

CONSTITUTIONAL LIMITS ON PRICE AND RENT CONTROL: THE LESSONS OF UTILITY REGULATION

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Despite the recent trend of economic deregulation, price regulation continues to be a vital part of the American economic system. Federal, state and local governments regulate prices for such disparate businesses as utilities, apartment leasing, nursing homes and insurance. Price regulation was not always so prevalent, however. Prior to *Nebbia v. New York*,¹ the United States Supreme Court's interpretation of the Constitution had allowed the states to regulate prices only of businesses "affected with a public interest,"² or during a temporary emergency.³ In *Nebbia*, the Supreme Court eliminated the "affected with a public interest" and emergency requirements and upheld the authority of the states to regulate prices as part of the states' general powers to promote the public welfare.⁴ Since *Nebbia*, price regulation has become an accepted, though

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1. 291 U.S. 502 (1934).

2. See, e.g., *Williams v. Standard Oil Co.*, 278 U.S. 235 (1929) (business of selling gasoline not "affected with public interest"); *Munn v. Illinois*, 94 U.S. 113, 125-26 (1877) (grain storage warehouses).

3. See, e.g., *Chastleton Corp. v. Sinclair*, 264 U.S. 543, 547-48 (1924); *Block v. Hirsh*, 256 U.S. 135, 155, 157 (1921).

4. The Court wrote:

So far as the requirement of due process is concerned, and in the absence of other constitutional restrictions, a state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare, and to enforce that policy by legislation adapted to its purpose. The courts are without authority either to declare such policy, or, when it is declared by the legislature, to override it.

291 U.S. at 537. See also *Olsen v. Nebraska*, 313 U.S. 236, 245-47 (1941). Most modern courts interpret the holding in *Nebbia* to mean that the existence of an emergency is no longer a constitutional prerequisite to price regulation. See, e.g., *Eisen v. Eastman*, 421 F.2d 560, 567 (2d Cir. 1969); *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 153-58, 550 P.2d 1001, 1019-22, 130 Cal. Rptr. 465, 482-86 (1976); *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. 543, 555-64, 350 A.2d 1, 7-13 (1975). See generally Baar & Keating, *The Last Stand of Economic Substantive Due Process—The Housing Emergency Requirement for Rent Control*, 7 THE URB. LAW. 447 (1975). A few courts and commentators mistakenly continue to explain that certain kinds of price regulation are

sometimes controversial, part of the government's control over the economic marketplace. Given the prevalence of price regulation today, it is surprising that the constitutional limits on price regulation are not generally understood.

The Supreme Court has gradually developed the constitutional price regulation doctrine during the past one hundred years in two distinct groups of cases. One group has dealt with utility rate regulation; the other, with federal price controls. Although the two groups of cases appear to establish inconsistent standards, understanding the consistency and the kinship between the groups is essential to understanding the constitutional limits on price regulation.

In the first set of cases, the Court interpreted the Constitution as establishing a lower limit on utility rates. The utility ratemaking cases require a court to judge the constitutionality of rates by a process that involves balancing the public and investor interests.⁵ The great majority of courts, agencies and commentators understand this constitutional constraint to require utility rates high enough to generate moderate profits for investors.⁶ In *Federal Power Commission v. Hope Natural Gas*,⁷ the opinion that established the modern constitutional limits on utility ratemaking, the Court explained the standard for determining whether utility rates satisfied the investor interest component of the constitutional balance:

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit

beyond governmental authority unless an emergency justifies the regulation. *See, e.g., City of Miami Beach v. Forte Towers, Inc.*, 305 So. 2d 764, 765 (Fla. 1974) (per curiam); *City of Miami Beach v. Fleetwood Hotel, Inc.*, 261 So. 2d 801, 804-05 (Fla. 1972).

5. *See, e.g., Permian Basin Area Rate Cases*, 390 U.S. 747, 769-70 (1968); *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591, 603 (1944).

6. *See, e.g., Minnesota Ass'n of Health Care Facilities, Inc. v. Dep't of Public Welfare*, 742 F.2d 442, 446 (8th Cir. 1984); *Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm'n*, 730 F.2d 816, 822-23 (D.C. Cir. 1984); *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. 543, 568-70, 350 A.2d 1, 14-15 (1975); 1 A.J.G. PRIEST, *PRINCIPLES OF PUBLIC UTILITY REGULATION* 191-93 (1969); Auerbach, *The Anatomy of an Unusual Economic Substantive Due Process Case: Workers' Compensation Insurers Rating Association v. State*, 68 MINN. L. REV. 545, 650, 652-53 (1984).

7. 320 U.S. 591 (1944).

and to attract capital.⁸

Although the public interest can outweigh the investor interest and justify rates that are too low to meet the investor interest,⁹ the investor standard of *Hope* plays the predominant role in utility regulation.

In the second group of cases, involving federal price controls, the Court has not applied standards like those in *Hope* or required the controlled prices to generate moderate profits for investors. Unlike the ratemaking cases, this second group of cases does not even require an examination of the financial effects on the regulated firms and their investors caused by price control.¹⁰ Nonetheless, the dichotomy in the price regulation doctrine stems from a consistent application of the principles of the takings clause of the fifth amendment,¹¹ which is the foundation of both the utility and price control branches of the constitutional doctrine.

The takings clause constrains all types of economic regulation by requiring the payment of "just compensation" if a regulation causes enough injury to constitute the "taking" of property from the regulated person or firm. Although there is hearty dispute among academics and judges over whether compensation is required for many different kinds of economic regulation, the Supreme Court has consistently ruled over the past one hundred years that utility ratemaking is a governmental taking that triggers the compensation requirement.¹² The *Hope* standards assure that adequate compensation for the taking is provided through utility rates. On the other hand, the Court has concluded that the federal price control programs did not constitute takings. With the compensa-

8. *Id.* at 603 (citation omitted). For a more comprehensive explanation of the constitutional limits on utility ratemaking, see generally Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U.L. REV. 65 (1985).

9. See Drobak, *supra* note 8, at 88-98, 119-24.

10. See *infra* text accompanying notes 17-55.

11. "[N]or shall private property be taken for public use without just compensation." U.S. CONST. amend. V, cl. 5.

12. During the initial development of the utility ratemaking doctrine after the Civil War, the Court analogized railroad rate regulation to eminent domain and concluded that the regulation was a taking of the use of a railroad's property, which entitled the railroad to just compensation in the form of reasonable rates. See Drobak, *supra* note 8, at 75-76, 80-81; Siegel, *Understanding the Lochner Era: Lessons from the Controversy over Railroad and Utility Rate Regulation*, 70 VA. L. REV. 187, 216-17 (1984). As both the ratemaking doctrine and the jurisprudence of the taking clause evolved, the Court recognized that the principles of the takings clause that constrain government regulation (sometimes referred to as "regulatory takings", *San Diego Gas & Elec. Co. v. San Diego*, 450 U.S. 621, 651 (1982) (Brennan, J., dissenting), or "partial takings," R. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN 57-62 (1985)) are the foundation of the constitutional ratemaking doctrine, rather than the eminent domain principles. See Drobak, *supra* note 8, at 82-83, 85.

tion requirement inapplicable, there is no requirement that price control schemes satisfy the *Hope* standards or generate any profits at all. Therefore, the determination of whether the *Hope* standards must be satisfied by a particular regime of price regulation involves a preliminary finding of whether the regime would otherwise constitute a taking.

The analysis of the preliminary takings issue could involve all the principles that the Court examines in regulatory takings cases.¹³ The federal price control cases demonstrate, however, that three factors play a predominant role in making the *Hope* doctrine inapplicable to particular types of price control: (1) the justification for the price regulation; (2) the duration of the regulation; and (3) the ability of a firm to withdraw from the regulated business. The relevance of the first two factors is not surprising because the factors also play important roles in the application of the takings clause of the fifth amendment as a limit on all types of economic regulation.¹⁴ The third factor, although occasionally mentioned in the regulatory takings opinions,¹⁵ is more important in the price regulation cases. The third factor is also the least understood and least appreciated, even though it is a powerful concept for analyzing the constitutionality of all types of economic regulation.

In examining the constitutionality of price regulation, most courts fo-

13. The takings doctrine involves many different principles that the Supreme Court applies with different weight in different cases. The doctrine leaves so much uncertainty in its application to a given problem that it has been criticized for permitting the Court "to reach whatever result it wants in any particular case." Epstein, *Not Deference, But Doctrine: The Eminent Domain Clause*, 1982 SUP. CT. REV. 351, 354-55. Even the Supreme Court acknowledges that it engages in "essentially ad hoc, factual inquiries" to decide takings cases. *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 426 (1982). For different perspectives on the unifying principles of the takings cases, see generally B. ACKERMAN, *PRIVATE PROPERTY AND THE CONSTITUTION* (1977); R. EPSTEIN, *supra* note 12; Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967).

The courts' ability to avoid the strictures of the *Hope* doctrine by concluding that a particular regulatory program is not an unconstitutional taking raises a special concern. The principles of the regulatory takings cases leave much discretion to the courts. Because the cases require the balancing of so many different factors, with differing degrees of importance, a court can often justify any result in a regulatory takings case by skillful application of the principles. The danger arises from courts upholding a particular price control program under the takings clause out of a desire to free the program from the *Hope* prescripts. The presumption, however, should be the other way. The *Hope* doctrine furnishes only moderate protection of investors, at best. Because the choice is between moderate versus no protection of property rights, the courts should apply the *Hope* doctrine unless the regulatory scheme is clearly not a taking.

14. See, e.g., Michelman, *supra* note 13, at 1196-1201 (justification); Williams, Smith, Siemon, Mandelker & Babcock, *The White River Junction Manifesto*, 9 VT. L. REV. 193, 218 (1984) (temporary duration).

15. See *infra* note 89.

cus only on legal barriers to exit from a regulated business or market. Utilities cannot cease service without governmental authorization. The inability to withdraw from the regulated business is one reason for applying the *Hope* doctrine to utility ratemaking. A service requirement is not the only effective barrier to exit, however. This Article discusses two other kinds of barriers that make the *Hope* doctrine applicable. First, a firm's investment in specialized assets, which cannot be easily converted to other uses, can make exit from a price-controlled business or market almost as infeasible as a legal service obligation. Second, laws that regulate the various means of withdrawing from a regulated business or market can also make exit virtually impossible. For example, the legal restrictions on the demolition of apartment buildings and the conversion of apartments to condominiums justify most state court decisions that apply the *Hope* criteria to judge the constitutionality of rent control.

This Article initially explains the Supreme Court's reliance on the three factors in upholding the constitutionality of federal price controls that did not meet the *Hope* standards. Part II examines the relationship between the ability to withdraw from a price-controlled business and the constitutional standards governing the price control. This Part considers how a firm decides whether to remain in a particular business and how nonlegal barriers to exit affect that decision. The Part also examines the barriers that result from investment in specialized assets and analyzes recent price regulation cases in which courts examined the relevance of nonlegal barriers to exit. Part II then examines the legal restrictions on exit from the rent-controlled residential leasing business, including the restrictions on demolition and condominium conversion, and concludes that rent control must satisfy the *Hope* doctrine because the legal restrictions comprise an effective barrier to exit. Finally, Part III applies the constitutional limits on utility ratemaking to determine the constitutionality of the typical standards used in rent control.¹⁶

16. Before beginning analysis of the three factors that determine whether the utility ratemaking constraints must be applied to determine the constitutionality of a particular type of price control, it is useful to establish the relationship between both groups of the Supreme Court's price regulation opinions and the modern economic substantive due process cases. As a doctrine, economic substantive due process requires only that the means chosen by a legislature have a rational relationship with legitimate governmental objectives. See, e.g., *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 124-25 (1978); *Nebbia v. New York*, 291 U.S. at 531. As applied, the doctrine hardly constrains economic regulation at all because the Court rarely reviews the propriety of legislative objectives and defers significantly to the legislature's perception of the means-end relationship. See, e.g., L. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 450-51 (1978); Costonis, *Presumptive and Per Se Takings: A Decisional Model for the Takings Issue*, 58 N.Y.U. L. REV. 465, 490 (1983); Gunther,

I. CONSTITUTIONAL PRINCIPLES OF NATIONWIDE PRICE CONTROL

The cases upholding the constitutionality of nationwide price controls during World War II and the early 1970s demonstrate the importance of the three factors—the justification for the regulation, the duration of the controls and the ability of the regulated firm to avoid the regulation by withdrawing from the regulated business. The cases also show that the factors generally arise in combination, just as they do in the regulatory takings cases, so the relative importance of each factor is sometimes difficult to discern. In the World War II cases, however, the unique problems of waging a major war played the predominant role, even though the Court expressly relied on each factor.

Congress enacted the Emergency Price Control Act of 1942 to regulate the wartime economy.¹⁷ The Act empowered the Administrator of the Office of Price Administration to control the maximum prices of nearly all goods and services sold throughout the United States, including manufacturing, wholesale and retail prices.¹⁸ The Act also authorized the Administrator to set maximum rents throughout the country.¹⁹ Given the nationwide reach of the controls, the Act did not require the Administrator to use individual proceedings in fixing prices or rents. Rather the

The Supreme Court, 1971 Term—Foreword: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection, 86 HARV. L. REV. 1, 42-43 (1972); McCloskey, *Economic Due Process and the Supreme Court: An Exhumation and Reburial*, 1962 SUP. CT. REV. 34, 38; Oakes, "Property Rights" In *Constitutional Analysis Today*, 56 WASH. L. REV. 583, 593 (1981); *The Supreme Court, 1983 Term*, 98 HARV. L. REV. 87, 232 (1984). Even if the courts actually examined the rationality of the means and the legitimacy of the objectives, price regulation would be a defensible method to achieve valid economic goals in virtually every industry. See, e.g., *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 158, 159-64, 550 P.2d 1001, 1022, 1023-27, 130 Cal. Rptr. 465, 486, 487-91 (1976); *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. 543, 563-65, 350 A.2d 1, 12-13 (1975). Thus, government at all levels has the constitutional authority to set prices for all kinds of goods and services. But just because governments have the authority to set prices, it does not follow that governments can fix prices as low as they desire. The takings doctrine, sometimes in conjunction with the *Hope* doctrine, establishes the lower limit on price regulation.

17. Pub. L. No. 421, 56 Stat. 23 (1942). See generally *The Emergency Price Control Act*, 9 LAW & CONTEMP. PROBS. 1 (1942).

18. Pub. L. No. 421 §§ 2(a), 302(c), 56 Stat. at 24, 26. See Ginsburg, *The Emergency Price Control Act of 1942: Basic Authority and Sanctions*, 9 LAW & CONTEMP. PROBS. 22, 26 (1942).

19. The Act authorized federal rent control in locales in which defense activities adversely affected the rental market. Pub. L. No. 421 §§ 2(b), 302(b), 56 Stat. at 25, 35. In the first few months, the Administrator designated particular areas as subject to federal rent control. See Willis, *A Short History of Rent Control Laws*, 36 CORNELL L.Q. 54, 79 (1950). By October 1942, the Administrator designated the entire United States as subject to rent control under the Act, although the rents in some, mostly rural, parts of the country were never controlled. See Noel, *Federal Rent Control*, 18 TEMP. L.Q. 477, 481 (1944); Willis, *supra*, at 79.

Act provided for maximum industry-wide prices that needed only to be “generally fair and equitable.”²⁰ The Act required the Administrator to roll back prices to those prevailing a few months prior to the Act’s enactment.²¹ It also gave the Administrator considerable discretion to adjust prices depending on such factors as general changes in costs or profits.²²

In *Bowles v. Willingham*,²³ a landlord claimed that the standard of “generally fair and equitable” rents made the Act unconstitutional because its application could result in rents that were unfair and inequitable to a particular landlord.²⁴ According to the landlord, the Constitution required that each landlord be accorded reasonable rents, just as the *Hope* doctrine protected each utility. The Court rejected the landlord’s claim, focusing briefly on the ability of a landlord to avoid the rent control. Because the Act did not compel the lease of rent-controlled apartments (or the sale of price-regulated goods),²⁵ the Court concluded without any analysis that the statute did not unconstitutionally take any property.²⁶ The option of not leasing apartments or not selling goods was financially impractical for most landlords and sellers, but the Court did not consider whether the option was illusory. Instead, the Court primarily rested its holding on the two justifications for the “generally fair and equitable” standard.

