
THE ELMWOOD EXPERIMENT: THE USE OF COMMERCIAL RENT STABILIZATION TO PRESERVE A DIVERSE NEIGHBORHOOD SHOPPING DISTRICT

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I. INTRODUCTION

A. *Urban Neighborhood Shopping Districts: The Struggle for Survival*

The plight of the neighborhood shopping district is a well-documented feature of the literature about the continuing crisis facing many of America's cities. Beset by a multitude of problems related to the decline and deterioration of America's inner cities, small neighborhood-based retail and service businesses have struggled to survive in the face of intense competition from both suburban shopping malls and revitalized central business districts (CBDs).¹ The typical problem that has confronted urban policymakers has been the decline, and often

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1. See generally R. NORTHAM, *URBAN GEOGRAPHY* (1975).

abandonment, of small business in the decaying neighborhoods of distressed inner cities.

1. The Plight of Small Businesses in Depressed Urban Neighborhoods

During the era of massive clearance-style urban renewal, inner-city redevelopment often displaced small businesses or hastened their demise.² It was the loss of an urban neighborhood's "diversity" that Jane Jacobs lamented in her celebrated plea for the preservation of urban neighborhoods and her attack on the clearance-style urban renewal made famous by Robert Moses in New York City.³

Even when the threat of displacement from slum clearance waned with the ending of the urban renewal programs in the early 1970s, a combination of urban poverty, crime, and housing abandonment that undermined the commercial viability of many inner-city shopping areas threatened many small businesses located in depressed urban neighborhoods. This type of commercial displacement led to the development of a coordinated federal strategy for neighborhood business revitalization as part of the Carter Administration's 1978 National Urban Policy.⁴ Despite cutbacks in federal support for neighborhood

2. See B. BERRY, S. PARSONS & R. PLATT, *THE IMPACT OF URBAN RENEWAL ON SMALL BUSINESS: THE HYDE PARK-KENWOOD CASE* (1968). The Hyde Park-Kenwood neighborhood redevelopment project displaced 447 businesses. *Id.* at 6. At least one-quarter of the merchants were displaced involuntarily and approximately one-third of the businesses were liquidated because of factors such as demolition, the uncompensated costs of relocation, higher post-relocation rents, and loss of customers. The displacees that liquidated generally "operated smaller businesses than those relocating. A greater proportion of service-type establishments liquidated than did retail units. Most of the barbers, laundries, places of entertainment, personal service establishments, grocery stores, eating places, and taverns went out of business." *Id.* at 143. This study concluded, however, that the liquidation rate of commercial displacees caused by urban renewal was not excessive. *Id.* at 133. Some arts and crafts businesses that otherwise might have been liquidated, survived in a subsidized shopping mall setting within the project. See also W. KINNARD, JR. & Z. MALINOWSKI, *THE IMPACT OF DISLOCATING FROM URBAN RENEWAL AREAS ON SMALL BUSINESSES* (1960); B. ZIMMER, *REBUILDING CITIES: THE EFFECTS OF DISPLACEMENT RELOCATION ON SMALL BUSINESSES* (1964).

3. See J. JACOBS, *THE DEATH AND LIFE OF GREAT AMERICAN CITIES* (1961). In the spirit of Jane Jacobs, a "special controlled diverse use district" was proposed for urban redevelopment. See Mixon, *Jane Jacobs and the Law—Zoning for Diversity Examined*, 62 NW. U.L. REV. 314, 335-36 (1967). Mixon proposed that a prescriptive general zoning ordinance contain general guidelines for permitted and excluded uses in diverse use districts. *Id.*

4. See *Neighborhood Business District Revitalization: Hearings Before the Subcomm.*

commercial revitalization, successes have occurred.⁵

2. Displacement of Small Businesses in Gentrifying Neighborhoods

This Article focuses on a different form of displacement that threatens small businesses in revitalized urban neighborhoods. When more affluent newcomers replace a population composed of low-income, minority, and elderly residents, the commercial face of "gentrifying" neighborhoods often changes.

The extent to which gentrification leads to the involuntary displacement of the poor population of revitalized urban neighborhoods and the costs and benefits of this process of neighborhood change have been the subject of numerous studies and a continuing debate over whether local governments should regulate revitalization to prevent residential displacement.⁶ In several cities experiencing gentrification, the question has arisen whether local governments should protect small, neighborhood-serving businesses, as well as residents, from displacement. Businesses most vulnerable to displacement typically are commercial tenants with low-priced or low-volume goods and services that cannot afford lease renewals accompanied by major rent increases. Unless comparable, inexpensive, vacant, nearby commercial space is available, displacement usually means liquidation of the business. Relocation is

on Capital, Investment, and Business Opportunities of the House Comm. on Small Business, 95th Cong., 2d Sess. (1978). The Small Business Administration (SBA) initiated a Neighborhood Business Revitalization Program in cooperation with the Economic Development Administration (EDA) and the Department of Housing and Urban Development (HUD). The National Commission on Neighborhoods later called for just such a coordinated federal approach. NATIONAL COMMISSION ON NEIGHBORHOODS, PEOPLE, BUILDING NEIGHBORHOODS 148-54 (1979). See generally B. GOLDSTEIN & R. DAVIS, NEIGHBORHOODS IN THE URBAN ECONOMY: THE DYNAMICS OF DECLINE AND REVITALIZATION (1977).

5. See, e.g., *No Lost Causes: Salvaging Neighborhood Shopping Districts*, 49 PLAN., Mar. 1983, at 12. In July 1983, the Berkeley, California City Council adopted a South Berkeley Revitalization Strategy to promote economic development in a depressed neighborhood while preventing gentrification-caused displacement. For an argument for decentralized neighborhood economic development, see McGrath, *Who Must Leave? Alternative Images of Urban Revitalization*, 48 J. AM. PLAN. A., Spring 1983, at 196.

6. See, e.g., D. GALE, NEIGHBORHOOD REVITALIZATION AND THE POST-INDUSTRIAL CITY: A MULTINATIONAL PERSPECTIVE (1984); J. PALEN & B. LONDON, GENTRIFICATION, DISPLACEMENT AND NEIGHBORHOOD REVITALIZATION (1983); M. SCHILL & R. NATHAN, REVITALIZING AMERICA'S CITIES: NEIGHBORHOOD REINVESTMENT AND DISPLACEMENT (1983); Bryant & McGee, *Gentrification and the Law: Combatting Urban Displacement*, 25 WASH. U.J. URB. & CONTEMP. L. 43 (1983).

either prohibitively expensive or the business is dependent upon its current location for its customers.

