Office of the City Manager

SUPPLEMENTAL AGENDA MATERIAL

Meeting Date: **March 7, 2017**

Item Number: **1**

Item Description: **Housing Demolition Mitigation Fee**

Submitted by: **Zach Cowan, City Attorney**

Supplemental Memorandum dated Jan. 3, 2017: Whether the City Can Require Rental Units to be Replaced on a One to One Basis with BMR Units as a Condition of Demolition

Office of the City Attorney

January 3, 2017

To: City Council/Rent Stabilization Board 4x4 Committee

From: Zach Cowan, City Attorney

Re: Whether the City Can Require Rental Units to be Replaced on a One to One Basis with BMR Units as a Condition of Demolition

Introduction

For several years, the City has been considering how to amend its controls on the demolition of rental units, which are contained in Section 23C.08.020 of the Berkeley Municipal Code (BMC).

Prior to its amendment in 2016, in order to preserve the existing stock of rental housing, Chapter 23C.08 made it very difficult to demolish rental units. In 2016, the Council adopted amendments that made demolition easier by allowing demolition upon payment of a demolition mitigation fee.[1] (BMC § 23C.08.020.A.)

After this amendment was adopted, staff conducted an analysis to determine the amount of the demolition mitigation fee, and on December 13, 2016, recommended that the Council adopt a fee of $105,202 per demolished unit. The Council did not adopt the fee at that time, but referred the item matter to the Agenda Committee to schedule a work session.

Question Presented

The 4x4 Committee has now requested an opinion regarding whether recent case law provides the City with a legal basis for requiring that demolished rental units subject to the City's rent stabilization program (BMC Chapter 13.76) be replaced on a one to one basis with below market-rate (BMR) units that would be reserved for income-qualifying households.

[1] The 2016 amendments also impose certain other requirements and limitations, but these are not directly relevant to the question addressed by this opinion and we do not discuss them here.

2180 Milvia Street, Fourth Floor, Berkeley, CA 94704
Tel: 510.981.6998 TDD: 510.981.6903 Fax: 510.981.6960

Background

The statutes and court decisions that bear on this question originated in the area of rent control regulation as well as takings jurisprudence. We begin with a short history of the relevant legal developments.[2]

The City adopted its rent stabilization program (BMC Chapter 13.76) in 1980.[3] The Chapter 13.76 controlled rent increases not only while units were occupied, but also when they became vacant.[4]

In 1986, the City adopted an inclusionary housing ordinance (BMC Chapter 23C.12), which required that 20% of all new units in projects containing 5 or more units – both rental and condominium – be permanently restricted at below market-rate (BMR) rents or sales prices, for rent or sale to income-qualifying households. Subsequent amendments allow developers of ownership (i.e., condominium) projects to pay an in lieu fee (apportioned to each unit in the project) instead of selling condominiums at BMR prices.

In 1995, the state Legislature adopted the Costa-Hawkins Rental Housing Act (Civ. Code §§ 1954.50 – 1954.535), abolishing vacancy control. Under the Costa-Hawkins Act, once a unit becomes vacant[5] its new rent is not subject to limitation by local ordinance (*e.g.*, the City's rent stabilization program), but may rise to market rates.[6]

In addition, the Costa-Hawkins Act prohibits local governments from limiting the initial rent of newly constructed or legalized units when a certificate of occupancy is issued. (Civ. Code § 1954.52(a).)[7] In 2009, the Court of Appeal interpreted this aspect of the Costa-Hawkins Act as invalidating inclusionary requirements for new rental projects. (*Palmer/Sixth Street Properties v. City of Los Angeles* (2009) 175 Cal.App.4th 1396.) *Palmer* held that the provision of Civil Code section 1954.52(a) that "an owner of real property may establish the initial and all subsequent rental rates" meant that local governments could not require new

---

[2] For the sake of brevity and clarity, the following account touches only on the major points of the statutes and cases as they relate to the question discussed in this memo.

[3] It was upheld by the Supreme Court in 1986, in *Fisher v. City of Berkeley*, 475 U.S. 260 (1986).

[4] This is known as "vacancy control".

[5] Not all vacancies will result in the rent being decontrolled (Civ. Code § 1954.53), however the exceptions are not relevant to the question this memorandum addresses.

[6] This is known as "vacancy *de*control".

[7] This limitation is subject to some exceptions, which are not relevant to this discussion. (See, Civil Code section 1952.53(A)(1)(B).)

rental units to be offered at BMR rents. *Palmer* thus essentially invalidated inclusionary requirements *applicable to rental units*.

Accordingly, the City adopted an affordable housing mitigation fee on new rental units in 2012, which was increased to $34,000 in 2016. (BMC § 22.20.065 & Resolution No. 67,614-N.S.) Developers may either pay the AHMF or provide 20% of the units as BMR rental units to income-qualifying households in lieu of doing so.

It should be noted that *Palmer* had no effect on inclusionary requirements for *ownership units*. Rather, inclusionary requirements for ownership units were challenged under the theory that they were unconstitutional exactions because they were not supported by a "nexus" between the construction of new ownership units and the need for new BMR ownership units.

In 2013 the California Supreme Court issued its decision in *Sterling Park, L.P. v. City of Palo Alto* (2013) 57 Cal.4th 1193, which appeared to agree with this theory and called into question the continuing viability of inclusionary programs for ownership units. In 2015, however, the Supreme Court reversed course in *California Building Industry Association v. City of San Jose* (*CBIA*) (2015) 61 Cal.4th 435, which strongly affirmed the ability of local governments to require that a percentage of new ownership units be sold at BMR prices without requiring any nexus. A subsequent case, *616 Croft Ave., LLC v. City of West Hollywood* (2016) 3 Cal.App.5th 621, followed and reaffirmed *CBIA*. Thus as of this writing, the provisions of the City's inclusionary housing ordinance that apply to new ownership projects remain in effect.