The Court first examined “considerations of feasibility and practicality.”²⁷ Nationwide rent control that assured fair rentals for each land-

20. Pub. L. No. 421 § 2(a), (b), 56 Stat. at 24.

21. Most prices were to be rolled back to those prevailing between October 1 and 15, 1941, and rents to those in effect on April 1, 1941. The Act permitted the Administrator to choose other dates if desirable. *Id.* See Ginsburg, *supra* note 18, at 24, 28-29.

22. Pub. L. No. 421 § 2(a), (b), 56 Stat. at 24-25.

23. 321 U.S. 503 (1944).

24. In *Block v. Hirsh*, 256 U.S. 135 (1921), the Supreme Court upheld the District of Columbia’s rent control statute, which specified that each landlord was entitled to reasonable rent. *Id.* at 157. See Noel, *supra* note 19, at 494.

25. Pub. L. No. 421 § 4(d), 56 Stat. at 27.

26. 321 U.S. at 517, *citing* *Wilson v. Brown*, 137 F.2d 348, 351-52 (Emer. Ct. App. 1943); *see* *Nash v. City of Santa Monica*, 37 Cal. 3d 97, 106, 688 P.2d 894, 901, 207 Cal. Rptr. 285, 292 (1984); *cf.* *Yakus v. United States*, 321 U.S. 414, 437-38 (1944) (considering absence of compulsion to sell as a factor supporting constitutionality of procedural aspects of Emergency Price Control Act). Paul Freund, who argued for the Administrator in *Bowles*, first expressed this relationship in Freund, *The Emergency Price Control Act of 1942: Constitutional Issues*, 9 LAW & CONTEMP. PROBS. 77, 83 (1942).

27. 321 U.S. at 517. To support its conclusion that feasibility was germane to the constitutional issues, the Court relied on *Jacob Ruppert v. Coffey*, 251 U.S. 264, 299 (1920) and *Opp Cotton Mills v. Administrator*, 312 U.S. 126 (1941). The issue in *Jacob Ruppert* was similar to the problem in *Bowles*. In *Jacob Ruppert*, the Court upheld Prohibition regulations that included beverages with

lord would have required individual proceedings, which the Court considered "quite impossible."²⁸ The precedents justified group regulation, going back as far as 1877 when the Supreme Court first upheld the authority of states to regulate prices.²⁹ The cases also recognized that although group regulation would cause financial harm to those firms with higher costs, that disparate result did not make group regulation unconstitutional.³⁰ Although the impracticality of individual regulation was an important justification for the holding in *Bowles*, the other justification, the economic demands of war, overwhelmed the Court's analysis.

War does not stay the operation of the constitutional protections of individual rights,³¹ but it influences greatly the Court's application of the Constitution. The approval of the internment of Japanese-Americans during World War II is the most poignant example of the Court's reliance on the special needs of war.³² The Court's recognition of the exigencies of war in upholding economic regulation, although pedestrian and less controversial, was equally important to those holdings. When the government banned the operation of gold mines in the hope that miners from that industry would alleviate the shortage of skilled workers in the nonferrous metal mines, the Court found no compensable taking because of the needs of the wartime economy.³³ In *Bowles*, the Court ended

very low alcohol content because an expansive law was thought necessary to make Prohibition effective. As in *Jacob Ruppert*, the Court in *Bowles* tolerated potential unfair treatment of some landlords as a consequence of the only feasible and effective procedure. *Opp* was not directly analogous to this part of *Bowles* because *Opp* was a decision that considered impracticality only in the context of upholding Congress' delegation of authority to an agency.

28. 321 U.S. at 517. The Court cited *Wilson v. Brown*, 137 F.2d 348, 353-54 (Emer. Ct. App. 1943), for this conclusion. Although the court in *Wilson* reached the same conclusions that the Supreme Court later reached in *Bowles*, part of the analysis in *Wilson* is unpersuasive. The court rejected the application of the utility regulation cases to rent control because utilities were subject to other extensive regulation besides rate-setting. The court perceived that the extensive regulation of utilities justified constitutional limitations based on takings principles. Because rent control did not entail other extensive regulation, the court found the utility cases inapplicable. *Id.* at 351-52. Unlike the Emergency Court of Appeals, the Supreme Court in *Bowles* did not make this distinction between utility regulation and rent control.

29. *Munn v. Illinois*, 94 U.S. 113 (1877) (group regulation of grain elevators). See generally *Kitch & Bowler, The Facts of Munn v. Illinois*, 1978 SUP. CT. REV. 313.

30. See *Bowles*, 321 U.S. at 518.

31. See, e.g., *Bowles*, 321 U.S. at 521; *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 426 (1934); *Aidlin, The Constitutionality of the 1942 Price Control Act*, 30 CALIF. L. REV. 648, 653 (1942).

32. See *Korematsu v. United States*, 323 U.S. 214, 219-20 (1944).

33. The Court explained:

In the context of war we have been reluctant to find that degree of regulation which, without saying so, requires compensation to be paid for resulting losses of income. . . . The

its analysis of the substantive challenge to the Emergency Price Control Act by relying on the paramount wartime justification for price controls:

We need not determine what constitutional limits there are to price-fixing legislation. Congress was dealing here with conditions created by activities resulting from a great war effort. . . . A nation which can demand the lives of its men and women in the waging of that war is under no constitutional necessity of providing a system of price control on the domestic front which will assure each landlord a "fair return" on his property.³⁴

The economic demands of war also played the primary role in the Court's approval of the government's requisition practices during World War II. *United States v. Commodities Trading Corp.*³⁵ is especially important because the government's requisition destroyed the firm's ability to withhold its goods from the market. The case involved a dispute over whether the ceiling price for black pepper imposed under the Emergency Price Control Act was also the constitutional measure of the just compensation that the government had to pay when requisitioning pepper. Commodities Trading Corporation, an investor in pepper, began to accumulate pepper with the intention of using the regular cyclical fluctuation of pepper prices to earn profits.³⁶ After the ceiling price was imposed, Commodities withheld its pepper from the market, choosing to wait for higher prices after the end of the war. Pepper became very scarce, so the government requisitioned about 760,000 pounds from Commodities and

reasons are plain. War, particularly in modern times, demands the strict regulation of nearly all resources. It makes demands which otherwise would be insufferable. But wartime economic restrictions, temporary in character, are insignificant when compared to the widespread uncompensated loss of life and freedom of action which war traditionally demands.

United States v. Central Eureka Mining Co., 357 U.S. 155, 168 (1958). To justify its holding, the Court emphasized that "the Government did not occupy, use or in any manner take physical possession of the gold mines or of the equipment connected with them." *Id.* at 165-66. This conclusion enabled the court to formally (and artificially) distinguish *United States v. Pewee Coal Co.*, 341 U.S. 114 (1951), a case in which the Court found a compensable taking when the government took over a mine in response to a strike threat. See B. ACKERMAN, *supra* note 13, at 257 n.71; Sax, *Takings and the Police Power*, 74 YALE L.J. 36, 47 (1964).

34. 321 U.S. at 519 (citation omitted). See Noel, *supra* note 19, at 479, 496 (war power as principle justification in *Bowles*). See also *Yakus v. United States*, 321 U.S. 414, 422-23 (1944) ("That Congress has constitutional authority to prescribe commodity prices as a war emergency measure . . . [is] not questioned here . . ."). In *Yakus*, the Court dismissed a procedural rather than a substantive challenge to the Emergency Price Control Act by relying on (1) the ability of firms to avoid the requirements of the Act by not selling, (2) the need for practical and expeditious procedures and (3) the special justification of war as reasons for the harsh procedures of the Act.

35. 339 U.S. 121 (1950).

36. *Id.* at 128, 131.

offered to pay the ceiling price.³⁷ Commodities refused the offer and chose instead to sue for compensation under the fifth amendment.

The right to withhold goods from the marketplace was unusually valuable to a pepper investor because pepper could be stored for years while the investor waited for the desired market price.³⁸ The requisition destroyed that right. The compensation requirement of the fifth amendment normally requires payment of the fair market value of requisitioned property, but the controlled economy during World War II was not the "free, open market" needed to determine that value.³⁹ Commodities rejected the government's alternative of using the ceiling price, based on historical market price, because it failed to include the "retention value" of pepper.

The majority of the Court relied on the unusual wartime economic problems and held that the ceiling price was just compensation. The majority was concerned that its acceptance of retention value would only benefit those few sellers of nonperishable goods who could and chose to withhold their goods from sale. Favoring this group "would create discrimination against owners impelled by a sense of duty to sell their goods to the Government at ceiling prices without waiting for requisition. A premium would be placed on recalcitrance in time of war."⁴⁰ The majority perceived that Commodities' loss of anticipated profits was no different from the wartime economic losses that countless other firms suffered.⁴¹

37. *Id.* at 122, 131-32.

38. The right was much less valuable to sellers of perishable products. *See United States v. John J. Felin & Co.*, 334 U.S. 624 (1948).

39. *See id.* at 629-30.

40. 339 U.S. at 127. *See also id.* at 135-36.

41. The Court compared the economic losses caused by the war:

Under this state of facts the situation of Commodities differed only in degree, if at all, from that of myriad other commodity owners who quite naturally wished to hold their goods for higher prices. Postwar inflationary influences are common and generally expected. Prices cycles, seasonal and otherwise, are also well-recognized economic phenomena. Doubtless owners of steel, textiles, foodstuffs, and other goods could produce evidence similar to that offered in regard to pepper to show cyclical fluctuations in their prices. Nor would there be much difficulty in showing that a great many owners had bought, produced, or manufactured their various merchandise with the idea of withholding from markets to await expected higher prices. Many lost anticipated profits due to price control or requisition. Sacrifices of this kind and others far greater are the lot of a people engaged in war. That a war calls for sacrifices is of course no reason why an unfair and disproportionate burden should be borne by Commodities. But the facts here show no such burden on Commodities. Commodities, just like other traders in pepper and other products, bought pepper with the intention of ultimately selling on the market. No more than any other owner is Commodities entitled to "retention value," a value based on specu-

Although the economic demands of war were the most important justification for the constitutionality of the World War II controls, the cases upholding price controls during the early 1970s demonstrate that a massive war effort is not a prerequisite to price controls that fail to satisfy the constitutional ratemaking doctrine. In 1971, President Nixon imposed a ninety-day freeze on nearly all prices, rents and wages, acting under the Economic Stabilization Act of 1970.⁴² General controls on prices, rents, wages and profits followed the freeze and remained in effect in different versions until the Act expired in 1974.⁴³ The United States was still fighting in Vietnam when Congress authorized and the President enacted the freeze and the controls, but the war effort was not the justification for the regulation. Rather, the economic program was an attempt to control inflation and to stimulate the unproductive segments of the economy.⁴⁴

The Supreme Court did not hear any takings or substantive due process challenges to these controls.⁴⁵ In *Western States Meat Packers Association v. Dunlop*,⁴⁶ the Temporary Emergency Court of Appeals rejected

lation concerning the price it might have obtained for pepper after the war and after price controls were removed.

Id. at 129. The Supreme Court also rejected the use of retention value because any proof of future economic conditions and prices would have been too speculative for a court to use in determining retention value. *See id.* at 126-27, 135.

42. Pub. L. No. 91-379, §§ 201-06, 84 Stat. 796, 799-800 (1970). *See* R. KAGAN, REGULATORY JUSTICE 25 (1978); Carr, Heinke & Ryan, *Short Historical Perspective of Economic Controls in the United States*, 33 BUS. LAW. 3, 19 (1977), reprinted in 1 FEDERAL PRICE AND WAGE CONTROL PROGRAMS 1917-1979: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS 2, 18-19 (B. Reams ed. 1980).

43. *See* R. Kagan, *supra* note 42, at 57 n.31; W.D. SLAWSON, THE NEW INFLATION 310-13, 315-17 (1981); Carr, Heinke & Ryan, *supra* note 42, at 18-25. *See generally* R. LANZILOTTI, M. HAMILTON & B. ROBERTS, PHASE II IN REVIEW: THE PRICE COMMISSION EXPERIENCE (1975).

44. *See, e.g.*, Fry v. United States, 421 U.S. 542, 548 (1975); H.R. Rep. No. 1330, 91st Cong., 2d Sess. 9-11 (1970), reprinted in 59 FEDERAL PRICE AND WAGE CONTROL PROGRAMS 1917-1979: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS, Doc. No. 270 (B. Reams ed. 1980); *cf.* Economic Stabilization Act Amendments of 1971, Pub. L. No. 92-210, 85 Stat. 743, 744 (1971) (continuing and amending the 1970 Act "in order to stabilize the economy, reduce inflation, minimize unemployment, improve the Nation's competitive position in world trade, and protect the purchasing power of the dollar"). *But cf.* Belknap, *The New Deal and the Emergency Powers Doctrine*, 62 TEX. L. REV. 67, 105 n.267 (1983) (pointing out that one could argue that the 1971 controls were actually justified by the Vietnam War).

45. This was also the case for the price controls in effect during the Korean War. The Court of Appeals upheld the constitutionality of those controls on the basis of the war power. *See* United States v. Excel Packing Co., 210 F.2d 596, 597-98 (10th Cir.), cert. denied, 348 U.S. 817 (1954). In the only case concerning the Korean War controls that reached the Supreme Court, the constitutional issues were premature because the plaintiff had not exhausted his administrative remedies. *See* Allen v. Grand Cent. Aircraft Co., 347 U.S. 535, 553 (1954).

46. 482 F.2d 1401 (Temp. Emerg. Ct. App. 1973).

a takings claim on the basis of *Bowles*.⁴⁷ The court did not consider whether *Bowles* was an inappropriate precedent because it involved wartime controls; nor did it investigate the difference between the need for controls during World War II and during the early 1970s. Although the justification for the World War II controls was much greater, the court's reliance on *Bowles* was proper. The serious economic problems of the early 1970s were a justification for requiring the firms to bear a share of the economic distress.⁴⁸ Even if the economic justification alone were not sufficient to permit a departure from the *Hope* requirements, the temporary duration of the controls easily satisfied the takings clause.

The temporary duration of the government's interference with property rights is a factor that the Supreme Court has relied upon to reject takings challenges to many different kinds of regulation.⁴⁹ In *Block v. Hirsh*,⁵⁰ the Court upheld rent control in the District of Columbia during World War I in part because the regulation was a temporary measure.⁵¹ Even though that opinion preceded the change in the economic substantive due process doctrine, the Court's reliance on the temporary duration of the rent control is still a vital principle.⁵² Consequently, the tempora-

47. *Id.* at 1403-04. *Accord* *Local 11, Int'l Bhd. of Elec. Workers v. Boldt*, 481 F.2d 1392, 1395 (Temp. Emer. Ct. App.) (rejecting claim that wage limitation affected a compensable taking), *cert. denied*, 414 U.S. 1092 (1973); *Minden Beef Co. v. Cost of Living Council*, 362 F. Supp. 298, 307-08 (D. Nev. 1973).

48. *See* W.D. SLAWSON, *supra* note 43, at 319 (1981). In upholding the power of Congress to enact The Economic Stabilization Act of 1970 under the commerce clause and the application of the Act to state employees, the Supreme Court explained that Congress enacted the Act "as an emergency measure to counter severe inflation that threatened the national economy." *Fry v. United States*, 421 U.S. 542, 548 (1975). *See also* *Belknap*, *supra* note 44, at 104-07 (arguing that the distinguishing of *Fry* by the majority in *National League of Cities v. Usery*, 426 U.S. 833, 852-53 (1976), resurrected the peacetime "emergency power doctrine" that justifies legislation that would be unconstitutional if there were no emergency).