Echoing the debate over residential displacement, opponents of commercial regulation argue that both the immediate neighborhood and the city benefit from the higher rents that follow commercial revitalization. They argue that the new businesses provide better goods and services, landlords and tenants improve the condition and appearance of commercial buildings, revitalized urban commercial districts attract suburban shoppers, and the city receives more revenue from increased real property and sales taxes. Those opposed to the unregulated displacement of small businesses emphasize the destruction of diversity, the replacement of "mom-and-pop" businesses by chain stores, the loss of essential services, and traffic problems caused by business expansion, all of which combine to change the character of gentrifying neighborhoods.

B. *Regulatory Responses*

1. Zoning

Land use controls provide the traditional regulatory response to these problems. Since its inception, American zoning has restricted the number and type of business uses in commercial districts. Municipal zoning ordinances often provide for the imposition of conditional use permits to ensure that land use is compatible with the character of a neighborhood.⁷ Courts have upheld the validity of conditional use zoning against challenges that it is an abuse of the police power, is inconsistent with comprehensive plans, and constitutes spot zoning.⁸ Municipalities can enlarge the conditional use concept into special district regulation. This is appropriate particularly for controlling uses in special circumstances. Historic preservation districts provide one example.⁹

7. See D. MANDELKER, *LAND USE LAW* §§ 6.48-6.56 (1982).

8. See generally Note, *Contract and Conditional Zoning: A Tool for Zoning Inflexibility*, 23 HASTINGS L.J. 825 (1972). California Boards of Zoning Adjustments are authorized to review and approve applications for conditional use. CAL. GOV'T CODE § 65,901 (Deering Supp. 1984).

9. See Wiedl, *Historic District Ordinances*, 8 CONN. L. REV. 209 (1976). The California State Historical Resources Commission is empowered to designate historic landmarks. CAL. PUB. RES. CODE § 5020.4(g) (Deering Supp. 1984). Historic preservation is one of the required elements of local general plans. Cities are required to identify historic sites and establish programs to protect them. CAL. GOV'T CODE § 65,303(j) (Deering 1979). Courts have upheld the constitutionality of historic district

2. Rent and Eviction Controls

Zoning regulations may control commercial uses, but they usually do not protect individual businesses from displacement when a commercial landlord either refuses to renew a lease or demands a major rent increase from a commercial tenant to renew a lease. In 1982, to protect small neighborhood-serving businesses, Berkeley, California voters began an unusual experiment by passing an initiative that placed Elmwood, a small shopping district of eighty-four stores, under commercial rent stabilization. This Article examines the Elmwood experiment, explores its legal ramifications, compares and contrasts land use regulations with rent and eviction controls as regulatory policies, and discusses the national significance of the Elmwood experiment. Berkeley is the only American city that currently has adopted commercial rent stabilization and it is the only American city that has ever enacted rent and eviction controls that apply only to a single neighborhood.

II. THE ELMWOOD COMMERCIAL RENT STABILIZATION EXPERIMENT

A. *Berkeley's Residential Rent Controls*

It is understandable that Berkeley would adopt neighborhood commercial rent stabilization in light of its pioneering adoption of residential rent controls during the preceding decade. In 1972, Berkeley became the first California city since World War II to enact rent controls. In 1976, the California Supreme Court held that municipalities could adopt rent controls by initiative, but found that Berkeley's particular measure was unconstitutional.¹⁰ While a 1977 rent control initiative was defeated decisively, in 1978 Berkeley voters approved an initiative which mandated that residential and commercial landlords rebate eighty percent of their Proposition 13 property tax savings to their tenants and restrict future rent increases to cost pass throughs. In

regulation. See *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104 (1978); *Maher v. New Orleans*, 516 F.2d 1051 (5th Cir. 1975), *cert. denied*, 426 U.S. 905 (1976).

10. In *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 173-74, 550 P.2d 1001, 1033, 130 Cal. Rptr. 465, 497 (1976), the California Supreme Court struck down the 1972 initiative because its rent-setting provisions violated landlords' due process rights and state law had preempted its eviction provisions. See generally Note, *The Right to Reasonable Rent Regulation: A Newer Economic Due Process*, 65 CALIF. L. REV. 304 (1977); Note, *Birkenfeld v. City of Berkeley: Blueprint for Rent Control in California*, 7 GOLDEN GATE L. REV. 677 (1977); Note, *Towards a Definable Body of Legal Requisites for Rent Control*, 10 U.C.D. L. REV. 273 (1977).

1980, the commercial version of this ordinance lapsed, but a much stricter rent control initiative superseded the residential version.

Thus, when neighborhood commercial rent control appeared on the June 1982 ballot, Berkeley voters had voted on rent control measures four previous times. Berkeley voters, therefore, were familiar with the arguments in favor of and against rent control. Voters approved the 1982 initiative and further strengthened residential rent control in Berkeley. The initiative required the election of the Berkeley Rent Stabilization Board instead of the appointment of commissioners by the Berkeley City Council. In June 1984, Berkeley and Santa Monica became the only American cities with elected rent control boards.¹¹

B. *Berkeley's Neighborhood Preservation Movement*

Berkeley has gained renown for its efforts to preserve its residential neighborhoods. In 1973, Berkeley voters approved a novel Neighborhood Preservation initiative.¹² The measure required that, when the construction of new rental housing required the demolition of existing housing, twenty-five percent of the replacement units must be low-income.

During the early 1970s, Berkeley down-zoned many residential neighborhoods to prevent high density construction at the urging of neighborhood associations affiliated with Berkeley's Council of Neighborhoods. In the late 1970s, these neighborhood groups persuaded the city to create a controversial system of traffic barriers to divert traffic from many residential neighborhoods.¹³ Berkeley also has had a strong historic preservation movement that has promoted the preservation of both historic buildings and neighborhoods. Beginning in 1970, and culminating in a successful 1976 initiative, a community group halted an industrial urban renewal clearance plan that threatened neighborhood housing and small businesses, and converted the plan into a mixed-use project featuring historic preservation and subsidized

11. For a discussion of the emergence of rent control in California, see W.D. KEATING, *RENT CONTROL IN CALIFORNIA: RESPONDING TO THE HOUSING CRISIS* (1983).

12. *BERKELEY, CAL., ORDINANCE 4641-N.S.* (1973). The housing replacement requirement only applies to newly constructed buildings with four or more units. See *Groch v. City of Berkeley*, 118 Cal. App. 3d 518, 522-25, 173 Cal. Rptr. 534, 536-39 (1981) (constitutionality upheld).