Discussion

The question presented is whether recent case law provides the City with a legal basis for requiring that demolished rental units that are subject to the City's rent stabilization program be replaced on a one to one basis with below market-rate (BMR) units that would be reserved for income-qualifying households.

As a threshold matter, there are already two state statutes that provide for a form of replacement.

First, the Ellis Act[8] provides that when a property owner withdraws rental units from the market and demolishes them, but constructs new rental units on the same property and offers them for rent or lease within five years of the date the demolished units were withdrawn, "the newly constructed accommodations shall

[8] The Ellis Act (Gov. Code §§ 7060 *et seq.*) gives landlords the right to withdraw all of the rental units on a parcel from the rental market, subject to various protections and mitigations for tenants, and other limitations.

be subject to any system of controls on the price at which they would be offered on the basis of a fair and reasonable return on the newly constructed accommodations, notwithstanding any exemption from the system of controls for newly constructed accommodations." (Gov. Code § 7060.2(d).) In other words, in such cases the demolished units would be replaced on a one to one basis with new rent controlled units, at the previous rents.

The Rent Stabilization Board has the power "to set rents which will provide a fair return [for these new units] and the landlord shall have the burden of establishing by competent evidence that the rent schedule proposed by the landlord is necessary to provide a fair return." (BMC § 13.77.040.D.) Depending on what a fair return might require, such units may or may not ultimately be offered at BMR rents; in any event, they would not be reserved for income-qualifying households.

However, this provision is not applicable in Berkeley, because Section 23C.08.020.B prohibits demolition of any building that was withdrawn from the rental market under the Ellis Act within the preceding 5 years.

Second, the state Density Bonus Law (Gov. Code § 65915), requires that an applicant who proposes a density bonus project on a property on which rental units have been vacated or demolished within the preceding 5 years must replace those units that were

- subject to a recorded covenant, ordinance, or law that restricts rents to levels affordable to persons and families of lower or very low income;
- subject to any other form of rent or price control through a public entity's valid exercise of its police power; or
- occupied by lower or very low income households.

(Gov. Code § 65915(c)(3)(A).)

This law defines "replacement" as follows:

- For occupied units, that the project provides "at least the same number of units of equivalent size or type, or both, to be made available at affordable rent or affordable housing cost to, and occupied by, persons and families in the same or lower income category as those households in occupancy.
- For unoccupied dwelling units in a development with occupied units, that the project provides "units of equivalent size or type, or both, to be made available at affordable rent or affordable housing cost to, and occupied by, persons and families in the same or lower income category in the same proportion of affordability as the occupied units."
- In projects that are entirely vacant, that the project provides "at least the same number of units of equivalent size or type, or both, as existed at the highpoint of those units in the five-year period preceding the application to

> be made available at affordable rent or affordable housing cost to, and occupied by, persons and families in the same or lower income category as those persons and families in occupancy at that time, if known. If the incomes of the persons and families in occupancy at the highpoint is not known, then one-half of the required units shall be made available at affordable rent or affordable housing cost to, and occupied by, very low income persons and families and one-half of the required units shall be made available for rent at affordable housing costs to, and occupied by, low-income persons and families."

For rental units, these limitations apply for at least 55 years; for ownership units, only the initial buyer must be income qualified, but must be subject to an equity sharing agreement.

These requirements do not necessarily result in the replacement units being reserved for very low- or low-income households. As they apply to demolished rent controlled units, the new units must only be affordable to persons in the same income category as the previous tenants, which could be moderate or even above moderate.

Except for these two provisions of state law, requiring one to one replacement of demolished rental units is prohibited by *Palmer*, which held that the Costa-Hawkins Act preempts any local rent limitations for newly-constructed units.

The question posed by the 4x4 Committee is whether *CBIA*, or any other case affects *Palmer's* prohibition on inclusionary requirements such as one for one replacement of demolished rental units.

We are aware of no case that does so. *CBIA* rejected the argument that San Jose's inclusionary requirement for new ownership housing constituted a "taking" of property without just compensation, and upheld it as a conventional exercise of local zoning authority. By implication, it validated inclusionary requirements for rental housing against the same type of challenge. However *CBIA* did not address the effect of the Costa-Hawkins Act or *Palmer* on inclusionary requirements for new rental housing, and left *Palmer* in place. Accordingly, while *CBIA* is strong authority for the proposition that inclusionary requirements for new rental units are not a "taking", it does not thereby enable them, given the statutory bar posed by the Costa-Hawkins Act.

Thus, we conclude that neither *CBIA* nor any other recent case law makes it possible to require one to one replacement of demolished rental units with BMR units.

However this does not necessarily mean that the City may not achieve this result through other means.

First, the demolition mitigation fee proposal by staff on December 13, 2016, included the option of providing BMR units (35% affordable to low income households and 65% affordable to moderate income households) to income qualifying households in lieu of paying the fee. Thus, depending on the economics of any given project, as well as any modifications the Council may choose to make to the number or affordability levels of in lieu BMR units, developers may choose to provide BMR units in lieu of paying the demolition mitigation fee.

Second, the City could adopt a density bonus ordinance under which it provides additional density bonuses in return for more BMR units, or it could otherwise provide for "direct financial contributions" in return for an agreement to provide BMR units. Both of these options are specifically permitted under the Costa-Hawkins Act (Civ. Code § 1952.53(a)(1)(B)(2).) A density bonus ordinance could also be combined with a reduction in densities or height limits.

Index: V.3.c.; V.8