49. *See, e.g.*, *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 428, 335 n.12, 440, 450-51 (1982); *PruneYard Shopping Center v. Robins*, 447 U.S. 74, 83-84 (1980); W. STOEBUCK, *NONTRESPASSORY TAKINGS IN EMINENT DOMAIN* 198 n.122 (1977); *Michelman*, *supra* note 13, at 1228-29 n.110; *Williams, Smith, Siemon, Mandelker & Babcock*, *supra* note 14, at 218. *But cf.* *San Diego Gas & Elec. Co. v. San Diego*, 450 U.S. 621, 657-58 (1981) (Brennan, J., dissenting) (suggesting that the temporary duration of regulation is unimportant to the determination of whether compensation is required).

50. 256 U.S. 135 (1921).

51. As Justice Holmes explained, "A limit in time, to tide over a passing trouble, well may justify a law that could not be upheld as a permanent change." *Id.* at 157. *See also* *Wilson v. Brown*, 137 F.2d 348, 352 (Emer. Ct. App. 1943) (relying on this part of *Block v. Hirsh* in upholding the World War II controls).

52. *See, e.g.*, *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 440, 450-51 (1982) (relying on *Block v. Hirsh* for the relevance of the duration of regulation); *Fresh Pond Shop-*

rieness of price control is an important factor that can make the constitutional utility ratemaking principles of *Hope* inapplicable.⁵³ Congress intended the Nixon-era price freeze and controls to be temporary, and they were.⁵⁴ Strangely, the court in *Dunlop* upheld the Nixon-era controls without relying on the temporary duration of the controls. Instead, the court rejected the takings claim simply by relying on the ability of the regulated firms to withdraw from the price-controlled business.⁵⁵

II. THE ABILITY TO WITHDRAW FROM A PRICE-CONTROLLED BUSINESS

A. *The Supreme Court's Reliance on the Freedom to Withdraw*

The Supreme Court's recognition of the relevance of a firm's ability to withdraw from a regulated business is as old as the constitutionality of the states' authority to fix prices. In *Munn v. Illinois*,⁵⁶ the Court used formal nineteenth-century legal analysis to uphold the states' authority to set the prices of those businesses "affected with a public interest." The Court explained that a business owner implicitly grants to the public a property interest when the owner uses the property in a manner that

ping Center, Inc. v. Callahan, 464 U.S. 875, 878 (1983) (Rehnquist, J., dissenting from dismissal of appeal) (same).

53. See *Fresh Pond Shopping Center, Inc. v. Callahan*, 464 U.S. 875, 878 (1983) (Rehnquist, J., dissenting from dismissal of appeal) (concluding that the absence of a "foreseeable end to the emergency takes this case outside the Court's holding in *Block v. Hirsh*"). New York has continuously justified rent control since World War II on the basis of a housing emergency, and the New York Court of Appeals has repeatedly relied on the existence of a temporary emergency in fashioning the constitutional standards that it uses to review rent control statutes. See *Baar & Keating*, *supra* note 4, at 481-85. The permanency of the housing problems and the rent control authorizations in New York preclude using temporariness as a reason for not applying the *Hope* standards.

54. The first authorization for the controls was to be effective for only about six months. See Economic Stabilization Act of 1970, Pub. L. 91-380, § 206, 84 Stat. 796, 800 (1970). Amendments extended the authorization for about three and one-half years. See Economic Stabilization Act Amendments of 1973, Pub. L. No. 93-28, § 8, 87 Stat. 27, 29 (1973); Economic Stabilization Act Amendments of 1971, Pub. L. No. 92-210, § 218, 85 Stat. 743, 752 (1971). The President began the freeze about nine months after Congress gave him the authorization to act. See Exec. Order No. 11615, 3 C.F.R. 602 (1971), reprinted in 63 FEDERAL PRICE AND WAGE CONTROL PROGRAMS 1917-1979: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS, Doc. No. 292 (B. Reams ed. 1980). Although the regulatory program officially ended on April 30, 1974, the program practically ended with the end of the Phase II controls in early 1973, because enforcement was curtailed and the Phase 3 controls were generally self-administered. See W.D. SLAWSON, *supra* note 43, at 311, 331; Carr, Heinke & Ryan, *supra* note 42, at 24.

55. 482 F.2d at 1403-04.

56. 94 U.S. 113 (1877).

affects the general public.⁵⁷ The public's property interest allows governmental control of the property, including price regulation. To demonstrate the fairness of the regulation, the Court noted that the business owner "may withdraw his grant [of the public interest] by discontinuing the use; but, so long as he maintains the use, he must submit to the control."⁵⁸ The grain elevator owner in *Munn* was not legally obligated to remain in the grain storage business, but the Court failed to consider whether exit from the business was actually a feasible option. Within a short time, the ability to exit became unimportant to the justification for the states' authority to regulate, because the Court firmly established the authority to regulate all businesses affected with a public interest, even those from which firms could not legally withdraw.⁵⁹

Legal barriers to exit from a regulated business are a major reason for the constitutional ratemaking doctrine.⁶⁰ The statutes require utilities to continue providing service until they obtain permission to cease.⁶¹ The obligation to provide service is so important that utilities may be forced to incur continuing operating losses while proceeding through reorganization procedures.⁶² The Court's perception of this service requirement as analogous first to eminent domain and then to regulatory takings, led to the development of the modern constitutional limits on utility ratemaking.⁶³ Currently, the inability of utilities to withdraw from their

57. *Cf. Olsen v. Nebraska*, 313 U.S. 236, 245 (1941) (relying on Justice Holmes' dissent in *Tyson & Brother v. Banton*, 273 U.S. 418, 446 (1927), which labeled the implied grant of a public interest "little more than a fiction").

58. 94 U.S. at 126.

59. *See, e.g., Covington & Lexington Turnpike Road Co. v. Sandford*, 164 U.S. 578, 580, 585-86 (1896); *Railroad Comm'n Cases*, 116 U.S. 307, 308, 331 (1886); Jones, *Origins of the Certificate of Public Convenience and Necessity: Developments in the States, 1870-1920*, 79 COLUM. L. REV. 426, 426-27, 506 (1979).

60. *See, e.g., Block v. Hirsh*, 256 U.S. at 157; *Reagan v. Farmers' Loan and Trust Co.*, 154 U.S. 362, 409 (1894).

61. *See, e.g., California v. Southland Royalty Co.*, 436 U.S. 519 (1978); *Alabama Pub. Serv. Comm'n v. Southern Ry.*, 341 U.S. 341, 352 (1951) (concurrency); *Northwestern Pac. R.R. v. United States*, 228 F. Supp. 690 (N.D. Cal.), *aff'd sub nom. McCulloch v. Ca. Franchise Tax Bd.*, 379 U.S. 132 (1964); Jones, *supra* note 59, at 426-27, 506.

62. *See, e.g., Regional Rail Reorganization Act Cases*, 419 U.S. 102, 122-25 (1974); Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 1010-12 (1983).

63. *See Drobak, supra* note 8, at 70-81. In a circuit court opinion that influenced greatly the development of the constitutional ratemaking doctrine, Justice Brewer emphasized the importance of the permanency of the utility business:

[W]hen the strong arm of the legislation is laid upon property invested in railroad transportation, it must be so laid as to do justice to such investors. There can be no justice in that which works to such investors a practical destruction of their property thus invested. It

businesses continues to influence regulatory decisions.⁶⁴

The ability to exit from the regulated business or market is important to group regulation of firms that would otherwise have their prices set in individual proceedings under the constitutional constraints of *Hope*. The best example of this arose when the Federal Power Commission lacked the resources to regulate the prices of natural gas producers with the kind of individual proceedings that it used to regulate interstate pipelines. In *Permian Basin Area Rate Cases*,⁶⁵ the Supreme Court upheld the constitutionality of the Commission's newly devised procedure of using average cost data to set the same rates for all the producers in a defined geographic producing region. Relying on a series of cases involving railroad and truck rates, the Court in *Permian Basin* explained that group rates had been upheld "if the agency [had] before it representative evidence, ample in quantity to measure with appropriate precision the financial and other requirements of the pertinent parties."⁶⁶ Notwithstanding the long history of group rates, the gas producers claimed that group price regulation violated the Constitution unless the members of the regulated class were "proffered opportunities either to withdraw from the regulated activity or to seek special relief from the group rates."⁶⁷ The Court in *Permian Basin* expressly avoided determining whether this was a constitutional imperative in every situation, and concluded that the Commission had provided satisfactory individualized special treatment.⁶⁸ If a producer's out-of-pocket expenses for a particular gas well exceeded

must always be borne in mind that property put into railroad transportation is put there permanently. It cannot be withdrawn at the pleasure of the investors. Railroads are not like stages or steamboats, which, if furnishing no profit at one place, and under one prescribed rate of transportation, can be taken elsewhere, and put to use at other places, and under other circumstances. The railroad must stay, and, as a permanent investment, its value to its owners may not be destroyed.

Ames v. Union Pac. Ry., 64 F. 165, 176-177 (C.C.D. Neb. 1894), *aff'd sub nom. Smyth v. Ames*, 169 U.S. 466 (1898). See Bernstein, *Utility Rate Regulation: The Little Locomotive That Couldn't*, 1970 WASH. U. L.Q. 223, 237.

64. See, e.g., *In re Boston Edison Co.*, 46 Pub. U. Rep. 4th (PUR) 431, 453-55 (Mass. Dep't Pub. Util. 1982), *aff'd sub nom. Attorney General v. Dep't Pub. Util.*, 390 Mass. 208, 455 N.E.2d 414 (1983).

65. 390 U.S. 747 (1968).

66. *Id.* at 769.

67. *Id.* at 770.

68. *Id.* Although the Court avoided this issue, the Court, citing only *Bowles*, acknowledged that some of its prior decisions suggested that the Constitution required that kind of individualized treatment. *Id.* Railroad group rates had included procedures for individual relief. See, e.g., *Chicago & N.W. Ry. v. Atchison, T. & S.F. Ry.*, 387 U.S. 326, 342 (1966); *New England Div. Case*, 261 U.S. 184, 197-99 (1922).

its revenue from the well under the area price, the Commission agreed either to permit abandonment of the well as a supply of interstate gas, which the Commission implied would be the preferred remedy, or to grant an exception to the area price.⁶⁹ Abandonment was a prerequisite to conversion of the gas to intrastate sales.⁷⁰ Thus, the special procedure for abandonment gave the producers an opportunity to withdraw their financially unproductive wells from the federally regulated interstate business. In the natural gas pricing cases decided since *Permian Basin*, the Court has reaffirmed the necessity for special, individual relief from group rates.⁷¹

Accepting the premise of the price-control cases that sellers have a true option of withholding their goods from sale,⁷² the individual relief to natural gas producers gives them similar options as the sellers of price-controlled goods. Thus, under this view, individual relief is essential to reconciling natural gas producer regulation with nationwide price control. Even if the premise of the price-control cases is incorrect, and many sellers cannot stop their sales without inordinate financial harm to their businesses, individual relief from group rates is desirable whenever it is feasible without harming important governmental objectives. The unique problems of the wartime economy and the impracticality of operating a nationwide pricing program applicable to nearly all goods and services justified the absence of individual relief in the federal price control programs.⁷³ Further, the limited duration of the Nixon-era controls

69. 390 U.S. at 770-71. The FPC had only sketched an outline of this special relief, leaving most of the details to be worked out when producers sought special treatment. The court of appeals found this outline inadequate and vague, but the Supreme Court was satisfied given the novelty and experimental nature of the group rates. The Court concluded that the "Commission quite reasonably believed that the terms of any exceptional relief should be developed as its experience with area regulation lengthens." *Id.* at 772.

70. *See generally* *California v. Southland Royalty Co.*, 436 U.S. 519 (1978) (prohibiting abandonment even after mineral lease expired).

71. *See* *FERC v. Pennzoil Producing Co.*, 439 U.S. 508 (1979); *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 328 (1974). The high-cost producers in *Permian Basin* also claimed that the group rates were unconstitutional because they were disproportionately harmed. In dismissing that claim, the Supreme Court relied on the rejection of a similar claim in *Bowles v. Willingham*, 390 U.S. at 768-69 (citing *Bowles*, 321 U.S. at 518). *See supra* text accompanying note 31. *Permian Basin* shared another similarity with *Bowles*. An important justification for group regulation in both cases was the infeasibility of individual price setting procedures. *Compare Permian Basin*, 390 U.S. at 757-58, 771-72, 777, with *Bowles*, 321 U.S. at 517, 519.

72. *See supra* text accompanying notes 25-26 & 55.

73. Even though the size of the group expanded from the natural gas producers in a geographic basin to all the producers in the country, *see, e.g.*, *Public Serv. Comm'n v. Mid-Louisiana Gas Co.*, 463 U.S. 319, 330-31 (1983), it is more difficult to carry out a procedure affording special, individual-

minimized the consequent financial harm.

B. *Barriers to Exit Resulting from Specialized Assets*

The utility and price control cases illustrate that any firm legally compelled to sell at a controlled price, even a firm that cannot be classified as a utility, is entitled to the protection of the *Hope* doctrine unless a strong justification, such as wartime economic needs or the limited duration of the regulation, justifies a departure from that constitutional protection.⁷⁴ It does not necessarily follow, however, that the absence of a legal compulsion to continue in business should make the *Hope* doctrine inapplicable. If a firm is both legally and practically able to withdraw from a price-controlled business, the firm does not need the protection of the *Hope* doctrine; the firm can protect itself.⁷⁵ If a firm is under no legal compulsion to remain in business, but its investments are such that it cannot afford to withdraw from the price-controlled business without inordinate financial loss, it is a fiction to justify the lack of constitutional protection on the basis of the ability to withdraw.⁷⁶ Before a court can fairly rely on withdrawal as a reason for not applying the constitutional

ized relief for all the firms subject to nationwide price controls. With feasibility an important consideration of the court in both *Bowles* and *Permian Basin*, see *supra* note 71, the greater difficulty of individualized relief in nationwide price control adds to the justification for the difference between *Bowles* and *Permian Basin*.

Special relief from nationwide price controls may sometimes be ineffective. Phase II of the controls in the early 1970s based the controlled prices on the prices in effect during the price freeze plus cost increases. See R. LANZILLOTTI, M. HAMILTON & B. ROBERTS, *supra* note 43, at 34-35, 66-70. To prevent a firm from selling at a loss, the Phase II controls contained an exception that allowed a firm to charge whatever price it needed to cover its costs. When the price freeze went into effect, most firms in the shoe industry were selling below cost in order to compete with foreign manufacturers. Although these firms were entitled to raise their prices to cover their costs, they could not raise them because the lower prices of the other firms kept the market prices down. Consequently, these firms had to operate at a loss during Phase II. Letter from W. David Slawson, General Counsel to the Price Commission during Phase II (Sept. 27, 1984). This would have been the case even without the price controls, unless the low-cost competitors raised their prices to achieve above normal profits. The controls prevented the competitors from raising their prices except as needed to cover increased costs. For a discussion of other problems under Phase II involving loss and low-profit firms, see R. LANZILLOTTI, M. HAMILTON AND B. ROBERTS, *supra* note 43, at 75-77.

74. See *Mora v. Mejias*, 223 F.2d 814, 817-18 (1st Cir. 1955) (concluding that rice importers required to sell at a loss were entitled to the same constitutional protection as utilities).

75. See *Alabama Comm'n v. Southern Ry.*, 341 U.S. 341, 353 (1951) (Frankfurter, J., concurring); Berger, *The New Residential Tenancy Law—Are Landlords Public Utilities?*, 60 NEB. L. REV. 707, 730 (1981).