13. This traffic barrier system has survived several legal and political challenges to date. See, e.g., *Rumford v. City of Berkeley*, 31 Cal. 3d 545, 645 P.2d 124, 183 Cal. Rptr. 73 (1982).

housing.¹⁴

C. *Concern and Controversy Over Commercial Displacement in the Elmwood District*

In 1982, Berkeley's Elmwood shopping district consisted of eighty-four businesses concentrated in a small four-block area south of the University of California campus. These businesses consisted of the following: 1) twenty neighborhood convenience stores and services; 2) six speciality food stores; 3) eight restaurants; 4) thirty-nine specialty stores and services; 5) one automotive establishment; and 6) ten offices and financial institutions.

In the 1970s, Elmwood grew increasingly popular as both a residential area and as a shopping district. Neighborhood associations became alarmed at the increased parking problems attributable to Elmwood shoppers and the expansion of the nearby Alta Bates medical complex.

Several significant changes occurred as a result of pressure primarily from these neighborhood associations. In 1975, the city amended Elmwood's commercial zoning regulations to restrict the total number of business establishments and to limit the percentage of nonservice uses. In 1978 and 1981, the Berkeley Planning Commission rezoned Elmwood as a restricted neighborhood commercial district "to provide locations for businesses providing goods and services to serve surrounding neighborhoods."¹⁵ The Commission enforced this scheme through the review of conditional use permits.

In response to increased traffic congestion, the city installed a controversial city-wide system of traffic diverters in Elmwood.¹⁶ The city established a preferential residential parking permit area in part of the surrounding residential area.¹⁷ Finally, the city built a small off-street parking lot in Elmwood. In 1982, after more than a decade of controversy, the city and the private hospital, which was causing develop-

14. In *Redevelopment Agency v. City of Berkeley*, 80 Cal. App. 3d 158, 171, 143 Cal. Rptr. 633, 640 (1978), a California appellate court invalidated the initiative. The city subsequently amended this redevelopment plan to conform with the purpose of the initiative.

15. BERKELEY COMPREHENSIVE PLANNING DEPARTMENT, ZONING CONTROLS FOR NEIGHBORHOOD COMMERCIAL DISTRICTS (1977).

16. See *supra* text accompanying note 13.

17. For a discussion of the constitutionality of neighborhood parking programs, see generally Miller, *Neighborhood Parking Programs: Are They Unconstitutionally Discriminatory?*, 6 ENVTL. AFF. 391 (1978).

mental pressures, agreed to limits on the long-range expansion of medical uses.

Nevertheless, the commercial gentrification pressures grew. Elmwood is immediately surrounded by four census tracts. Between 1970 and 1980, the United States Census revealed a pattern of bifurcation. The low-income and high-income family and non-student unrelated individual populations in these census tracts generally remained stable or increased. While the percentage of high-income families rose in two of four census tracts, the percentage of very low-income unrelated individuals also rose.¹⁸ Therefore, as of 1980, no residential gentrification trend indicative of higher income exclusively leading to changing consumption was discernible.

While much of the increase in Elmwood business activity came from these adjacent neighborhoods, a significant percentage was attributable to nonresident shoppers. A 1982 planning survey commissioned by the city divided Elmwood's businesses into two categories: "neighborhood establishments" and "region-serving businesses."¹⁹ The survey reveals that sixty-three percent of Elmwood shoppers interviewed lived within one-half mile of the district and sixty-nine percent of shopping visits were to neighborhood-serving establishments.²⁰ This does not confirm that Elmwood had become a regionally-based retail district. Nevertheless, the Elmwood area had grown in popularity and sales.

The city's planning consultants listed the following citizen concerns about the problems of the Elmwood district: 1) the potential loss of basic neighborhood shops and services (hardware, drug, general food); 2) a trend toward speciality shops and services (boutiques, gourmet restaurants, financial services); 3) the potential increase in absentee owners, chains, or franchises; 4) the potential for high-volume, high-impact uses (discount records, clothing, drug, large restaurants) that

18. LANDAU, GENTRIFICATION AND POPULATION CHANGE IN BERKELEY: AN ANALYSIS OF TRENDS, table 8, at 21, table 10, at 32 (1983).

19. BLAYNEY-DYETT, ZONING ORDINANCE AMENDMENTS STUDIES: NORTH SHATTUCK AND ELMWOOD COMMERCIAL AREAS—WORKING PAPER #2: EXISTING CONDITIONS: EVALUATION OF CANDIDATE SOLUTIONS 3 (1982).

Neighborhood establishments are defined as convenience stores and services, specialty food store[s], banks and savings and loans, and some specialty shops and services including book store[s], [camera] and photography [supply stores], flower and plant shops, and hardware and houseware stores. Restaurants, all other speciality shops and services, automotive services, and offices and financial institutions are classified for this analysis as region-serving business.

Id.

20. *Id.* at 4.

would be heavy parking and traffic generators; 5) the potential for invasion of shopping centers or malls on larger parcels if owners subdivided space for the maximum number of small shops; 6) a trend toward higher-priced shops as landlords increased rents; 7) the potential for establishment of variously defined "out of character" businesses; 8) the potential for loss of retail sidewalk merchants; and 9) the potential loss of the present variety of small shops and services.²¹ These concerns reflect the desire for commercial diversity expressed by Jane Jacobs. The consultants concluded that "[i]f current market forces prevail, many businesses with low rent-paying capability will disappear or relocate."²²

The gentrification opponents focused on escalating rents as the causal force for the present and future displacement of Elmwood's older, low-rent businesses. Typically, commercial leases are long-term and often have rent escalator clauses tied to the inflation rate.²³ The pattern of Elmwood leases varies from month-to-month (twenty percent), two to three years (twenty-nine percent), four to nine years (forty-three percent), and ten years or longer (nine percent).²⁴ Rent levels vary considerably. In 1982, commercial rents ranged from a low of fifteen cents per square foot to a high of one dollar thirty-two cents per square foot.²⁵

In the State of California, the impact of property tax increases leading to greatly increased commercial rents through "pass through" clauses was reduced significantly as a result of the 1978 passage of the Proposition 13 state-wide tax initiative. As applied to commercial landlords and tenants, a very low ceiling was created, even when the building is sold.²⁶ Approximately half of Elmwood's landlords pay property taxes. Conversely, approximately half of the tenants pay

21. *Id.* at 5.

22. *Id.* at 26.

23. In Elmwood, this is the San Francisco-Oakland Consumer Price Index—All Items (CPI-U).

24. K. BAAR & W.D. KEATING, *ELMWOOD LANDLORD AND TENANT SURVEY: SUPPLEMENTARY REPORT TO THE BERKELEY BOARD OF ADJUSTMENTS*, table 1, at 2 (1983).

25. *Id.* table 3, at 3.

