the requirements of the study are only vaguely described, and there is no the requirement that the jurisdiction have engaged in any manner of study prior to the adoption or amendment or that the jurisdiction engage an outside entity to conduct the study. However, a jurisdiction will be better prepared to provide HCD with a study passing muster if it engaged in a feasibility analysis prior to adoption or amendment of the ordinance. A finding that the analysis constitutes an economic feasibility study and determined that the ordinance would not unduly constrain the production of housing could then be included in the ordinance, and HCD would likely give those findings deference. Findings could also be memorialized in a staff report and the community's housing element or other general plan element.

This analysis and process need not be difficult, cumbersome or costly. In fact, most jurisdictions adopting inclusionary housing requirements in the last twenty years have undertaken some level of feasibility analysis. Between the community development and planning staff most local governments will have the capacity to perform a credible analysis, especially when drawing on the expertise of nonprofit housing developers and the experience of communities that have already completed these analyses. There is no requirement that the jurisdiction engage an outside consulting entity to conduct the study.

Communities with Inclusionary Laws Not Providing for Alternative Compliance

Most local inclusionary requirements provide alternative methods of compliance such as payment of in-lieu fees, off site development or dedication of land. The few communities with laws that only allow onsite production will have to amend their laws if they want to continue to apply them to rental housing *unless* the ordinance is written broadly enough to permit extension to rental development administratively without amendment. If the community must amend its ordinance in order to cover rental development, the amendment, of course, could trigger the provisions of AB 1505 that allow HCD review.

Communities that Adopted Housing Impact Fees to Address *Palmer*

Although almost all existing IZ ordinances have an in lieu fee option, many cities adopted rental housing development impact fees after *Palmer* to provide an alternative means of facilitating construction of affordable housing in rental housing developments. With the adoption of AB 1505, local governments will likely elect to revert to the simpler and less costly inclusionary in-lieu fee system.

Unlike IZ in-lieu fees, development impact fees (akin to commercial linkage affordable housing fees), must be based solely to the need for affordable housing created by new market rate rental housing development. Communities therefore conducted impact fee *nexus* studies to establish the extent to which new rental housing development impacted the need for affordable rental housing. The range of the permissible fee was then determined based on the cost of developing the affordable housing need attributed to new market rate rental housing development. These studies are expensive and limit the basis of the fee to the affordable housing need created by the new housing development rather than the existing need for affordable housing.

In-lieu fees, on the other hand, generally are based on the simple calculation of what gap financing/subsidy is necessary to finance the development of the inclusionary units a developer opts not to construct under the inclusionary requirement. No nexus study is required because the fee is not based on the impact of new development but on the estimated cost of the development of the affordable housing units forgone by the developer. Most IZ ordinances contain this basic methodology for the in-lieu fee alternative, and most communities update the gap financing calculations and related in-lieu fee on a periodic basis.[6]

Localities, therefore, will need to decide whether to:

1) Repeal or suspend the impact fee and its nexus study requirement; or
2) Retain the impact fee as an alternative to the IZ on-site rental housing production requirement in addition to or instead of an in lieu fee.

Factors important to the decision will include: a) the difference in the relative amount of the fees (depending on the market, one type of fee may yield a greater amount than the other); b) the importance of ensuring affordable units are provided on-site (a decision with significant fair

[6] For a analysis of the differing legal requirements for affordable housing impact fees and inclusionary in-lieu fees, see PILP's INCLUSIONARY ZONING AFTER PALMER & PATTERSON (May 2010), PDF

housing implications); c) the cost of a nexus study and periodic updates to the study; d) the possible legal vulnerability of nexus studies for rental housing impact fees. (Some have argued that the rental housing nexus study methodology is flawed, but we are not aware of any litigation making that contention).

RECENT CASES RELATED TO INCLUSIONARY HOUSING LAWS

The California Supreme Court decision in *California Building Industry Assn. v. City of San José*, 61 Cal. 4th 435 (2015), *cert denied* 577 U. S.___; 136 S.Ct. 928 (2016) places inclusionary housing laws in California on solid legal ground:

> [W]hen a municipality enacts a broad inclusionary housing ordinance to increase the amount of affordable housing in the community and to disperse new affordable housing in economically diverse projects throughout the community, the validity of the ordinance does not depend upon a showing that the restrictions are reasonably related to the impact of a particular development to which the ordinance applies. Rather, the restrictions must be reasonably related to the broad general welfare purposes for which the ordinance was enacted. *Id.* at *474.*

All inclusionary laws generally meet this standard because they reasonably mandate that new residential development include a limited proportion of affordable housing to address the community's need for affordable housing and further many legitimate purposes, including regional housing needs, workforce housing needs, integration, increasing scarcity of land and greenhouse gas reduction. See the description of the findings and purposes of San José's ordinance in *CBIA* at 448-449. See also *2910 Ga. Ave. LLC v. District of Columbia* 234 F. Supp. 3d 281 (D.D.C. 2017), citing to *CBIA* in upholding Washington D.C.'s inclusionary zoning program.

A recent case attempted to circumvent *CBIA* in attacking the inclusionary housing in-lieu fee of West Hollywood. In *616 Croft Ave., LLC v. City of West Hollywood*, 3 Cal.App. 5th 621 (2016) the owners of a parcel proposed for development 11 residential units attacked the inclusionary in-lieu fee under the Mitigation Fee Act (Gov. C. § 66000 *et seq.*) and the California Constitution as constituting a taking because the City had not demonstrated that the fee was related to the impact of the development on the need for affordable housing. The Court of Appeal rejected both theories. The California Supreme Court denied review and then the U.S. Supreme Court denied certiorari. (138 S. Ct. 377 (2017))

First, the Court of Appeal found that the fee was not subject to the Mitigation Fee Act requirements because it was not a monetary exaction charged to defray the cost of the development to the City (i.e., it was not an impact fee). On the constitutional attack, the Court relied on *CBIA v. San José* holding that inclusionary in-lieu fees are an alternative to the on-site inclusionary requirement, which the California Supreme Court upheld as a permissible land use regulation. The Court found, therefore, that the question was not whether the fee is reasonably related to the impact of the development, but rather, like the underlying on-site inclusionary

requirement, whether the fee is reasonably related to the availability of affordable housing in the city.

So, going forward in California, local governments are assured that in-lieu fees, like the inclusionary requirement itself, must simply be reasonably related to the cost of developing the affordable units the developer otherwise must provide under the IZ requirement. Almost all IZ in-lieu fees are directly based on the "gap" financing required to construct the foregone affordable units and, therefore, plainly are reasonably related to the IZ production obligation.