76. Notwithstanding the infeasibility of withdrawal from the price-controlled business, the *Hope* doctrine need not be satisfied if the economic needs of war justify the controls or if the controls are only temporary.

utility ratemaking limitations, the regulated firm should have an opportunity to prove that withdrawal is not feasible without inordinate financial loss. If price regulation produces losses great enough to trigger the takings clause, the court can satisfy the compensation requirement by awarding damages or by requiring the controlled prices to meet the requirements of the constitutional utility ratemaking doctrine.⁷⁷

It can be expensive for a firm to withdraw from the business of producing and selling a particular product or to change its entire business. According to basic microeconomic principles, a profit-maximizing firm will cease production when its total revenues do not at least equal its total operating costs.⁷⁸ A firm always has the option of not producing at all; then it would have a loss equal to its fixed costs. As long as production adds more to revenue than it adds to cost, production will generate some revenues to pay part of the firm's fixed costs. Thus, the firm's loss will be less if it produces, so the profit-maximizing firm will continue production if its only other option is to close its business.⁷⁹ With price controls, the government can decrease the prices that the firm charges so that the firm's revenues barely exceed its operating costs and provide only a small amount toward fixed costs. The firm will forego returns to common shareholders and pay most of its interest and preferred dividends out of something other than its revenues.⁸⁰ Although this could create a large financial loss, the firm will remain in the price-controlled business even though it is not legally compelled to do so, unless the firm can find an-

77. See *Troy, Ltd. v. Renna*, 727 F.2d 287, 300 (3rd Cir. 1984). Some financial loss is tolerable because the takings clause permits regulation to decrease value substantially before the compensation requirement is triggered. See, e.g., *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 131 (1978); *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591, 601 (1944). The greater the need for the regulation, like the economic needs of war, the greater the diminution in value tolerable under the takings clause. See, e.g., *Costonis*, *supra* note 16, at 468, 499-501. See generally *Drobak*, *supra* note 8, at 101-03. The use of the *Hope* doctrine to assure just compensation for the takings aspect of price regulation is analogous to the "amortization" of an existing property use that fails to conform to zoning requirements. See generally D. MANDELKER, *LAND USE LAW* 135-37 (1982). Both regulated rates and amortization of an existing use ameliorate the financial harm caused by government regulation; without them, the regulation would be unconstitutional.

78. See, e.g., *R. Lipsey & P. Steiner*, *Economics* 274 (2d ed. 1969). The term "operating costs" in the text is used to mean variable costs.

79. See *id.* The special relief in *Permian Basin* was consistent with this economic theory. The relief was available for those gas wells that an unregulated firm would shut down or sell, *i.e.*, those wells with operating revenues less than operating costs. See *supra* text accompanying notes 68-70.

80. The firm would have to find a source of cash to pay interest and preferred dividends, such as retained earnings or a depreciation fund.

other unregulated market for its products or convert its facilities to produce other products that will generate greater returns.

Many firms will withdraw from a price-controlled business even if the controlled prices result in a sizeable contribution to fixed costs. A firm will reassess the expected returns from its price-controlled products, compare those returns with expected returns from selling its products in other unregulated markets and from selling other products, and determine the costs of producing the alternative products.⁸¹ If the firm can feasibly sell its current products in a different market that is not price-controlled and earn greater returns in that market, the firm will withdraw from the price-controlled market. Similarly, if alternative products will generate greater returns and it is not too costly to convert to production of the alternative products, the firm will switch from production of the price-controlled product.⁸²

For example, if a town sets a low price for wholewheat bread sold by bakers in an attempt to encourage a switch from plain white bread, the bakers can avoid the price control by producing other kinds of breads with the facilities used to make wholewheat bread. If the town controls the prices of all breads, the bakers can switch to other baked goods that can be made with the same facilities used to make bread. If the town controls the prices of all baked goods and the bakers cannot feasibly sell their products elsewhere, the bakers still retain the option of selling their facilities and investing the sale proceeds in another business. Given the nature of the bakery business, only the last alternative of closing the bakery business is likely to impose considerable financial losses on the bakers. This, however, would be otherwise for businesses that involve large specialized investments.

A firm that invests in specialized assets, which are considerably less valuable when used for anything other than their intended purposes, opens itself up to opportunistic behavior. If a party to a contract invests in specialized assets in order to fulfill the contract, the other party will be in a position to negotiate for more than the contract provides because the specialized assets lock the first party into the contractual relationship.⁸³

81. The firm will also consider the anticipated duration of the price controls and the likelihood of expansion of the controls to other products.

82. See generally H. LEVY & M. SARNAT, *CAPITAL INVESTMENT AND FINANCIAL DECISIONS* 12-114 (1978). Cf. Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. PA. L. REV. 497, 530-31 (1984) (discussing the methodology for deciding whether to invest in new facilities).

83. See, e.g., O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IM-*

This opportunistic behavior is possible because the party making the investment cannot use the assets for another purpose without a significant decrease in the revenues produced by the assets.⁸⁴ Once the specialized assets are acquired, the other party to the contract can bargain to pay slightly more than the revenues that the assets would produce in their next best use and still be the most financially attractive alternative available to the investing party.⁸⁵

This theory of opportunistic behavior provides an important justification for utility regulation.⁸⁶ A utility plant, like the generating stations and distribution network of an electric utility, has few alternative uses. Once the plant is built, the utility is subject to its customers' opportunistic behavior. Some aspects of utility regulation encourage the construc-

PLICATIONS 26-37 (1975); Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1100-02 (1981); Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 240 (1979).

84. Armen Alchian has illustrated this phenomenon with the example of a printing press owner who prints a daily paper for a newspaper company for \$1,000 a day, the value of the printing service to the company. If the next best alternative user of the press would pay only \$600 a day for the printing services, the newspaper company would have an incentive to bargain down its payments to the press owner to slightly more than \$600 a day. See Alchian, *Decision Sharing and Expropriable Specific Quasi-Rents: A Theory of First National Maintenance Corporation v. NLRB*, 1 SUP. CT. ECON. REV. 235, 239 (1982). See also Klein, Crawford & Alchian, *supra* note 83, at 298-99 (similar example). In Alchian's model, a "quasi-rent is any return to a resource above that necessary for its temporary existence." Alchian, *supra*, at 239. If it costs only \$100 a day to continue the press's operations once the press is built, the quasi-rent is \$900 (\$1,000 payment from the newspaper minus \$100). The "value to a specific user in excess of its value to all other users is the *specific* quasi-rent." *Id.* (emphasis in original). In the example, the specific quasi-rent is \$400, calculated from (\$1,000-\$100) minus (\$600-\$100). Since the \$400 may be expropriated by the newspaper company, the \$400 is an "expropriable specific quasi-rent." *Id.*

85. This kind of opportunistic behavior does not invariably entail renegotiation or breach of the contract, because long-term contracts often lack sufficient detail and provision for unanticipated contingencies and because performance cannot always be measured objectively. Alchian, *supra* note 84, at 239. For example, after General Motors agreed in 1919 to buy substantially all its metal auto bodies from Fisher Body for the next ten years, General Motors was open to opportunistic behavior because it could no longer threaten to take its business elsewhere. See Klein, Crawford & Alchian, *supra* note 83, at 308-09. Taking advantage of the growing demand for both automobiles and metal auto bodies and the ambiguities in the contract's definition of the price that General Motors was to pay Fisher, Fisher Body charged prices that General Motors believed to be too high. General Motors' dissatisfaction with its contractual arrangement with Fisher Body culminated in the auto maker's vertical integration by purchasing Fisher. See *id.* at 309-10.

86. See Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426, 434-35 (1976). The most common rationale for utility rate regulation is the economic theory of natural monopoly. See, e.g., S. BREYER, *REGULATION AND ITS REFORM* 15-19 (1982); T. MORGAN, *ECONOMIC REGULATION OF BUSINESS* 18-20 (1976). For a criticism of the natural monopoly justification, see Demsetz, *Why Regulate Utilities?*, 11 J. L. & ECON. 55 (1968).

tion of utility plants and minimize the risks of this opportunistic behavior, such as exclusive franchises, restrictions on entry, protection from competing technologies and assurances of adequate prices.⁸⁷ Conversely, customers depending upon one firm for a particular utility service are subject to the firm's opportunistic behavior. Thus utility regulation protects the customers' right to be served at a regulated price and quality.⁸⁸

The theory of opportunistic behavior also helps the understanding of other types of price regulation. Firms with investments in specialized assets are less able to withdraw from a price-controlled business. As a result, a government can set lower prices for these firms with a greater likelihood that the firms will continue to sell their products at the regulated prices. The specialized assets allow the government to act opportunistically, just as they do for a contracting party.⁸⁹ Unlike a party to a contract who acquires assets to perform the contract or a utility that invests in specialized assets to carry out its legal service obligations, a price-controlled firm with specialized assets did not acquire the assets to

87. See Goldberg, *supra* note 86, at 426-27, 432-36; Williamson, *Franchise Bidding for Natural Monopolies—In General and With Respect to CATV*, 7 BELL J. ECON. 73, 73-75, 103 (1976).

88. See Goldberg, *supra* note 86, at 439-41; cf. Klein, Crawford & Alchian, *supra* note 83, at 310-11 (discussing the ability of an oil pipeline owner to appropriate quasi-rents from both oil producers and refiners).

89. To use Alchian's terminology, see *supra* note 84, the government can expropriate the specific quasi-rent from the regulated firm for the benefit of the firm's customers. This relationship between the effectiveness of regulation and specialized investment extends to all types of economic regulation, not just price control. For example, in *Ruckelshaus v. Monsanto*, 104 S. Ct. 2862 (1984), a manufacturer of pesticides claimed that the federal laws regulating the use of pesticides unconstitutionally took the manufacturer's property by allowing the Environmental Protection Agency to disclose publicly trade secrets filed with the EPA as part of the registration of a new pesticide and by permitting the agency to use the trade secrets filed by one manufacturer in support of the registration of a competitor's pesticide. In rejecting the takings claim, the Court explained that Monsanto chose to file the trade secrets with the EPA in order to register its pesticides, knowing that the statutes permitted disclosure and use of the secrets. *Id.* at 2875. Although federal law requires pesticides to be registered before they can be sold in the United States, the Court said that Monsanto could avoid the risk of public disclosure of its trade secrets by not registering new pesticides for sale in the United States but selling them only in foreign markets. *Id.* at 2875-76 & n.11. Although some of the plant and processes used in pesticide manufacture probably could be used for other chemical products, Monsanto surely has considerable investments in pesticide development and manufacture that would be worth much less if used for other products. It would be very costly for Monsanto to give up its United States market for pesticides. Consequently, the "voluntary submission of data by an applicant in exchange for the economic advantages of a registration," *id.* at 2876, is not as voluntary as the Court would have us believe. Cf. *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 439 n.17 (1982) (upholding a takings claim even though the plaintiff could avoid the effects of regulation by ceasing to rent out apartments because "a landlord's ability to rent his property may not be conditioned on his forfeiting the right to compensation for a physical occupation").

fulfill a government obligation. Nonetheless, as long as the regulatory takings doctrine protects the price-controlled firm's use of the specialized assets,⁹⁰ the firm should also be accorded the protection of the *Hope* doctrine.

A few courts have relied recently on the ability to withdraw from a price-controlled business as a reason for not applying the constitutional utility ratemaking doctrine. Some courts considered whether withdrawal was a feasible option; others did not.⁹¹ For example, in refusing to stay a reduction in workers' compensation insurance rates pending a constitutional challenge to the legislation, the Minnesota State District Court in *Workers' Compensation Insurers Rating Association v. State*⁹² concluded that the *Hope* standards did not apply to insurance companies because the companies were free not to write insurance policies in Minnesota.⁹³ The court noted the feasibility, as well as the legality, of withdrawing from business when it contrasted the insurance companies' lack of "extensive capital investments" with the investments of utilities.⁹⁴ Appar-

90. The aspects of the takings doctrine concerning reasonable investment-backed expectations and vested rights are relevant to this issue. See, e.g., *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978); cf. *Gentry v. Howard*, 365 F. Supp. 567, 573 (W.D. La. 1973) (rejecting a constitutional challenge to an ordinance regulating ambulance rates because the firm entered the business after the rate regulation went into effect).

91. The Supreme Court touched on the feasibility of withdrawal when it acknowledged in *Commodities Trading Corp.* that sellers of perishable products had less opportunity to avoid the World War II price controls than sellers of nonperishable goods. See *Commodities Trading*, 339 U.S. at 127; *United States v. Felin & Co.*, 334 U.S. 624, 645-46 (1948) (concurrency); cf. *Mora v. Mejias*, 223 F.2d 814, 817 (1st Cir. 1955) (concluding that it was unrealistic to think that rice importers would stop importing "the most important staple in the diet of the people"); Klein, Crawford & Alchian, *supra* note 83, at 314 (noting that producers of highly perishable crops are subject to opportunistic behavior by labor unions). The Court in *Commodities Trading Corp.* did not point out this difference to give greater protection to sellers of perishable goods; rather it used the difference to justify less protection for the sellers of nonperishable products. See *supra* text accompanying notes 39-40.

92. No. 452706 (Dist. Ct. Minn. Sept. 24, 1981), reprinted in Auerbach, *supra* note 6, at 667-68.

93. Memorandum Denying Stay, *Workers' Compensation Insurers Rating Ass'n v. State*, No. 452706 (Dist. Ct. Minn. Sept. 24, 1981), reprinted in Auerbach, *supra* note 6, at 667-68.

94. *Id.* Unlike the Minnesota District Court, the Massachusetts Supreme Judicial Court has flatly declined to rely on the ability to withdraw from the price-controlled business:

The writing of insurance is a lawful business and the Commonwealth may not impose unconstitutional conditions upon the exercise of the right to engage therein. . . . While it is not constitutionally required to fix rates which will guarantee a profit to all insurers, it may not constitutionally fix rates which are so low that if the insurers engage in business they may do so only at a loss. The insurers are not required to either submit to confiscatory rates or go out of business.

Aetna Casualty & Sur. Co. v. Commissioner of Ins., 358 Mass. 272, 281, 263 N.E.2d 698, 703 (1970). While the court's decision to protect the economic interests of insurance companies is understandable, the court needlessly imposed constitutional requirements on insurance rate regulation. As long as the firms can truly withdraw from the regulated activity without inordinate financial harm,

ently the insurers did not attempt to prove that withdrawal was impractical,⁹⁵ but the court's conclusion is sensible. Firms writing insurance elsewhere could just terminate their Minnesota business. Firms writing workers' compensation insurance only in Minnesota might be able to switch to other kinds of insurance. If they cannot, they should be able to either close their business or convert to another business without too great a financial loss, because the business of workers' compensation insurance does not entail large investments in specialized assets.⁹⁶

The courts have reached a similar conclusion concerning nursing home rates. For example, Minnesota regulates nursing home rates by conditioning the eligibility of nursing homes to receive medical assistance payments on the nursing homes' agreement to charge all residents, including those who do not receive Medicaid payments, only the state-approved rates for Medicaid recipients.⁹⁷ In *Minnesota Association of Health Care Facilities, Inc. v. Department of Public Welfare*,⁹⁸ the Court of Appeals for the Eighth Circuit held that the constitutional utility ratemaking doctrine did not apply to this price regulation because the nursing homes were free either to go out of business or to stop admitting Medicaid recipients.⁹⁹ The opinions in this and similar cases involving nursing home rates contain very little data to show whether withdrawal is an economically feasible alternative. Some nursing homes depend upon a large percentage of Medicaid recipients to succeed financially.¹⁰⁰

the firms are in a position to protect their own financial interests and the protection of the constitutional utility ratemaking doctrine is unnecessary. If a state chooses to use utility principles to assure fair returns to insurance companies, that should remain a matter of policy for the state, not a constitutional issue for the courts.

95. The insurers' challenge was premised on the claim that the constitutional utility ratemaking doctrine applied to them regardless of their ability to stop writing insurance in Minnesota. See Auerbach, *supra* note 6, at 545, 649-54.

96. If a firm in this kind of case proved that it had no alternatives except remaining in the price-controlled business or closing down entirely and that closing down would cause it inordinate financial harm, the court should not rely on the ability to withdraw as a way to avoid the application of the *Hope* doctrine.