26. Proposition 13 reduced property taxes to their 1975 level and imposed constitutional ceilings of 1% of full cash value and 2% on annual increases, unless a local override is approved by a two-thirds vote on a tax referendum. CAL. CONST. art. 13A. Berkeley voters approved such a measure in 1980 to finance the city's libraries in the wake of Proposition 13 budgetary cutbacks.

property taxes themselves.²⁷ Increased property taxes in the wake of Proposition 13 are not the main factor in rent increases.

Between 1978 and 1981, seventy-one percent of the tenants reported receiving rent increases. Including tenants that received more than one increase during this period and those that reported none, the cumulative average rent increase during this three year period was 27.9 percent.²⁸ During the same period, the regional All Urban Consumer Price Index (CPI-U) increased by 45.1 percent.²⁹ As Table I indicates, if only tenants reporting rent increases are included, however, average rent increases exceeding the CPI-U are found in each year and reported average rent increases grew annually.

Table 1

Average Percentage Rent Increases			
<u>Only for Units Reporting Rent Increases: 1979-1981³⁰</u>			
	<u>1979</u>	<u>1980</u>	<u>1981</u>
Number of Units Reporting Rent Increases	9	15	21
Unweighted Average Percentage Rent Increase	11%*	16.8%	17.5%
Percent Increase (San Francisco-Oakland, CPI-U)	8.5%	15.2%	12.8%

*Two tenants reported decreases averaging 4.6%.

In 1982, three tenants reported rent increases in excess of one hundred percent. A similar rent increase the previous year of a popular Elmwood business sparked the movement to preserve Elmwood's small businesses from commercial gentrification.

The analytical problem presented by this limited data is that no benchmark exists with which to compare it. There is no comparable data on the terms of commercial leases and rent increases for small retail and service businesses elsewhere in Berkeley, Berkeley's neighboring communities, and the region as a whole. Data on downtown office space rents is not useful for comparative analysis because this

27. K. BAAR & W.D. KEATING, *supra* note 24, table 2, at 3. Approximately 60% of Elmwood's commercial tenants responded.

28. *Id.* table 4, at 4.

29. *Id.* at 4.

30. *Id.* table 6, at 5.

affects a far different commercial sector that is not threatened similarly with displacement by the levels of commercial rents and rent increases.

Moreover, no systematic data exist on the relocation and liquidation rate of small businesses comparable to those located in the Elmwood district. Therefore, it is difficult to conclude with any assurance that the prevailing rents in Elmwood in 1981 were excessively high or that actual or threatened rent increases displaced small businesses from the neighborhood.

Nevertheless, many merchants and concerned residents held this view. The doubling by new owners of the rent of the city's last surviving soda fountain, a subtenant for more than thirty years in a building purchased in 1981, received widespread publicity and provoked a tremendous controversy. The prospective closing of this landmark neighborhood business inspired the formation of the Elmwood Preservation Alliance, which pressured the Berkeley City Council and Planning Commission for further protective regulation to preserve the existing small businesses in this district.

D. *Alternate Solutions*

1. Zoning

The city's planning consultants stated that the city could best preserve Elmwood's neighborhood-serving character by: 1) limiting total commercial area; 2) limiting floor area per establishment; 3) establishing quotas for banks, savings and loans, and restaurants; 4) establishing inclusionary regulations to create opportunities for needed services that have low rent-paying capability; and 5) excluding certain types of offices and office frontage.³¹ The planning consultants recommended rezoning Elmwood: 1) to limit the space occupied by certain types of businesses that generate high traffic volumes and businesses that might, if not limited, expand to displace businesses needed to serve surrounding neighborhoods; 2) to prevent development of commercial space exceeding the amount and intensity of use that can be served by available traffic capacity and existing and potential parking supply; 3) to ensure that additional commercial development is accompanied by residential development sufficient to accommodate the net increase in workforce; 4) to encourage businesses with moderate rent-paying capability that provide needed household repair services; and 5) to ensure that new

31. BLAYNEY-DYETT, ZONING ORDINANCE AMENDMENTS STUDIES: NORTH SHATTUCK AND ELMWOOD COMMERCIAL AREAS: FINAL REPORT 2 (1982).

buildings, alterations, and additions to existing buildings harmonize with their surroundings.³²

Zoning controls are the typical response to this type of conflict. The cited proposals are aimed at restricting occupancy of existing and new space by those businesses that are not neighborhood-oriented and cause traffic problems. Zoning achieves this through use and building permits issued in conformity with zoning standards for the district.

This approach will not necessarily preserve existing small businesses, the focus of the furor. Zoning may protect them against certain competitors, but not all. Zoning does not protect existing small businesses against the nonrenewal of expiring leases or very large rent increases that may force them to relocate or to liquidate.

The only part of the rezoning proposal that directly addressed the rent-gentrification issue contained an "inclusionary" approach to newly-developed commercial space. This approach, however, was dropped from the final rezoning ordinance. This proposal would have required certain owners to offer below-market rents for at least two years to certain types of tenants providing "household repair services."³³ Berkeley and other California municipalities have used this "inclusionary" housing approach to regulate new residential housing development and condominium conversions to provide more affordable housing.³⁴ The proposal would have had little or no effect on most

32. BLAYNEY-DYETT, *supra* note 19, at 13.

33. The proposal stated:

The owner of new, added, or converted commercial space exceeding 6,000 square feet on a site shall, prior to initial occupancy of the premises, offer during a period of 60 days or more leases of two years or longer for up to 10 percent of the gross floor area for occupancy by businesses having as their principal source of income on-premises repair of shoes, small household appliances, jewelry, bicycles, or clothing alterations at a rent per square foot not exceeding 50 percent of the average base rental obtained or sought for all other rental space on the site. Such leases may contain provisions allowing total rent per square foot to rise to the average for the site. Such leases may contain provisions allowing total rent per square foot to rise to the average for the site after one year if sales volume per square foot equals or exceeds the average for the site.

Id. at 25.

34. Many California cities have adopted inclusionary zoning policies to promote more affordable housing. Berkeley led the way by passing the Neighborhood Preservation initiative in 1973. *See supra* text accompanying note 12. *See generally* A. MAL-LACH, *INCLUSIONARY HOUSING PROGRAMS: POLICIES AND PRACTICES* (1984); Burton, *California Legislature Prohibits Exclusionary Zoning, Mandates Fair Share: Inclusionary Housing Programs a Likely Response*, 9 SAN FERN. V.L. REV. 19 (1981); Ellickson, *The Irony of "Inclusionary" Zoning*, 54 S. CAL. L. REV. 1167 (1981).