97. See MINN. STAT. § 256B.48(1)(a) (1984).

98. 742 F.2d 442 (8th Cir. 1984).

99. *Id.* at 446. Accord *Minnesota Ass'n. of Health Care Facilities, Inc. v. Department of Pub. Welfare*, 602 F.2d 150, 154 (8th Cir. 1979) (denial of preliminary injunction in same case); *National Union of Hosp. Employees v. Carey*, 557 F.2d 278, 282 (2d Cir. 1977); *LaCrescent Constant Care Center, Inc. v. Department of Pub. Welfare*, 222 N.W.2d 87, 91 (Minn. 1974); *Sigety v. Ingraham*, 29 N.Y.2d 110, 115, 324 N.Y.S.2d 10, 14 (1971). The court in *Minnesota Ass'n of Health Care Facilities, Inc.* relied on the discussion in *Permian Basin* of the pertinence of abandonment of unprofitable wells. 742 F.2d at 446. See *supra* text accompanying notes 67-70.

100. See *National Union of Hosp. Employees v. Carey*, 557 F.2d 278, 288 (2d Cir. 1977) (dis-

It may be impractical for these institutions to avoid price regulation by declining to accept Medicaid recipients.¹⁰¹ For these nursing homes, the question becomes whether they can convert to other businesses without inordinate financial loss.¹⁰² If nursing homes prove that conversion is too costly, they should receive either compensation for their losses under price regulation or the protection of the *Hope* doctrine.

C. *Barriers to Exit from the Rental Business*

An owner of an apartment building can withdraw from the rental business in several different ways. The owner can convert the building to a condominium or some other use if feasible. The owner can demolish the building and construct a different kind of building, or the owner can sell the apartment building. With these options available, a town should be able to enact a rent control ordinance that does not have to satisfy the substantive constitutional requirements controlling utility ratemaking.¹⁰³ Conversion of apartment buildings to condominiums or other uses, however, undercuts a town's attempt to use rent control to provide an adequate supply of apartments at the controlled prices.¹⁰⁴ Consequently, the regulation, sometimes resulting in the prohibition, of the withdrawal of rent-controlled apartments from the rental market through controls on condominium conversion and demolition has become the norm.¹⁰⁵

senting opinion) (explaining that some nursing homes depend "heavily upon Medicaid reimbursement (as much as 90% in some instances)").

101. *Id.*

102. That involves examining the alternative uses for their facilities, the salvage value of their equipment, the cost of demolition of their buildings and the alternative uses of the land.

103. In holding that rent control had to meet the *Hope* criteria, the New Jersey Supreme Court rejected the notion that landlords could withdraw from rent control:

Although in theory the owner of a large apartment building may convert it to other uses or tear it down and construct something else in its place, in practice such a course is economically prohibitive, and to force it would be confiscatory. Nor, if the permissible rents are set significantly below what is just and reasonable, is he likely to be able to find a buyer willing to pay a reasonable price.

Hutton Park Gardens v. West Orange Town Council, 68 N.J. 543, 568 n.9, 350 A.2d 1, 14-15 n.9 (1975). Contrary to the court's conclusion, demolition and conversion will be economically feasible given proper market conditions, as shown by the large number of demolitions of apartment buildings in Santa Monica in the late 1970s. See *Nash v. City of Santa Monica*, 37 Cal. 3d 97, 100-01, 688 P.2d 894, 896-97, 207 Cal. Rptr. 285, 287-88 (1984); Baar, *Guidelines for Drafting Rent Control Laws: Lessons of a Decade*, 35 RUTGERS L. REV. 721, 838-39 (1983).

104. See, e.g., *Santa Monica Pines, Ltd. v. Rent Control Bd.*, 35 Cal. 3d 858, 868, 679 P.2d 27, 34, 201 Cal. Rptr. 593, 600 (1984); *Flynn v. City of Cambridge*, 383 Mass. 152, 158-59, 418 N.E.2d 335, 338-39 (1981); Baar, *supra* note 103, at 835.

105. See *Berger*, *supra* note 75, at 732-33; Baar, *supra* note 103, at 836. Rent controls also include controls on eviction that frequently confer perpetual tenure on tenants who pay the fixed

1. *The Constitutionality of Controls on Conversion and Demolition*

Two general types of condominium conversion controls are currently in use.¹⁰⁶ One type of control permits the conversion but limits the ability to evict tenants from the apartments that have become condominium units; the second type regulates the conversion.¹⁰⁷ Although few pub-

rent and abide by the lease terms and the law. See Baar, *supra* note 103, at 833-35; Berger, *A Public Utility View of Rental Housing*, 50 PA. BAR ASS'N Q. 234, 237 (1979) [hereinafter cited as C. Berger]; Berger, *supra* note 75, at 727-28. Many jurisdictions allow evictions if the landlord desires to occupy an apartment, permanently remove it from the rental market or demolish the building. See Baar, *supra* note 103, at 833-34; Berger, *supra* note 75, at 727-28. Some do not. See *infra* text accompanying notes 106-130.

Some commentators have examined the effect on opportunistic behavior in terms of the relationship between landlords and tenants. For example, tenants are prone to landlords' opportunistic behavior when the tenants have a strong preference not to move because of their emotional attachment to their apartments or neighborhoods or because of the high transaction costs involved in moving. See C. Berger, *supra*, at 238. This potential for opportunistic behavior by landlords is one of the reasons for rent control. See *id.* at 238-39. On the other hand, increased legal protection of tenants' rights, such as implied warranties of habitability and anti-eviction laws, make opportunistic behavior by tenants easier. They also make being a landlord less attractive. Berger, *supra* note 75, at 734; see Day & Fogel, *The Condominium Crisis: A Problem Unresolved*, 21 URB. L. ANN. 3, 17 (1981).

106. These controls usually apply to conversions of apartment buildings to cooperatives as well. See, e.g., Baar, *supra* note 103, at 835-36.

107. See *id.* at 836. See generally *id.* at 835-38; Berger, *supra* note 75, at 734-37; Day & Fogel, *supra* note 105, at 44-50. The different kinds of limitations on evictions and condominium conversions vary greatly. New Jersey, for example, stays eviction for three years, and if a developer is unable to find a comparable replacement apartment for a tenant, the tenant has a right to five additional one-year stays. N.J. REV. STAT. § 2A:18-61.2(g), -61.11(a) (West Supp. 1984). See Baar, *supra* note 103, at 836-37; Berger, *supra* note 75, at 735. After the first one-year period expires, however, the developer can obtain possession by paying the tenant five months' rent. N.J. REV. STAT. § 2A:18-61.11 (West Supp. 1984). See Baar, *supra* note 103, at 837; Berger, *supra* note 75, at 735. In addition to this protection, New Jersey permits tenants who are at least 62 years old or substantially disabled to remain in a converted condominium unit for up to 40 more years. N.J. REV. STAT. § 2A:18-61.22 to -61.31 (West Supp. 1984); see *Troy Ltd. v. Renna*, 727 F.2d 287 (3d Cir. 1984) (upholding the constitutionality of this statute). New York, on the other hand, conditions the right to convert an apartment building on the agreement by a specified percentage of the tenants to buy their apartments. N.Y. GEN. BUS. LAW § 352-eee (McKinney 1984) (applicable to three counties in the New York City area). See Baar, *supra* note 103, at 836 & n.435. If only 15% agree, the developer may convert the building, but cannot evict tenants who do not purchase their apartments. N.Y. GEN. BUS. LAW § 352-eee 1.(b), 2.(c) (McKinney 1984). If 35% agree, the developer can evict after waiting three years. N.Y. GEN. BUS. LAW §§ 352-eee 1.(c), 2.(d) (McKinney 1984). For a description of a similar conversion option under the New York City ordinances, see Berger, *supra* note 75, at 736-37. New York also prohibits the eviction of certain elderly tenants. See N.Y. GEN. BUS. LAW § 352-eee 2.(d) (iii) (McKinney 1984); Baar, *supra* note 103, at 836. See also Day & Fogel, *supra* note 105, at 50-53 (discussing other provisions that protect elderly, handicapped and low- and moderate-income tenants).

Rather than controlling evictions, some towns limit the number of apartments that may be converted to condominiums. For example, Beverly Hills limits conversions to approximately one per-

lished opinions consider takings challenges to conversion controls,¹⁰⁸ four recent cases involving controls in Brookline and Cambridge, Massachusetts, illustrate the scope of eviction control laws and the importance of rent control to the constitutionality of the laws.

Brookline first tried to limit conversions by making eviction certificates unavailable to condominium developers and by requiring purchasers of condominium units to wait six months before they could obtain a certificate permitting eviction of the tenant occupying their unit.¹⁰⁹ The rent control board was empowered to grant an additional six-month delay if a hardship existed. In *Grace v. Brookline*,¹¹⁰ the Massachusetts Supreme Judicial Court rejected a takings claim based on the argument that the law transferred the right of possession from the condominium owner to the tenant and compelled the owner to become a landlord.¹¹¹ Two factors persuaded the court that an unconstitutional taking had not occurred. First, the duration of the law's impact on a unit purchaser was short, either six months or at most a year.¹¹² Second, a purchaser would receive controlled rental income that generated a reasonable return on investment as compensation for the delay in occupancy.¹¹³ Because this income satisfied the constitutional utility ratemaking standards,¹¹⁴ the court implicitly relied on the converse of the principle that the price control cases established: if price regulation results in a reasonable return, withdrawal from the regulated business may be severely restricted. This

cent of the rental housing stock. Baar, *supra* note 103, at 836 n.437. San Francisco limits conversions to 1000 units a year. Berger, *supra* note 75, at 736. Many ordinances prohibit conversions unless the apartment vacancy rate exceeds some percentage of the total housing stock in the area, commonly three to five percent. Day & Fogel, *supra* note 105, at 49; see Berger, *supra* note 75, at 736 & n.132.

108. Judson, *Defining Property Rights: The Constitutionality of Protecting Tenants From Condominium Conversion*, 18 HARV. C.R.-C.L. L. REV. 179, 209 (1983).

109. See *Grace v. Brookline*, 379 Mass. 43, 46-47, 399 N.E.2d 1038, 1040 (1979). Prior to this law, Brookline routinely permitted developers to evict tenants from rent-controlled buildings that were being converted to condominiums. *Id.* at 46, 399 N.E.2d at 1040.

110. *Id.* at 43, 399 N.E.2d at 1038.

111. *Id.* at 55, 399 N.E.2d at 1045. The compulsion to become a landlord increased the cost of purchasing a condominium unit because typical residential mortgages are conditioned upon the borrower's occupying the property as a resident. One of the plaintiffs in *Grace* lost her mortgage financing because she could not occupy the unit. *Id.* at 47, 399 N.E.2d at 1041.

112. *Id.* at 56-57, 399 N.E.2d at 1046.

113. *Id.* at 57, 399 N.E.2d at 1046. The supreme judicial court had interpreted Brookline's requirement of "fair net operating income" for the landlord as requiring a reasonable return on investment. See *Marshall House, Inc. v. Rent Control Bd.*, 358 Mass. 686, 703, 266 N.E.2d 876, 887-88 (1971).

114. See *infra* text accompanying notes 159-61.

converse principle has become increasingly important as the restrictions on exit from the rental business have increased in both number and scope.

Even before the court issued its opinion in *Grace*, the town of Brookline strengthened its conversion laws. The amended law prohibited the eviction of a tenant who had occupied a condominium unit continuously since a time prior to the conversion of the building to a condominium.¹¹⁵ Subsequently, condominium purchasers pursued their takings claims in federal court. In *Loeterman v. Town of Brookline*,¹¹⁶ the Massachusetts District Court upheld the constitutionality of the eviction prohibition as applied to a unit owner who had purchased the unit knowing that the prohibition had gone into effect.¹¹⁷ This knowledge led the court to conclude that the purchaser's expectation of occupancy was not the kind of legitimate investment-backed expectation that the takings clause protected.¹¹⁸ Like the court in *Grace*, the district court also relied on the purchaser's ability to earn a reasonable return under rent control.¹¹⁹ The court recognized that the eviction ban could forever prevent the purchaser's occupancy of the unit, but the purchaser's knowledge of the prohibition and the ability to earn a fair income established the ban's constitutionality. In a separate case, the same court considered the constitutionality of the eviction prohibition as applied to a purchaser who bought a unit before the prohibition was enacted. This purchaser expected to occupy the unit after the delay established by the then-applicable eviction law had expired. In an opinion denying a preliminary injunction, the court indicated that the ban probably was unconstitu-

115. See *Grace*, 379 Mass. at 49 n.12, 399 N.E.2d at 1041 n.12.

116. 524 F. Supp. 1325 (D. Mass. 1981), *vacated as moot*, 709 F.2d 116 (1st Cir.), *cert. denied*, 456 U.S. 906 (1983).

117. Pending resolution of the appeal from the district court's initial decision, 524 F. Supp. 1325, the Supreme Court decided *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982), so the court of appeals remanded the case for reconsideration in light of *Loretto*. *Loeterman v. Town of Brookline*, 709 F.2d 116, 117 (1st Cir. 1983). The district court, in an unpublished opinion, concluded that *Loretto* was inapplicable and reaffirmed its original decision. See *Loeterman*, 709 F.2d at 117; Judson, *supra* note 108, at 224 n.177. Before the second appeal was resolved, the tenant vacated the condominium unit voluntarily. Consequently, the court of appeals vacated the judgment of the district court as moot. *Loeterman*, 709 F.2d at 119.

118. 524 F. Supp. at 1329. See also Judson, *supra* note 108, at 224 n.177 (explaining that the district court reached this same conclusion on remand). For an analysis of the court's use of investment-backed expectations in the takings doctrine, see generally Mandelker, "Investment-Backed Expectations"—Is There a Taking? (forthcoming U. CINN. L. REV.).

119. 524 F. Supp. at 1329.

tional as applied to the purchaser.¹²⁰ The court never decided that issue, however, because the case became moot when the tenant voluntarily vacated the unit.¹²¹

The Massachusetts Supreme Judicial Court resolved a similar issue in *Flynn v. City of Cambridge*,¹²² in which it upheld the constitutionality of a Cambridge ordinance prohibiting the removal of any rent-controlled unit from the rental market without a permit from the rent control board. The ordinance gave the board considerable discretion to deny a removal permit.¹²³ The ordinance did not prevent the conversion of rent-controlled apartments into condominium units, but it required a permit before a purchaser could occupy the unit. In a brief analysis, the court held that the ordinance was not an unconstitutional taking as applied to owners of condominium units that were purchased and being used for rental housing before the ordinance went into effect.¹²⁴ The *Flynn* court relied on the expectations of the unit owners, but contrary to the dictum of the federal district court, the Massachusetts court decided that the ordinance did not frustrate the owners' expectations. Without explanation, the court concluded that the owners' *primary* expectation concerning the use of the property, the expectation that the takings doctrine protected, was to use the property for rental housing. Apparently the court believed that the owners' rental of the units on the effective date of the ordinance demonstrated that they were primarily landlords, and

120. See *Chan v. Town of Brookline*, 484 F. Supp. 1283, 1284, 1286 (D. Mass. 1980). Even though the court thought that it would probably hold the law unconstitutional, the court refused to enjoin enforcement of the law pending a decision on the merits out of a concern for the harm that would be imposed on tenants and the rent control board if the status quo were unnecessarily disturbed. See *id.* at 1286-87.

121. See 524 F. Supp. at 1326.

122. 383 Mass. 152, 418 N.E.2d 335 (1981).

123. As Justice Rehnquist explained in another case involving the Cambridge ordinance:

Ordinance 926 delegates virtually unfettered discretion to the Board to determine whether to grant a removal permit. The Board may consider the benefits of denying removal to the tenants protected by rent control, the hardship upon existing tenants of the units sought to be removed, and the effect of removal on the proclaimed housing shortage in Cambridge. Nowhere does the ordinance suggest that these considerations be balanced against the landlord's right to put his property to other uses. In short, Ordinance 926 permits denying a "removal" permit in any situation.