Elmwood businesses, however, because they occupy existing space. One large rehabilitation project contains several small shops and offices. Even this major development would not have been affected by rezoning because of the "grandfathering" of its "vested" development rights.³⁵

In November 1982, Berkeley, by initiative, enacted the neighborhood sponsored "Neighborhood Commercial Preservation Ordinance" (Measure V).³⁶ This initiative was designed to require commercial zoning to conform to the city's 1977 Master Plan to encourage regional businesses to locate in Berkeley's CBD, and to allow for greater neighborhood participation in the city's review of use permits in neighborhood commercial districts. In May 1984, the Berkeley City Council, on the recommendation of the Planning Commission, adopted the rezoning proposal for Elmwood.³⁷ The rezoning of Elmwood represents the intended effect of Measure V and includes many of the consultants' recommendations. It establishes use limitations and quotas for a three year period, and limited development densities and uses to promote neighborhood-serving businesses and to prevent traffic problems.³⁸ Because this is district zoning, which is consistent with the city's Master Plan, it is not subject to the legal attacks directed at conditional use

35. This project already had received all necessary construction permits and construction was completed prior to approval by the Berkeley City Council of the rezoning of Elmwood in November 1983. Thus, no issue of the vesting of development rights would have arisen concerning this project. *See generally* Recent Development, *Developers' Vested Rights*, 23 URBAN L. ANN. 487 (1982).

36. BERKELEY, CAL., ORDINANCE 5506-N.S. (1982). The rezoning of Elmwood became effective July 19, 1984, more than two years after the passage of Measure I. *See infra* notes 45-63 and accompanying text.

37. BERKELEY, CAL., ORDINANCE 5603-N.S. (1983).

38. Its purposes include:

To maintain a scale and balance of retail goods and services in the district to compatibly serve the everyday needs of surrounding neighborhoods by:

1. providing locations for retail goods and service establishments to serve surrounding neighborhoods;
2. preventing development which exceeds the amount and intensity of use that is compatible with adjacent residential neighborhoods;
3. limiting the space occupied by businesses that generate high traffic and/or parking demands;
4. controlling the proliferation of establishments which, if not limited, might expand to displace establishments needed to serve surrounding neighborhoods; and
5. permitting other uses which serve this objective.

Id. § 9 D.1.

permits that are unsupported by zoning.³⁹

San Francisco also has utilized this approach. San Francisco has experienced considerable gentrification—both residential and commercial.⁴⁰ After the San Francisco Department of City Planning completed the neighborhood Commercial Conservation and Development Study in 1980, San Francisco established ten interim Neighborhood Commercial Special Use Districts.⁴¹ The planning department established density thresholds for specified businesses to protect neighborhood-serving retail service businesses. Any business exceeding these thresholds must obtain a special use permit.

In May 1984, the San Francisco Department of City Planning released proposed amendments to the Master Plan in the form of a Neighborhood Commercial section of the Commerce and Industry element of the city's Master Plan. The Department proposed the permanent establishment of neighborhood commercial district zoning controls to promote diversity among the city's neighborhood commercial districts, while assuring that each district continues to provide neighborhood-serving goods and services.⁴² The Department proposed

39. California requires that zoning ordinances be consistent with general plans. CAL. GOV'T CODE § 65,860 (Deering 1979). California courts have exempted conditional use permits from the consistency requirement. *Hawkins v. County of Marin*, 54 Cal. App. 3d 586, 594-95, 126 Cal. Rptr. 754, 760-61 (1976). For an analysis of the consistency doctrine, see DiMento, *Developing the Consistency Doctrine: The Contribution of the California Courts*, 20 SANTA CLARA L. REV. 285 (1980); DiMento, *Improving Development Control Through Planning: The Consistency Doctrine*, 5 COLUM. J. ENVTL. L. 1 (1978); DiMento, *Mandating Consistency Between General Plans and Zoning Ordinances: The California Experience*, 8 NAT. RESOURCES LAW 455 (1976).

40. See generally HARTMAN, *THE TRANSFORMATION OF SAN FRANCISCO* (1984).

41. See Cohen, *San Francisco's Neighborhood Commercial Special Use District Ordinance: An Innovative Approach to Commercial Gentrification*, 13 GOLDEN GATE L. REV. 367, 369 (1983).

42. See SAN FRANCISCO DEPARTMENT OF CITY PLANNING, *NEIGHBORHOOD COMMERCIAL REZONING STUDY*, May 1984, at 10. The Department explained this policy:

A function common to all neighborhood commercial districts is the provision of a variety of goods and services at affordable prices to meet the convenience needs of residents in adjacent neighborhoods. Many commercial districts also provide specialty goods and services to a larger, often city-wide trade area.

One of the unique charms of San Francisco is the diversity of its neighborhood shopping areas. The distinctive ethnic and lifestyle characteristics of different districts are a reflection of the needs, interests and tastes of the city's varied and ever changing population. The differing sizes of lots and blocks, and the scale and architectural style of buildings in various districts contribute also to their diversity.

The variation in function and character of commercial districts should be recognized through zoning whose controls on building form, scale, commercial use, and

to protect the creation of another fifteen special neighborhood commercial districts against over-development through this type of zoning.⁴³ This city-wide rezoning proposal remains under public review.

Like its Berkeley counterparts—Measure V and the rezoning of Elmwood—this policy does not protect directly the existing commercial tenants within protected neighborhood commercial districts from displacement. Instead, the policy restricts the use of properties within the district to promote diversity and neighborhood-serving businesses.

2. Historic Preservation

Recognizing that rezoning alone might not satisfy the concerns expressed by the Elmwood Preservation Alliance, the consultants also suggested classifying Elmwood as an historical preservation district. This recognizes the continuing effort of the Elmwood Landmarks Committee to designate Elmwood as an historic district.⁴⁴ Historic

operation reflect the differences between districts and reinforce the variations in individual land use patterns.

The essential character of neighborhood commercial districts should be preserved by discouraging uses which would be incompatible in scale or type with the district in which they are to be located. And while it is important to preserve and maintain the unique qualities of the various neighborhood commercial districts, districts should also be allowed to evolve over time in response to changes in the neighborhoods they serve and in consumer tastes and preferences.

The determination of the appropriateness of a proposed land use in a certain district should include consideration of the following basic aspects:

- Individual district character;
- Customer orientation of the district;
- Residential community living within and adjacent to the district;
- Necessity and desirability of the proposed use to the community; and
- Environmental impacts of the proposed use.

Id. at 10-11.

43. The proposed rezoning would limit the type and number of specified neighborhood-serving uses in Neighborhood Commercial Districts classified as follows:

- NC-1 Neighborhood Commercial Cluster District;
- NC-2 Small-Scale Neighborhood Commercial District;
- NC-3 Moderate-Scale Neighborhood Commercial District; and
- NC-4 Neighborhood Commercial Shopping Center District.

Id. at 53-279.