Fresh Pond Shopping Center, Inc. v. Callahan, 104 S. Ct. 218, 218-19 (1983) (Rehnquist, J., dissenting from dismissal of appeal).

124. The court easily disposed of the takings claim of owners who purchased after the ordinance became effective. Like the condominium owners in *Loeterman*, these purchasers knew of the ordinance when they bought, so the takings doctrine did not protect their expectations of occupancy. 383 Mass. at 159-60, 418 N.E.2d at 339.

only secondarily future occupants.¹²⁵ This assumption, however, is unrealistic in many instances. Some owners surely were deferring occupancy only temporarily, while waiting for a lease to expire or for other reasons, and their primary intention was to occupy the units.¹²⁶ Given the harsh treatment of condominium owners who purchased their units for occupancy and not investment, the *Flynn* court should have explained why it reached its conclusion concerning primary expectations.¹²⁷ The court may have treated this issue so lightly, however, because of the importance of the second reason that justified its finding of no taking. As in the other cases upholding the Massachusetts eviction controls, the *Flynn* court relied on the unit owner's ability to earn a reasonable return on investment under rent control.¹²⁸

125. *See id.* at 160-61, 418 N.E.2d at 340.

126. *See Day & Fogel, supra* note 105, at 76-77 n.327. *But cf.* Judson, *supra* note 108, at 228-30 (arguing that the "occupancy interest" of a tenant should be preferred over the occupancy interest of a condominium unit purchaser in order to protect the greater reliance that the tenant has built up by living in the community). After the supreme judicial court decided *Flynn*, the Cambridge City Council amended the rent control ordinance so that the ban on occupancy would not apply to the condominium unit owners who purchased their units before the ordinance went into effect. *See Judson, supra* note 108, at 229 n.199.

127. The *Flynn* opinion raises problems concerning the types of expectations of property owners that the takings clause protects and the relevance of the actual intentions of the regulated party or class. For example, although the court relied on *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 136 (1978), for the importance of protecting the primary expectation concerning the use of the property, 383 Mass. at 160, 418 N.E.2d at 339, the court's application of that factor in *Flynn* is different from the Supreme Court's use of it in *Penn Central*. Grand Central Station was built in 1913 to use as a railroad terminal. *Penn Central* used it that way for years, as it still does. The only nonrailroad use has been the rental of extra space to a variety of commercial interests. *See* 438 U.S. at 115. Given the more than a half century's use of Grand Central Station for railroad purposes, the Supreme Court concluded that *Penn Central*'s primary expectation was to use the facility as a railroad terminal with some office space and concessions. *Id.* at 136. The court in *Flynn* did not even attempt to make the same kind of investigation about primary expectation that the Supreme Court made in *Penn Central*. Even if the court had, its conclusion that the owner's primary expectation was to use the property as rental housing would be even more suspect because the owners of the condominiums did not have a history of decades of the same use of the property. The resolution of these problems, however, is beyond the scope of this Article. *See generally* Mandelker, *supra* note 118.

128. 383 Mass. at 161, 418 N.E.2d at 340. *See Day & Fogel, supra* note 107, at 76-77 n.327. Other opinions upholding the constitutionality of ordinances protecting the supply of apartments also rely on the ability to earn a fair profit under rent control. *See, e.g., Troy Ltd. v. Renna*, 727 F.2d 287, 300 (3d Cir. 1984); *Nash v. City of Santa Monica*, 37 Cal. 3d 97, 103, 688 P.2d 894, 898, 207 Cal. Rptr. 285, 289 (1984). Under another interpretation of the takings clause, which has some limited judicial and academic support, the compensation provided by controlled rents does not satisfy the compensation requirement of the fifth amendment. Justice Rehnquist contends that additional compensation must be awarded for the loss of the right to exclude others from the owner's property. *See Fresh Pond Shopping Center, Inc. v. Callahan*, 104 S. Ct. 218, 220 (1983) (Rehnquist,

As part of local rent control procedures, some towns even regulate the removal of rent-controlled units from the rental market by the demolition of apartment buildings. For example, before the rent control board of Santa Monica can issue a removal permit, the board must find that removal would not adversely affect the housing supply, that the apartments are not occupied or affordable by low or moderate income families and that the landlord cannot make a fair return on investment from the apartments.¹²⁹ The permit is required if an owner desires to remove the apartments from the rental market by demolition or conversion. Santa Monica's demolition regulation resulted in the California Supreme Court's examination of the importance of the ability to withdraw from business as part of its constitutional analysis in *Nash v. City of Santa Monica*.¹³⁰

In *Nash*, a landlord asserted that Santa Monica's requirement of a removal permit violated substantive due process because it prevented him from evicting his tenants, demolishing the building and holding the undeveloped land for resale.¹³¹ Nash admitted that he could earn a fair return on investment from the controlled rents and that demolition would adversely affect the supply of housing in Santa Monica.¹³² Consequently, Nash did not satisfy the prerequisites for obtaining a removal permit. In his appeal to the California Supreme Court, Nash argued that his case should not be judged under the rational relationship test normally used for economic substantive due process claims,¹³³ but rather under the more restrictive strict scrutiny test because the ordinance restrained his

J., dissenting from dismissal for want of a substantial federal question). In at least two cases, courts held statutes to be unconstitutional takings because they prohibited landlords from recovering possession even though the statutes entitled the landlords to fair rental income. See *Kennedy v. City of Seattle*, 94 Wash. 2d 376, 384-87, 617 P.2d 713, 718-20 (1980); *Rivera v. R. Cobian China & Co.*, 181 F.2d 974, 977-78 (1st Cir. 1950). See also R. EPSTEIN, *supra* note 12, at 186-88 (arguing that rent control standards are "simply a euphemism for the confiscation of private property, bit by bit and year by year").

129. Santa Monica, Cal. City Charter § 1083(t) (1979), *quoted in* *Santa Monica Pines, Ltd. v. Rent Control Bd.*, 35 Cal. 3d 858, 862 n.2, 679 P.2d 27, 29 n.2, 201 Cal. Rptr. 593, 595-96 n.2 (1984).

130. 37 Cal. 3d 97, 688 P.2d 894, 207 Cal. Rptr. 285 (1984).

131. The landlord was 17 years old when his mother purchased a \$260,000 apartment building for him. He soon became disenchanted with the rental business. As he put it, "There is only one thing I want to do, and that is to evict the group of ingrates inhabiting my units, tear down the building, and hold on to the land until I can sell it at a price which will not mean a ruinous loss on my investment." *Id.* at 101, 688 P.2d at 897, 207 Cal. Rptr. at 288.

132. *Id.* The trial court also found that the building was occupied by tenants of low or moderate income. *Id.*

133. See *supra* note 16.

“fundamental right” to cease doing business as a landlord.¹³⁴ Nash emphasized the “liberty” aspect of his right to withdraw from business. He claimed that the ordinance compelled him to be a landlord against his will.¹³⁵ The court found no compulsion, however, because Nash could cease being a landlord by selling the property.¹³⁶ Because this way to withdraw from the business was unimpeded, the court concluded that the “indirect and minimal” burden on Nash’s liberty interest did not justify strict scrutiny.¹³⁷

The *Nash* decision is correct. By selling his building, Nash can easily avoid the problems of being a landlord, so he does not need the protection of the strict scrutiny test. Although Nash may be dissatisfied and

134. 37 Cal. 3d at 103-04, 688 P.2d at 899, 207 Cal. Rptr. at 290. In both due process and equal protection analyses, courts use strict scrutiny to protect those fundamental rights that are essential to our society. See generally Ely, *The Supreme Court, 1977 Term—Foreword: On Discovering Fundamental Values*, 92 HARV. L. REV. 5 (1978); Gunther, *supra* note 16.

135. See 37 Cal. 3d at 102-03; 688 P.2d at 898; 207 Cal. Rptr. at 289.

136. See *Maier v. City of New Orleans*, 516 F.2d 1051, 1066 (5th Cir. 1975) (relying on ability to sell in denying a takings challenge to an ordinance that prohibited demolition), *cert. denied*, 426 U.S. 905 (1976). The court in *Nash* pointed out that Nash could minimize his involvement by using a manager to handle all the landlord’s duties and by withholding each apartment from the rental market when it became vacant. See 37 Cal. 3d at 103, 688 P.2d at 898, 207 Cal. Rptr. at 289.

137. Although Nash disclaimed any takings claim, the court nonetheless explained why the takings clause was satisfied: The ordinance did not interfere with Nash’s primary investment-backed expectations, and it did not preclude him from earning a reasonable return on his investment. In a similar case, Justice Rehnquist disagreed with this kind of analysis. In dissenting from the Court’s dismissal of an appeal for want of a substantial federal question in *Fresh Pond Shopping Center, Inc. v. Callahan*, 464 U.S. 875 (1983), Justice Rehnquist concluded that the Cambridge ordinance involved in *Flynn v. City of Cambridge* resulted in an unconstitutional taking when its application prevented the demolition of a six-unit apartment building. In *Fresh Pond*, a shopping center bought the apartment building in order to demolish it and convert the land to a parking lot for one of its tenants. The tenant had lost part of its parking lot by eminent domain; the shopping center intended to replace the lost parking area. See 464 U.S. at 875 (Rehnquist, J., dissenting); *Nash v. City of Santa Monica*, 37 Cal. 3d at 107-08, 688 P.2d at 901-02, 207 Cal. Rptr. at 292-93. Although only one apartment was occupied when the shopping center applied for the removal permit, the rent control board denied the permit. After the Massachusetts courts upheld the constitutionality of the board’s decision, Justice Rehnquist supported the Supreme Court’s complete review of the case because he believed that the case raised takings issues that the Court had never decided. He thought that the ordinance effected a taking, notwithstanding the owner’s ability to earn a reasonable return on investment under rent control. See 464 U.S. at 876-77 (Rehnquist, J., dissenting). As Justice Rehnquist analyzed the case, the shopping center lost the power to exclude others from its property and to use the land as it chose. The rent control provisions did not require the board to compensate for the loss of those property rights. Because Justice Rehnquist determined that there was an unconstitutional taking, he implicitly concluded that the controlled rent was insufficient compensation. Besides Justice Rehnquist’s lone dissent in *Fresh Pond* being contrary to the analysis of the majority in *Nash*, it is also contrary to that of the Fifth Circuit Court of Appeals in *Maier v. City of New Orleans*, 516 F.2d 1051, 1066 (5th Cir. 1975) (upholding demolition prohibition), *cert. denied*, 426 U.S. 905 (1976).

worse off financially without the ability to raze his building, that is part of the burden of citizenship in society.¹³⁸ If Nash remains in business, the fair return allowed under rent control minimizes his financial harm. All the cases upholding the constitutionality of the various barriers to exit from the rental business rely on the right to earn a fair return.¹³⁹

2. *The Reciprocal Relationship between the Hope Doctrine and the Constitutionality of the Barriers to Exit from the Rental Business*

The constitutional limits on utility ratemaking and the inability to withdraw from the rental business have a reciprocal relationship. Selling an apartment building is a less attractive option when the building is subject to rent control and to restrictions on demolition and condominium conversion.¹⁴⁰ In their most extreme form, the legal restrictions on landlords approach the utilities' service obligation because the landlords' only options are either to continue in the rental business subject to all the restrictions or to sell at a loss.¹⁴¹ Effective legal barriers to exit from the rental business therefore result in an unconstitutional taking, requiring just compensation either by damages or by rents that satisfy the constitutional ratemaking principles. The state courts that have considered the constitutionality of rent control recognize the need for adequate compensation through the application of the *Hope* doctrine, although they frequently ignore the importance of barriers to exit.¹⁴² The existence of barriers to exit from the rental business mandates the application of *Hope*

138. See, e.g., *Andrus v. Allard*, 444 U.S. 51, 66-67 (1979); *Hadacheck v. Sebastian*, 239 U.S. 394, 410 (1915). See generally Michelman, *supra* note 13, at 1172-83, 1224-45.

139. Even Justice Rehnquist's analysis in *Fresh Pond* is consistent with the importance of a fair return. See *supra* note 137. He just concludes that the controlled rents are insufficient compensation. 464 U.S. at 875-78.

140. See, e.g., *Nash*, 37 Cal. 3d at 106 n.6, 688 P.2d at 901 n.6, 207 Cal. Rptr. at 292 n.6; Berger, *supra* note 75, at 727, 729, 733-34; Judson, *supra* note 108, at 210-11 & n.110; cf. *Helsmley v. Borough of Fort Lee*, 78 N.J. 200, 214, 394 A.2d 65, 72 (1978) ("arms'-length sales of rent controlled apartment buildings are rare").

141. See generally C. Berger, *supra* note 105; Berger, *supra* note 75.

142. Most state courts that have examined the constitutionality of modern rent control conclude that the *Hope* doctrine applies. See, e.g., *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 165, 550 P.2d 1001, 1027, 130 Cal. Rptr. 465, 491 (1976); *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. 543, 568-70, 350 A.2d 1, 15 (1975). A few towns permanently remove apartment units from rent controls when the unit is first vacated after the controls go into effect. See Baar, *supra* note 103, at 826 & n.391. The temporary duration of these controls justifies disregarding the *Hope* standards for some time. If the tenants are likely to remain for a while, the rate of return required by *Hope* may be decreased to reflect the expected temporary duration of the controls.

to rent control, while the constraints imposed by *Hope* result in the constitutionality of the barriers. Because the utility ratemaking doctrine is central to the constitutionality of rent control, it is important to consider how that doctrine applies to the typical methods used to fix rents.

III. AN APPLICATION OF THE CONSTITUTIONAL LIMITS ON UTILITY RATEMAKING TO RENT CONTROL

The Constitution does not require use of a particular method to fix prices. Instead, the financial impact of the new prices must satisfy the standards that *Hope* established.¹⁴³ These standards require that the constitutionality be determined by “a balancing of the investor and consumer interests.”¹⁴⁴ The investor interest requires that the new prices generate enough revenue to cover operating and capital costs.¹⁴⁵ To pay the capital costs, the revenues must pay the interest on the debt and provide earnings to the equity investors.¹⁴⁶ The earnings to the equity investors must compensate the investor for the risks of the business and assure confidence in the financial integrity of the business.¹⁴⁷ If new prices satisfy the investor interest, the Constitution is satisfied. If, however, the new prices fail to satisfy the investor interest, the inquiry is not over, because the countervailing public interest may justify the prices. Although the meaning of the public interest is not as clear as the investor interest, the Supreme Court’s ratemaking opinions give some definition to that term. Courts may exclude from the price-setting process those costs resulting from mismanagement, inefficient operations or imprudent investments.¹⁴⁸ Deteriorating service justifies lower prices.¹⁴⁹ The need to use effective and efficient procedures can also outweigh the investor interest.¹⁵⁰ Given these requirements of *Hope*, the constitutional review of new prices does not depend on a simple calculation.

Rent control procedures generally roll back all rents to the market rents on a fixed date prior to the effective date of the rent controls and

143 See *Hope*, 320 U.S. at 602 (“It is not theory but the impact of the rate order which counts.”).

144. *Id.* at 603.

145. *Id.*

146. Even though an individual or partnership owner of an apartment building has no stock investors, the owner is entitled to a return on its own investment in the building.

147. 320 U.S. at 603.

148. See, e.g., *Reagan v. Farmers’ Loan & Trust Co.*, 154 U.S. 362, 412 (1894). For a discussion of the meaning of the public interest in the ratemaking cases, see Drobak, *supra* note 8, at 88-98.