44. Commercial districts are recognized as historic sites throughout the country. Often, this results in the imposition of zoning controls designed to promote the preservation or restoration of the visual design of the designated buildings. *See supra* note 9. These aesthetic controls have not included price controls like those embodied by Measure I. *See* ADVISORY COUNCIL ON HISTORIC PRESERVATION, REMEMBER THE NEIGHBORHOOD: CONSERVING NEIGHBORHOODS THROUGH HISTORIC PRESERVATION TECHNIQUES (1981).

landmark designation is not likely to prevent displacement of existing businesses. Historic district status, which is used in many cities, does not guarantee continuing occupancy to existing commercial tenants.

3. Commercial Rent Stabilization

a. *The Proposed Initiative*

While supporting both rezoning and historic district designation, the Elmwood Preservation Alliance concluded that neither policy was sufficient to protect existing neighborhood businesses. Therefore, they proposed and placed on the June 1982 ballot an initiative entitled the "Elmwood Commercial Rent Stabilization and Eviction Protection Ordinance," more commonly known as Measure I. Measure I's stated purposes are: 1) to protect commercial tenants in the Elmwood district from rent increases that are not justified by landlord's cost increases; 2) to enable those tenants to continue serving residents of the Elmwood district without undue price increases, expansion of trade (which may exacerbate parking problems), or going out of business; and 3) to test the viability of commercial rent stabilization as a means of preserving businesses that serve the needs of local residents in Berkeley neighborhoods outside the downtown business district.⁴⁵ To accomplish these purposes, all commercial premises within the Elmwood district, including newly-constructed and rehabilitated units, are subject to rent and eviction regulation.

Measure I establishes a base rent date of October 1, 1981.⁴⁶ Leases remain unaffected until expiration of the lease.⁴⁷ An exception is provided for pre-existing leases executed within one year prior to the base rent date under which landlords increased the rent more than the increase in the regional CPI-U. Measure I reduces these rent increases to the level of the CPI-U increase for that period.⁴⁸ If the landlord did not raise the rent under a fixed payment lease within the year prior to the base date, the landlord is entitled to a five percent annual increase in the base rent for each year prior to the effective date of the ordinance in which the landlord did not raise the rent.⁴⁹

45. BERKELEY, CAL. ORDINANCE 5468-N.S. (1982) [hereinafter cited as MEASURE I]. For the full text of MEASURE I, see APPENDIX, *infra* p. 112.

46. MEASURE I, *supra* note 45, § 5(b).

47. *Id.* § 13(a).

48. *Id.* § 13(b).

49. *Id.* § 5(b)(iii).

Landlords are entitled to increased rents based on the following specified cost increases: 1) maintenance and operating expenses; 2) property taxes; 3) fees; and 4) improvements (amortized over their useful life).⁵⁰ Increases in debt service, which consists of principal and interest charges, can be passed on to tenants for financing capital improvements, but not for refinancing or purchase financing.⁵¹ Landlords may increase rents after giving tenants written notice and informing them of the cost increases involved.⁵²

In addition, landlords are guaranteed "a fair and reasonable return on investment."⁵³ Administration of this provision is delegated to Berkeley's Board of Adjustments (BBA)—a zoning board of appeals appointed by the Berkeley City Council—rather than to the city's independent Rent Stabilization Board. Measure I requires the BBA to enact fair return regulations.⁵⁴

Landlords may not evict tenants except for eight specified reasons.⁵⁵ Measure I prohibits retaliatory eviction, uncompensated reduction of services, and unreasonable refusals to permit lease assignments by landlords.⁵⁶ Lease waivers of protected tenant rights are deemed invalid.⁵⁷

Measure I designates the BBA as the agency for resolution of landlord and tenant disputes.⁵⁸ Tenants, the city, any interested party, or any neighborhood organization may sue any landlord that intentionally overcharges tenants.⁵⁹ Landlords found in violation are subject to both actual damages and treble, punitive damages.⁶⁰

While Measure I contains no sunset clause, the BBA may recommend that the City Council place amendments on the ballot.⁶¹ In addi-

50. *Id.* § 5(c)(i).

51. *Id.*

52. *Id.* § 5(c)(iv).

53. *Id.* § 6(a).

54. *Id.* § 6(c).

55. *Id.* § 9. See generally Note, *Just Cause Eviction: Limiting a Landlord's Ability to Evict*, 11 SAN FERN. V.L. REV. 71 (1983).

56. MEASURE I, *supra* note 45, §§ 7, 10. In the past, California landlords were not required to permit tenant lease assignments. See Comment, *The Approval Clause in a Lease: Toward a Standard of Reasonableness*, 17 U.S.F.L. REV. 681, 683 (1983).

57. MEASURE I, *supra* note 45, § 12.

58. *Id.* § 8.

59. *Id.* §§ 11(b), (c).

60. *Id.* §§ 11(a), (b).

61. *Id.* § 8(h).

tion, the Berkeley Comprehensive Planning Department is required to report annually on the impact and effectiveness of the ordinance. In its report, the Department may make recommendations concerning whether the City Council should leave the ordinance in operation, repeal it, or whether the City Council should expand the ordinance to include other neighborhood shopping districts in the City of Berkeley outside the downtown business district.⁶²

b. *The Campaign*

The Save Our Shops Committee, supported by other neighborhood groups, waged a successful campaign to enact Measure I. The Committee emphasized neighborhood preservation and protection for small businesses against displacement caused by speculation. Zoning was rejected as a viable alternative.

Opponents, including the Berkeley Chamber of Commerce, argued that commercial rent stabilization was unnecessary, would deter commercial investment, would not protect existing small businesses against displacement, and would require overly expensive administration.

Berkeley's two major political factions split over the initiative. Measure I passed by a resounding fifty-eight to forty-two percent margin on June 8, 1982. This unique regulatory experiment raised many administrative and legal issues, which are reviewed below. Many issues are similar to those long associated with residential rent control and the continuing controversy over its necessity and impact. These issues have been explored by proponents and opponents—including planners and economists—and by the courts, whose assessments and conclusions are relevant to the Elmwood experiment.⁶³

III. COMMERCIAL RENT CONTROL PRECEDENTS

Two commercial rent control precedents for Berkeley's Elmwood experiment are noteworthy: New York City and Berkeley itself. Albany, New York, also briefly instituted commercial rent control in 1948.⁶⁴

62. *Id.* § 16.

63. *See supra* note 11.

64. *See* 1948 N.Y. Laws ch. 679. *See also* B. FRIEDLANDER & A. CURRIERI, RENT CONTROL: FEDERAL, STATE, AND MUNICIPAL § 115 (1948).