149. See, e.g., *Market Street Ry. v. Railroad Comm’n*, 324 U.S. 548 (1945).

150. See, e.g., *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

then provide for annual rent increases applicable to all landlords.¹⁵¹ The procedures also permit individual landlords to petition for increases in their own rents if they can demonstrate that their return is too low. The more generous the annual adjustments, the less need for individual increases. If, however, a town uses annual adjustments to keep rents as close as possible to the constitutional minimum, it needs to use procedures that quickly resolve individual petitions.¹⁵² Because the *Hope* doctrine permits any kind of price-setting methodology, any of the methods for annual adjustments or individual increases may result in constitutional rents. But the result of rent control will most likely be constitutional if the standards used to adjust individual rents correspond with the *Hope* requirements.

A. *The Constitutionality of the Standards Used in Individual Rent Adjustment Proceedings*

The standards used in individual rent adjustment proceedings fit into five general classifications.¹⁵³ One type, the return-on-value standard, is very similar to the methodology used in utility ratemaking. The standard entitles a landlord to rents that cover operating expenses and yield a return on the fair value of the property.¹⁵⁴ Value can be defined in different ways, including market value, assessed value and reproduction cost. In *Hope*, the Supreme Court rejected the notion, which had dominated utility ratemaking for nearly fifty years, that the Constitution required a return on either the current market value or the reproduction cost of a

151. See, e.g., *Troy Hills Village v. Township Council*, 68 N.J. 604, 613-14, 350 A.2d 34, 38-39 (1975). For a survey of the variety of across-the-board increases, see Baar, *supra* note 103, at 767-81.

152. See, e.g., *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 169-73, 550 P.2d 1001, 1029-33, 130 Cal. Rptr. 465, 493-97 (1976); *Helmsley v. Borough of Fort Lee*, 78 N.J. 200, 242, 394 A.2d 65, 68-69 (1978). Most towns adjust the rent for only a very small percentage of apartments with individual proceedings, although some adjust a substantial percentage annually. Baar, *supra* note 103, at 783-84.

153. See Baar, *supra* note 103, at 784.

154. See, e.g., *Troy Hills Village v. Township Council*, 68 N.J. 604, 622-23, 350 A.2d 34, 44 (1975); Baar, *supra* note 103, at 797. Most rent control ordinances evaluate the fairness of rental income generated by an apartment building or an apartment. See, e.g., *Troy Hills Village v. Township Council*, 68 N.J. 604, 627, 350 A.2d 34, 46 (1975); Baar, *supra* note 103, at 862-65 (quoting typical ordinances). The Constitution does not require that practice. As long as the landlord's aggregate rental income from all of its buildings in the jurisdiction satisfy the *Hope* criteria, the landlord's financial interests are protected and the Constitution is satisfied. The *Hope* doctrine is satisfied even if one building generates rental income below the level that *Hope* requires as long as another building makes up the deficiency. See, e.g., *Baltimore & O. R.R. v. United States*, 345 U.S. 146, 148 (1953).

utility's property.¹⁵⁵ The Supreme Courts of California and New Jersey have recognized that the Constitution does not require rents to include a return on the value of the property, whichever valuation method is chosen.¹⁵⁶ Likewise, the Constitution does not require any adjustment to property valuation in order to protect a landlord from an inflationary loss of purchasing power.¹⁵⁷ The return-on-value standard may result in

155. See generally Bernstein, *supra* note 63; Siegel, *supra* note 12.

156. See Fisher v. City of Berkeley, 37 Cal. 3d 644, 680-81, 693 P.2d 261, 290-91, 209 Cal. Rptr. 682, 711-12 (1984), *aff'd*, 106 S. Ct. 1045 (1986) (appeal involved only antitrust issue); Helmsley v. Borough of Fort Lee, 78 N.J. 200, 215, 394 A.2d 65, 71-72 (1978). See generally Baar, *supra* note 103, at 797.

157. Fisher v. City of Berkeley, 37 Cal. 3d at 680-85, 693 P.2d at 290-92, 209 Cal. Rptr. at 711-14 & n.38. The Supreme Court's ratemaking opinions show that the Constitution does not require adjustments to property valuations as protection against inflation. In the landmark opinion in *Smyth v. Ames*, 169 U.S. 466 (1898), the Supreme Court held that valuation for ratemaking purposes could be based on reproduction cost. As a result of the extended depressions of the 1870s and 1890s, reproduction cost was lower than original construction cost, the standard advocated by the utilities. See 1 A. KAHN, *THE ECONOMICS OF REGULATION* 39 (1970); Siegel, *supra* note 12, at 222-23. Thus the holding in *Smyth* denied utility investors any constitutional immunity from the financial harms of deflation. Schwartz, *Inflation and Utility Rate Regulation*, 1982 UTAH L. REV. 89, 97. During the early twentieth century, utilities benefited from valuations at reproduction cost because inflation made reproduction cost greater than original cost. See, e.g., 1 A. KAHN, *supra*, at 40; Schwartz, *supra*, at 97. Later opinions, which interpreted *Smyth* as requiring valuations based on reproduction cost, resulted in a "constitutional right to inflation insurance." Schwartz, *supra*, at 97. The reproduction cost standard favored investors in many other ways besides inflation protection. See, e.g., 2 J. BONBRIGHT, *VALUATION OF PROPERTY: A TREATISE ON THE APPRAISAL OF PROPERTY FOR DIFFERENT LEGAL PURPOSES* 1078-1156 (1937); Siegel, *supra* note 12, at 222, 233-34, 240-43; Schwartz, *supra*, at 97. When the Supreme Court in *Hope* freed regulators from any particular valuation method, it showed that the Constitution does not require a rate base valuation that protects utility investors from inflation.

By requiring returns sufficient to attract capital, the investor interest standard of *Hope* furnishes some indirect protection against inflation because the costs of raising funds in the capital markets reflect expectations of future inflation. See Fisher v. City of Berkeley, 37 Cal. 3d at 681-85, 693 P.2d at 291-92, 209 Cal. Rptr. at 712-14; Schwartz, *supra*, at 98-99, 103. But *Hope* requires that the public interest be balanced against the investors' interest, and it would be unfair to poor tenants if they must help protect the landlord against inflationary losses. Consideration of fairness in allocating the burdens of inflation

is not easy because price inflation, by its very nature, is unfair and disorderly in its impacts on different classes of people, and because any attempt to save one particular class against its inequities runs the risk of imposing even more severe burdens on unprotected classes. It also runs the risk of adding fuel to the inflationary fire.

J. BONBRIGHT, *PRINCIPLES OF PUBLIC UTILITY RATES* 273 (1961) (hereinafter cited as J. BONBRIGHT PRINCIPLES). Nonetheless, denying landlords protection of the purchasing power of their investments is not unfair to them. Inflation harms many investors this way, such as bondholders, preferred stock owners and others with fixed-rate investments. *Id.* at 124. Landlords, like other investors, should expect to suffer the financial consequences of the changes in national economic conditions.

Landlords would not fare any better under state ratemaking precedent because state utility commissions and courts do not interpret the Constitution as requiring compensation for the loss of

constitutional rents, but whether rents are constitutional cannot be known until the impact on the landlord is determined.¹⁵⁸ The second standard, return-on-equity, incorporates the impact on the landlord.

The return-on-equity standard results in rents that cover operating expenses and mortgage payments and provides a return on the owner's own cash investment in the property.¹⁵⁹ This standard is a direct application of the investor interest of *Hope*.¹⁶⁰ When the return is sufficient to satisfy the *Hope* criteria, rents set under the return-on-equity standard are constitutional.¹⁶¹ This does not mean, however, that a landlord is constitu-

purchasing power. Utility regulators have been concerned with a different aspect of inflation—the inability of utilities to actually achieve the authorized rate of return as a result of the “regulatory lag” in processing an application for a rate increase during inflationary times. See generally Schwartz, *supra*; Warren, *Regulated Industries' Automatic Cost of Service Adjustment Clauses: Do They Increase or Decrease Cost to the Consumer?*, 55 NOTRE DAME LAW. 333 (1980). The Constitution does not even require that utilities be protected against regulatory lag. See, e.g., Gulf States Utils. Co. v. Public Serv. Comm'n, 364 So. 2d 1266, 1274 (La. 1978). An inflationary increase in two different kinds of costs causes the inability to earn the authorized rate of return. First, as inflation causes increased expenses during the time that an authorized set of rates is in effect, investors' earnings are eroded until a new rate schedule is approved. See, e.g., New England Tel. Co. v. Department Pub. Util., 371 Mass. 67, 73-74, 354 N.E.2d 860, 865 (1976); Warren, *supra*, at 334, 335-37. Second, as new plant at inflated construction costs goes into service, investors' returns decrease until the rates are increased to reflect the added plant. See, e.g., New England Tel. Co. v. Department Pub. Util., 371 Mass. 67, 73-75, 354 N.E.2d 860, 864-65 (1976); 1 A.J.G. PRIEST, *supra* note 6, at 203-04. This “attrition” in return caused by increased investment and regulatory lag is much less of a problem in rent control than in utility regulation. Capital investment in existing apartment buildings is irregular and miniscule when compared with the on-going extensive construction programs of most utilities. Consequently, neither the constitutional ratemaking doctrine nor the utility ratemaking principles compel the use of rent control as a way of furnishing landlords inflation insurance.

158. The return-on-value standard has conceptual and practical drawbacks besides failing to examine directly the financial impact of the rents on the landlords. Because market value depends on the expected future income from the property, it is circular to use the market value to set rents, which produce the future income of the property. See, e.g., Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 292 (1929) (Brandeis, J., concurring); Helmsley v. Borough of Fort Lee, 78 N.J. 200, 213-14, 394 A.2d 65, 71 (1978). Determining value by hypothesizing a comparable rental market free of the aberrations that led to the rent control is infeasible. The New Jersey Supreme Court suggested that methodology in Troy Hills Village v. Township Council, 68 N.J. 604, 623-24, 350 A.2d 34, 44 (1975). In a later case, the New Jersey Supreme Court recognized the impossibility of using a hypothetical rental market and rejected the return-on-value standard as “practically unworkable.” *Helmsley*, 78 N.J. at 215, 394 A.2d at 72.

159. See, e.g., Zussman v. Rent Control Bd., 371 Mass. 632, 638, 359 N.E.2d 29, 33 (1976); *Helmsley*, 78 N.J. at 216 n.8, 394 A.2d at 72 n.8. See generally Baar, *supra* note 103, at 790-96.

160. Many courts require that the allowed rate of return meet the *Hope* criteria. See, e.g., Hutton Park Gardens v. West Orange Town Council, 68 N.J. 543, 569-70, 350 A.2d at 15-16 (1975).

161. A few trial courts have questioned the constitutionality of the return-on-equity standard because it results in different rents for identical apartment buildings if the financing for each building differs. See Baar, *supra* note 103, at 793-94 & n.270. The California Supreme Court, however, recently rejected an equal protection claim based on this kind of disparate result. *Fisher v. City of*

tionally entitled to a return on all of its own investment. To account for inefficient financial practices, utility ratemaking principles permit an agency to impute an appropriate capital structure in calculating the allowed return if the utility's actual debt-equity ratio is improper.¹⁶² Likewise, a rent control board may constitutionally apply the return-on-equity standard using hypothesized appropriate financial data instead of an owner's actual, but imprudent, investment.¹⁶³ In addition, if the mortgage interest rate is excessive or the purchase price inflated, the rents need not reflect those improper costs.¹⁶⁴ Finally, the Constitution does not require that rents be based on the purchase price of an apartment building if the building is sold after rent control has gone into effect. Utility ratemaking principles demonstrate that rents may be based on the investment that is equivalent to the depreciated value of the building on the date rent control began.¹⁶⁵

Berkeley, 37 Cal. 3d at 683, 693 P.2d at 293, 209 Cal. Rptr. at 714. Each landlord's constitutional rights are satisfied if the landlord's rental income meets the *Hope* criteria. The reasons for preferring the return-on-equity standard justifies the different treatment of the landlords as well as of the tenants in each building. Equal protection is not violated.

162. See, e.g., 1 A.J.G. PRIEST, *supra* note 6, at 210-15.

163. For example, in *Zussman v. Rent Control Board*, 371 Mass. 632, 359 N.E.2d 29 (1976), the Massachusetts Supreme Judicial Court affirmed a rent increase that failed to cover all of the owner's debt service, in part because the owner financed all of the building's purchase price with a mortgage loan, a highly unusual practice. *Id.* at 639-40, 359 N.E.2d at 33-34; see *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. 543, 570, 350 A.2d 1, 16 (1975); *Mahoney v. Hoboken Rent Leveling Bd.*, 178 N.J. Super. 51, 58-59, 427 A.2d 1138, 1141 (1981); *Baar*, *supra* note 103, at 789, 790 n.254, 792 n.263.

164. See, e.g., *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. at 570, 350 A.2d at 16.

165. A rent control standard, like the return-on-equity standard that bases rents on the landlord's own debt service requirements and investment will allow variable rents depending upon the purchase price of the property and the market interest rate prevailing when the purchase occurred. A purchase, which can result in a significant increase in rents, also provides a way for landlords to exercise some control over the rent regulation process. See *Baar*, *supra* note 103, at 788. Some cases have considered a utility's purchase of the operating properties of another utility. If the purchase price exceeded the depreciated original cost of the properties, most utility commissions have continued to value the properties for ratemaking purposes at the depreciated original cost. See, e.g., *Niagara Falls Power Co. v. Federal Power Comm'n*, 137 F.2d 787, 793 (2d Cir.) (L. Hand, J.), *cert. denied*, 320 U.S. 792-93, *reh'g denied*, 320 U.S. 815 (1943); 1 A.J.G. PRIEST, *supra* note 6, at 189. Utility investors are compensated for the capital they devote to the utility business. The purchasing utility now provides service to the same customers with the transferred properties, which did not change in any way with the sale. The properties were a contribution to service valued at depreciated original cost before the sale, so they retain that value for ratemaking purposes after the sale. See J. BONBRIGHT, *PRINCIPLES*, *supra* note 157, at 175-78. If the property transfer resulted in a gain in operating efficiencies, some commissions will recognize the purchase price as the proper valuation for ratemaking purposes. See *id.* at 177-78; 1 A.J.G. PRIEST, *supra* note 6, at 189-90. No constitutional impediment exists to disregarding the purchaser's investment that exceeds the depreciated

Besides requiring a return *on* investment, utility principles also require a return *of* investment. Investors, in effect, loan their capital for the use of the customers. While the loan remains unpaid, investors earn the return on their outstanding investment. Customers gradually repay the loan because utility rates include an annual depreciation expense.¹⁶⁶ As long as the *Hope* requirements are satisfied, utility investors need not receive any profits from the sale of utility property. Constitutionally, the profits may be used to decrease the rates that the customers would otherwise pay.¹⁶⁷ Rent controls cannot feasibly base a reduction in rents on the profits from the sale of a rent-controlled building because a later rent reduction does not affect the former owner who received the profits. No reason exists, however, for allowing a landlord to recover twice the investment in the property, once from the proceeds of the sale and once from an annual depreciation expense in the rents.¹⁶⁸ If the landlord will recoup its investment from the sale of the buildings, a depreciation expense in the rents is not constitutionally required. The return of investment will come from the sale.

The third and fourth standards used in individual rent-adjustment procedures depart from the typical utility ratemaking methodology. The maintenance-of-net-operating-income standard, which may be the most effective and fair rent control procedure,¹⁶⁹ permits individual adjust-

original cost of the properties. This principle means that rents may constitutionally be based on the capital that is equivalent to the depreciated original cost of the rental property, with original cost determined at the current value of the investment when rent control went into effect. Some ordinances disregard any increases in mortgage payments that occur after the adoption of rent control to approximate the depreciated original cost. See Baar, *supra* note 103, at 788. In addition, ordinances that permit rent control boards to disregard excessive purchase prices can also result in valuations similar to depreciated original cost. See *Zussman v. Rent Control Bd.*, 371 Mass. 632, 359 N.E.2d 29 (1976). Finally, the "maintenance-of-net-operating-income" standard, see *infra* text accompanying notes 169-72, accomplishes a similar result because it bases rents on the original owner's net operating income, which in turn was dependent on the original owner's debt service and return.