A. *New York City: 1945-1963*

1. Statutory Structure

In 1945, New York State determined that emergency conditions attributable to World War II existed in New York City's commercial rental sector. The state enacted two companion laws to control rents: the Emergency Commercial Space Rent Control Law that was applicable to commercial space other than stores and offices,⁶⁵ and the Emergency Business Space Rent Control Law that was applicable to stores and offices.⁶⁶ New York's experience with commercial rent control from 1945 to 1963 offers the only sustained precedent for commercial rent control in American history. In view of recently renewed efforts to revive commercial rent control in New York City to protect small businesses from displacement, it is particularly instructive to review briefly the history of New York City's prior commercial rent control system.

In 1920, New York State and New York City promulgated the first rent control legislation in the United States.⁶⁷ In 1945, federal wartime residential rent control existed in New York City.⁶⁸ Unlike other major American cities, New York City continued residential rent controls when federal legislation expired in 1950. While New York City's complex rent control system has undergone many changes since 1943, it remains as controversial as ever.⁶⁹

New York's commercial rent control legislation resulted from an investigation in 1944 by a special committee of the New York State Legislature that responded to complaints about excessive rents and evictions from New York City commercial tenants. The committee's proposed remedial legislation was adopted quickly.⁷⁰ Modelled on the

65. N.Y. UNCONSOL. LAWS §§ 8521-38 (Consol. 1945) (Expired Dec. 31, 1963) [hereinafter cited as ECSRCL].

66. N.Y. UNCONSOL. LAWS §§ 8551-67 (Consol. 1945) (Expired Dec. 31, 1963) [hereinafter cited as EBSRCL]. The Emergency Commercial Space and Emergency Business Space Rent Control Laws were virtually identical. *See generally* Note, *New York Commercial and Business Rent Control Laws*, 21 N.Y.U. L. REV. 427 (1946); Note, *New York Commercial Rent Control Acts*, 19 ST. JOHN'S L. REV. 179 (1945).

67. 1920 N.Y. Laws chs. 130-39, 209-10. *See* Aron, *The New York Landlord and Tenant Laws of 1920*, 6 CORNELL L.Q. 1, 5 (1920).

68. B. FRIEDLANDER & A. CURRIERI, *supra* note 64, § 8.

69. *See, e.g.*, M. STEGMAN, *THE DYNAMICS OF RENTAL HOUSING IN NEW YORK CITY* (1982).

70. *See* Meringolo, *Rent Control: What Remains and Its Future*, 22 BROOKLYN L. REV. 207, 208-12 (1958).

original 1920 New York residential rent control law and the World War II federal legislation, the laws enacted in 1945 are very different from Berkeley's Measure I.

a. *Coverage*

The New York Legislature enacted city-wide legislation did not attempt to single out small business for protection. Exempted from control were the following: 1) specified businesses (for example, places of public assembly, port-related uses, and temporary parking lots); 2) leases with less than four month terms; 3) condemned property; 4) new construction;⁷¹ and 5) vacated space.⁷² This last exemption, a 1950 amendment, was particularly important. Vacancy decontrol and tenant turnover ensured the decontrol of many units as time passed.

The legislature also exempted leases with variable rents tied to sales volume and graduated rents. Upon lease expiration, the legislation required landlords to set these rents either by arbitration or on the basis of comparable rents.⁷³ Leases in effect since June 1, 1939, also were allowed to continue in effect. If the rent exceeded the allowable ceiling, however, the legislation required landlords to reduce the rent to a comparable rent level.⁷⁴

b. *Base Rents*

The base rents were those rents in effect on March 1, 1943, for commercial space and June 1, 1944, for business space.⁷⁵ The legislation allowed landlords to add fifteen percent to this base rent to cover this "rollback" period.⁷⁶ The legislation allowed increases through three different processes: 1) a written agreement between the landlord and the tenant; 2) arbitration, with the consent of the tenant; or 3) by order of the New York Supreme Court.⁷⁷ Like New York's original 1920

71. ECSRCL, *supra* note 65, § 8535 and EBSRCL, *supra* note 66, § 8564. New construction was not exempted originally. This exemption was added by a 1946 amendment.

72. ECSRCL, *supra* note 65, § 8533; EBSRCL, *supra* note 66, § 8562.

73. ECSRCL, *supra* note 65, § 8534; EBSRCL, *supra* note 66, § 8563.

74. ECSRCL, *supra* note 65, § 8522(e); EBSRCL, *supra* note 66, § 8552(c).

75. ECSRCL, *supra* note 65, § 8522(e); EBSRCL, *supra* note 66, § 8552(c).

76. ECSRCL, *supra* note 65, § 8522(e); EBSRCL, *supra* note 66, § 8552(c).

77. ECSRCL, *supra* note 65, §§ 8524(1), (3); EBSRCL, *supra* note 66, §§ 8554(1), (3).

rent control law, the legislature selected the courts, rather than an administrative agency, as the enforcement mechanism.

The legislation established guidelines for determining a reasonable rent based upon the tenants' proportional use of rentable commercial space in a building. The legislation required arbitrators and judges to consider maintenance and operating costs, including taxes but excluding amortization or interest on incumbrances. Also, the legislation required arbitrators and judges to consider the kind, quality, and quantity of services furnished by the landlord.⁷⁸ In effect, this allowed landlords to pass through their operating and maintenance costs to their tenants, and thereby maintain their net operating income (NOI) as long as they maintained services.

c. *Fair Return*

Landlords who believed that their controlled rents denied them a reasonable return could petition the New York Supreme Court for a rent increase. The statutory fair return formula entitled landlords to a net annual return of eight percent on the fair value of their property.⁷⁹ The statute presumed that fair value was the latest assessed value, but the landlord could offer other evidence on fair value.⁸⁰ The statutory scheme allowed landlords a six percent return on the value of the land and buildings, and two percent for amortization of outstanding mortgages. The legislation limited fair return rent increases to no more than fifteen percent annually.⁸¹

d. *Eviction Control*

Landlords could not evict protected commercial tenants except for specified causes similar to those contained in Measure I.⁸²

e. *Expiration*

Originally, the legislature set the 1945 laws to expire in 1946. Beginning with 1946 and continuing through 1963, the New York State Legislature periodically renewed the laws. The legislature also amended them, based upon the recommendations of the New York Temporary

78. ECSRCL, *supra* note 65, § 8524(1); EBSRCL, *supra* note 66, § 8554(1).

79. ECSRCL, *supra* note 65, § 8524(2); EBSRCL, *supra* note 66, § 8554(2).

80. ECSRCL, *supra* note 65, § 8524(1); EBSRCL, *supra* note 66, § 8554(1).

81. ECSRCL, *supra* note 65, § 8524(2); EBSRCL, *supra* note 66, § 8554(2).

82. ECSRCL, *supra* note 65, § 8528; EBSRCL, *supra* note 66, § 8558.

State Commission created in 1948 to study rents and rent conditions.⁸³ Landlords opposed these extensions through the political and legal processes, but did not succeed until 1963, when the statutes finally expired.