166. See, e.g., 1 A.J.G. PRIEST, *supra* note 6, at 112-16.

167. See, e.g., *Democratic Cent. Comm. v. Washington Metropolitan Area Transit Comm'n*, 485 F.2d 786 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 935 (1974); cf. *Bridgeport Hydraulic Co. v. Council on Water Co. Lands*, 453 F. Supp. 942, 952-53 (D. Conn. 1977) (*dictum*), *aff'd mem.*, 439 U.S. 999 (1978).

168. See, e.g., *Apartment & Office Bldg. Ass'n v. Washington*, 381 A.2d 588, 589 (D.C. 1977); *Troy Hills Village v. Town Council*, 68 N.J. at 626, 350 A.2d at 46; Note, *Rent Control and Landlords' Property Rights: The Reasonable Return Doctrine Revived*, 33 RUTGERS L. REV. 165, 186 n.142 (1980). The rents should not include both depreciation expense and mortgage principal payments; otherwise the landlord would be compensated twice for the debt investment in the property. Cf. *Helmsley v. Borough of Fort Lee*, 78 N.J. 200, 212 n.5, 394 A.2d 65, 70 n.5 (1978).

169. See Baar, *supra* note 103, at 810-11, 816-17.

ments when the rental income from a building is less than the base period rent plus the increase in operating expenses since the base period.¹⁷⁰ The standard permits a landlord to pass through to the tenants any increase in operating expenses and results in the landlord earning the same net operating income that it earned in the base period, which the landlord can use for debt service and as a return on investment.¹⁷¹ As long as the base period net operating income satisfies the *Hope* requirements, which generally will be the case because the landlord set the base period rents, the maintenance-of-net-operating-income standard will result in constitutional rental income. As an added assurance of constitutionality, most ordinances permit the landlord to obtain an additional increase by demonstrating that the base period net operating income was too low.¹⁷² Because the standard maintains the original net operating income, a new owner will have to pay debt service and earn a return from that income. That may be difficult if financing costs have increased, but the resulting rents will not be unconstitutional because the new owner should have considered the expected income when agreeing to the purchase price.

The net-operating-income standard permits a rent increase if the net operating income from the property decreases below a certain percentage of the gross rental income.¹⁷³ Fulfilling the investor interest of *Hope* depends on the percentage chosen. Too low of a percentage will result in a low net operating income that cannot pay debt service and provide a return. If the percentage is high enough, the rental income will satisfy the *Hope* test. As a result, the net operating income standard does not necessarily produce a constitutional rental income level.¹⁷⁴

170. Baar, *supra* note 103, at 809. For an explanation and analysis of this standard, see *id.* at 809-17.

171. Net operating income is total income minus operating expenses. *Helmsley v. Borough of Fort Lee*, 78 N.J. at 212 n.5, 394 A.2d at 70 n.5. For determining net operating income, operating income is generally defined as not including depreciation. See *id.*; Note, *Rethinking Rent Control: An Analysis of "Fair Return,"* 12 RUTGERS L.J. 617, 647 n.219 (1981).

172. See Baar, *supra* note 103, at 814-15. The Massachusetts courts accomplish the same result by interpreting the requirement of a fair net operating income in the ordinances to require rents that assure landlords reasonable returns on their investment. See, e.g., *Niles v. Boston Rent Control Admin.*, 6 Mass. App. Ct. 135, 139, 374 N.E.2d 296, 300 (1978); cf. *Palos Verdes Shores Mobile Estates, Ltd. v. City of Los Angeles*, 142 Cal. App. 3d 362, 190 Cal. Rptr. 866 (1983) (upholding the constitutionality of a fair-net-operating-income adjustment that also required that landlords receive a just and reasonable return).

173. See generally Baar, *supra* note 103, at 803-09.

174. Ordinances typically allow rent increases if the net operating income is less than 35 to 50% of the gross rental income. See Baar, *supra* note 103, at 804 & n.324; Note, *supra* note 171, at 647. The Interstate Commerce Commission used net operating income for years to set trucking rates that

The final standard, cash flow, does not assure that the rental income will satisfy the investor interest of *Hope* because it does not provide any return on the owner's investment. The cash flow standard assures rental income that is only sufficient to pay operating expenses and mortgage payments.¹⁷⁵ The investor interest may still be satisfied, however, because periodic adjustments for all landlords may keep rents high enough. If the cash flow measure results in a landlord failing to earn any return on investment, except for payment of debt service, the result will be unconstitutional—unless the public interest part of the *Hope* balance justifies the low return.

The need for an effective and efficient method of regulation is not a public interest sufficient to justify the constitutionality of rents that fail to meet the investor interest. The Supreme Court cases upholding group regulation consistently rely on the ability to obtain individual relief.¹⁷⁶ Even the standard in *Permian Basin*, which provided the barest relief, gave more protection to the natural gas producers than that afforded landlords under a cash flow criterion.¹⁷⁷ The use of the other types of individual procedures, more protective of landlords, shows that the cash flow standard is not essential to making rent control work.¹⁷⁸ Other aspects of the public interest, such as mismanagement, will justify the failure to satisfy the investor interest in particular cases.¹⁷⁹ Sometimes even the social goal of subsidizing poor tenants will justify what would otherwise be unconstitutionally low rents.¹⁸⁰ In most instances, however, the public interest will not outweigh the investor component of the *Hope* balance. The chosen method of rent control must then result in rents

meet the constitutional requirements. See, e.g., *Middle West Gen. Increases*, 48 M.C.C. 541 (I.C.C. 1948).

175. See generally Baar, *supra* note 103, at 786-89. A variation of this standard, which allows additional rental income to provide some return on the owner's investment, will result in income that satisfies the investor interest if the return is sufficient.

176. See *supra* text accompanying notes 67-71.

177. The relief in *Permian Basin* offered abandonment as an option, which is available in rent control only through sale of the property. The relief applied to individual wells, so a producer could earn profits from other wells and still obtain relief from unprofitable ones. See *supra* text accompanying notes 67-70. The cash flow standard examines the rental income from the entire building, not individual apartments.

178. Cf. *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 173, 550 P.2d 1001, 1032-33, 130 Cal. Rptr. 465, 496-97 (1976) (delays inherent in unit-by-unit hearings were not essential to accomplish purposes of rent control).

179. See *supra* notes 148 & 149 and accompanying text.

180. See Drobak, *supra* note 8, at 88-98.

that meet the investor interest. The cash flow standard, therefore, is the least likely method to satisfy the *Hope* standard.

B. *The Constitutionality of Tenant Subsidies*

A few municipalities have tried to assist poor tenants by either preventing or limiting increases in their rent. These attempts to assist the poor have not fared well in New Jersey and California, which have recently considered the issue.¹⁸¹ For example, the New Jersey Supreme Court in *Property Owners Association v. Township of North Bergen*¹⁸² held unconstitutional a rent control ordinance that prevented rent increases for poor, elderly tenants. The landlord's increased costs were to be paid first by rent increases for the other tenants and second by a small subsidy from the township.¹⁸³ The ordinance contained a fifteen percent annual limit on rent increases for the other tenants. The *North Bergen* court reasoned that the sum of the maximum rent increase from all the nonprotected tenants plus the town's subsidy could be less than the rent otherwise required to satisfy the investor interest standard of *Hope*. Thus, the court held that the ordinance violated the takings clause.¹⁸⁴

Logically, the abstract conclusion about the potential failure to meet the investor interest is correct, but it does not justify the holding of unconstitutionality. The *Hope* doctrine requires an examination of the expected financial consequences of a price-setting decision. In order to assess the financial impact on a landlord, a court must examine the actual rental income to be derived under the ordinance. Given the amount of the expected increase in annual costs and the number of subsidized tenants in a particular building, a landlord could possibly earn all that the investor interest requires. This result would mean that the ordinance is constitutional as applied to that particular landlord. On the other hand, a landlord may earn some positive profit, yet fail to meet the investor interest standard. In this situation, a court must determine the expected deficiency in rental income in order to assess the extent of the financial harm imposed on the landlord.¹⁸⁵ Just as the regulatory takings cases

181. *Property Owners Ass'n. v. Township of North Bergen*, 74 N.J. 327, 378 A.2d 25 (1977); *Pennell v. City of San Jose*, 154 Cal. App. 3d 1019, 201 Cal. Rptr. 728 (Ct. App. 1984) (relying on *Township of North Bergen*).

182. 74 N.J. at 327, 378 A.2d at 25.

183. *Id.* at 331-33, 378 A.2d at 27.

184. *Id.* at 336-37, 378 A.2d at 30.

185. In the same manner, the expected duration of the financial harm imposed on the landlord is relevant to the constitutionality. See *Parrino v. Lindsay*, 29 N.Y.2d 30, 323 N.Y.S.2d 689, 272

permit government regulation to impose significant financial harm to further an important governmental objective,¹⁸⁶ the *Hope* doctrine permits the public's interest to outweigh the investors'.¹⁸⁷

The purpose of the North Bergen ordinance was to help provide affordable housing for the elderly poor, which is a valid—and important—governmental objective. If landlords fail to obtain all the rental income that the investor interest standard would otherwise provide, North Bergen's objective is accomplished partially by a wealth transfer from landlords to poor, elderly tenants. Many regulatory takings opinions have upheld the constitutionality of government actions that resulted in wealth transfers.¹⁸⁸ These actions had some other governmental objective instead of wealth transfer; the transfer was an incidental consequence of furthering that other objective. The constitutionality of the North Bergen ordinance, however, is a more complex problem because the wealth transfer from landlords to tenants is not just an incidental consequence of providing affordable housing to the elderly poor. The wealth transfer is the chosen means. Nonetheless, the ordinance may still be constitutional.

The ordinance was tailored to limit the wealth transfers to progressive

N.E.2d 67 (1971) (upholding an ordinance that froze the rents of poor elderly tenants for 17 months); *cf.* *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. at 566-67, 350 A.2d at 13 (suggesting that temporary emergencies justify returns otherwise unfair for a limited time).

186. *See, e.g.,* *Andrus v. Allard*, 444 U.S. 51 (1979); *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, *reh'g denied*, 439 U.S. 883 (1978); *Miller v. Schoene*, 276 U.S. 272 (1928); *Michelman*, *supra* note 13, at 1198-99; *Oakes*, *supra* note 16, at 605; *Drobak*, *supra* note 8, at 99-103. One of the purposes of the takings doctrine is to assure a fair sharing of public burdens. *See, e.g.,* *PruneYard Shopping Center v. Robins*, 447 U.S. 74, 83 (1980); *Penn Central Transp. Co.*, 438 U.S. at 123; *Armstrong v. United States*, 364 U.S. 40, 49 (1960); *Kmiec, Regulatory Takings: The Supreme Court Runs Out of Gas in San Diego* 57 *IND. L.J.* 45, 64 (1982). Although the class of landlords subject to rent control is smaller than the class of people subject to other kinds of economic regulations, such as the class subject to nationwide price controls, the class of landlords is large enough to conclude that rent control broadly distributes the burdens of rent control.

187. *See Drobak*, *supra* note 8, at 88-98; *cf. Zussman v. Rent Control Bd.*, 371 Mass. at 640, 359 N.E.2d at 34 (using goal of providing affordable housing to families of low and moderate income as a reason for disallowing above average rents); *Niles v. Boston Rent Control Adm'r*, 6 Mass. App. 135, 146-48, 374 N.E.2d 296, 303 (1948) (interpreting Constitution as prohibiting rents so low that they cause landlords to incur losses); *Hutton Park Gardens v. West Orange Town Council*, 68 N.J. at 566-67, 350 A.2d at 13 (suggesting that temporary emergencies justify a period of returns otherwise unfair); *Apartment & Office Bldg. Ass'n v. Washington*, 381 A.2d 588, 592 (D.C. 1977) (upholding rent control ordinance that provided individual relief only if return on investment was less than 8%, a rate of return below mortgage interest rates); *Judson*, *supra* note 108 at 222-27 (arguing that investment interests should be protected less than occupancy interests).

188. *See Drobak*, *supra* note 8, at 109.

ones—from landlords to poorer tenants.¹⁸⁹ Progressive wealth transfers have more validity as a proper governmental objective than regressive transfers or transfers between people of comparable wealth. Furthermore, the constitutionality of the ordinance depends upon the size of the wealth transfer. Under the principles of the regulatory takings cases and the *Hope* doctrine, the constitutionality of a North Bergen-type rent control subsidy should depend upon a weighing of the actual financial harm imposed on landlords with the public purposes of the ordinance. If the financial consequences to the landlords in North Berger are slight, the ordinance will be constitutional. Thus, the constitutionality cannot be resolved until the court determines the expected financial effects on landlords.¹⁹⁰

IV. CONCLUSION

The Supreme Court's opinions upholding the constitutionality of nationwide price controls and the opinions establishing the modern limits on utility ratemaking together define the constitutional constraints on all forms of price regulation. The first group of opinions explain when a price regulation program constitutes a taking. The standards of the second set of opinions assume that the regulated prices provide the just compensation needed to make the program constitutional. The price control cases show that the governmental justification for price regulation and the duration of the regulation affect whether the ratemaking principles must apply, just as the justification and duration of other kinds of economic regulation affect whether compensation is required under the tak-

189. The North Bergen ordinance protected tenants aged 65 years or older whose income did not exceed \$5,000. Income was defined to exclude gifts, inheritance, social security and government pensions. 74 N.J. at 331-33, 378 A.2d at 27.

190. The court in *North Bergen* also believed that the cross-subsidization of the poor, elderly tenants by other tenants "might" be unconstitutional. 74 N.J. at 336-38; 378 A.2d at 30. The court, however, was also mistaken on this issue. Cross-subsidization of one customer class by another, a common feature of utility regulation, is constitutional. See generally J. BONBRIGHT, PRINCIPLES, *supra* note 157, at 369-85; 1 A.J.G. PRIEST, PRINCIPLES, *supra* note 6, at 285-345. The cross-subsidization aspect of the *North Bergen* ordinance should easily satisfy the rational relationship test of both economic substantive due process and economic equal protection. The purpose of the ordinance is to help supply affordable apartments for the elderly poor. Having other tenants contribute to that goal is no less rational than natural gas customers cross-subsidizing poor gas customers to help them afford gas heat. Two reasons support the ordinance's conformity with the takings clause. First, the 15% cap on annual rent increases minimized the financial losses of the subsidizing tenants. Second, subsidizing tenants are free to move, to other apartment buildings in which their subsidization would be less or to other towns or to single-family residences in which there would be no subsidy.

ings clause. The unique economic demands of waging World War II justified price controls that did not comply with the *Hope* requirements. During the 1970s, the short duration of the price controls furnished another justification. Although less important to the nationwide price control decisions, the ability to withdraw from the controlled business is the primary factor today that permits state and local governments to control prices without the constraints that limit utility ratemaking.

Legal prohibitions on exit from the utility business implicate the *Hope* doctrine; actual exit barriers from other businesses should do the same. If a firm cannot withdraw from the price-controlled business without inordinate financial loss, as would be the case for a firm with large investments in specialized assets, that firm faces the likelihood of large losses from unconstrained price control, even though the law does not compel the firm to remain in the business. Protection of the firm with the constitutional ratemaking doctrine does not necessarily make state and local price regulation inefficient or ineffective. The balance of the public and investor interests in the *Hope* doctrine gives governments considerable leeway in their attempts to fashion effective regulation. A government may strike the balance for the public interest, causing some financial harm to the investors, or, as some of the rent control standards show, for the investor interest. Whatever the balance, the outcome should be reached in the interests of beneficial social policy.

This Article has focused on the constitutional bounds of price regulation, not on the social utility of different types of regulation. The Constitution fixes the lower limit on controlled prices. It does not, however, define socially beneficial price regulation. The important issues facing legislators and regulators concern the decision to regulate and the choice of the means. Understanding the determinants of the constitutional limits on price regulation shows the variety of regulatory means permissible under the Constitution.