As this outline indicates, similarities exist between these World War II era New York statutes and Measure I. On the other hand, the most significant differences are: 1) coverage—New York was city-wide in scope with some businesses and new construction exempted, while Berkeley's coverage is limited geographically, but contains no exemptions; 2) vacancy decontrol—New York allowed vacancy decontrol, while Berkeley does not; 3) fair return—New York's fair return formula was statutory, while Berkeley delegates its definition to an administrative agency; 4) administration—while both are partially self-enforcing by landlords and tenants, New York's system was legally enforceable only through the courts, while Berkeley selected the BBA as its administrative agency for resolution of disputes; and 5) duration—New York laws contained sunset clauses and the state determined extension, while Berkeley's experimental initiative contains no sunset clause and must be amended or repealed by voter referendum.

2. Gradual Decontrol

Perhaps the most important difference between New York City's system and Berkeley's experiment is that very shortly after its creation, the New York Legislature amended its laws to provide for gradual decontrol of commercial rents.

The 1950 vacancy decontrol amendment did not ensure decontrol of the regulated commercial rental market because commercial tenants might refuse to vacate voluntarily. So-called "misfit" tenants refused to vacate unless landlords paid them handsomely to leave. Other commercial tenants vacated, but sublet the premises to subtenants that paid them, rather than their landlords, rent in excess of regulated rent. The legislature, under landlord pressure to encourage selective decontrol in the absence of repeal of the laws and to prevent tenant "holdouts" and windfalls, successively weakened the legislation to encourage decontrol.

Beginning in 1949, the legislature permitted landlords to evict store tenants that failed to meet the terms of "matching" leases offered to prospective replacement tenants. Initially, landlords could evict ten-

83. See Meringolo, *supra* note 70, at 224.

ants that were unable or unwilling to match a noncancellable lease at an annual rental rate of \$7,500 for a term of ten years or more. By 1960, the legislature reduced the threshold annual rent for a noncancellable matching lease to \$2,500.⁸⁴

In 1952, the legislature weakened further store controls by allowing landlords to evict tenants without making a matching offer when they intended to assemble several spaces into a single unit renting for \$10,000 or more annually.⁸⁵

In 1956, the legislature authorized landlords to evict tenants whose leases had expired if they refused to accept a lease with a term of two years or more. Initially, this applied to stores and non-store space renting for \$20,000 or more annually and was reduced to only \$2,500 by 1960.⁸⁶

To prevent tenant windfalls attributable to subletting, a 1950 amendment provided landlords with the option of requiring subtenants subletting twenty percent or more of their space to pay to the landlord the net rent that they received from the subtenant.⁸⁷

In conclusion, the combination of vacancy decontrol, the matching lease and space consolidation provisions, and the restrictions on subletting made the New York legislation significantly weaker than Berkeley's Measure I.

3. Judicial Interpretation

Exhaustive analysis of judicial interpretation of the New York statutes is not a primary focus of this Article. Numerous reported decisions have interpreted New York's commercial rent control scheme. Because these decisions focus on particular statutory provisions, they are not necessarily relevant to future judicial review of Measure I and any additional contemporary counterparts. Nevertheless, they do provide guidance on many issues likely to arise in the future.

Analysis of the commercial rent control precedents established in New York is limited to two subjects: constitutionality and fair return. Both of these fundamental issues are likely to arise if Berkeley's Measure I is challenged legally. Therefore, a discussion of the leading decisions of the New York Court of Appeals follows.

84. ECSRCL, *supra* note 65, § 8528(k); EBSRCL, *supra* note 66, § 8558(k).

85. ECSRCL, *supra* note 65, § 8528(kk); EBSRCL, *supra* note 66, § 8558(kk).

86. ECSRCL, *supra* note 65, § 8528(gg); EBSRCL, *supra* note 66, § 8558(gg).

87. ECSRCL, *supra* note 65, § 8524(4); EBSRCL, *supra* note 66, § 8554(4).

a. *Constitutionality*

The New York Court of Appeals swiftly reviewed the constitutionality of the Commercial Rent Control Act. Within six months of its enactment, the court upheld the Act's constitutionality in *Twentieth Century Associates v. Waldman*.⁸⁸ The challengers claimed that the Act impaired a pre-existing lease contract that the landlord sought to enforce.

The court upheld the use of the state's police powers in an emergency to regulate commercial rents. The court based its holding upon the findings of the legislative committee, United States Supreme Court precedents that upheld the 1920 residential rent control law against similar challenges,⁸⁹ and the depression-era mortgage moratorium laws.⁹⁰ The court found the legislation reasonably related to its purposes. It noted that the statutory scheme entitled landlords to judicial review of regulated rents. It also concluded that the statute did not violate constitutional guarantees of due process and equal protection.⁹¹

In *Finn v. 415 Fifth Avenue Co.*,⁹² the Second Circuit Court of Appeals, in an opinion by Judge Learned Hand, upheld the constitutionality of the same act when a landlord claimed that the Act constituted a taking of private property without due process of law under the fourteenth amendment. Judge Hand cited the New York Court of Appeals decision and the precedents relied upon by that court. The United

88. 294 N.Y. 571, 63 N.E.2d 177 (1945), *appeal dismissed*, 326 U.S. 696 (1946). In *Court Square Bldg. v. City of New York*, 298 N.Y. 380, 83 N.E.2d 843 (1948), *cert. denied*, 337 U.S. 916 (1949), the court of appeals summarily upheld the validity of the Emergency Business Space Rent Control Law relying upon the rationale of this decision.

89. See *Levy Leasing Co. v. Siegal*, 258 U.S. 242 (1922); *Marcus Brown Holding Co. v. Feldman*, 256 U.S. 170 (1921); *Block v. Hirsh*, 256 U.S. 135 (1921). For an analysis of these cases, see Baar & Keating, *The Last Stand of Economic Substantive Due Process—The Housing Emergency Requirement for Rent Control*, 7 URB. LAW. 447, 460-65 (1975).

90. See *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 447-48 (1934).

91. See *A.E.F.'s v. City of New York*, 295 N.Y. 381, 68 N.E.2d 177 (1946). The New York Court of Appeals rejected a tenant claim that the statutory exemption of piers, docks, and ferries violated its due process and equal protection rights. *Id.* at 385, 68 N.E.2d at 179. The commercial tenant operated a flower and fruit stand concession in the terminal of the Staten Island Ferry, which was found to fall within this exception to the EBSRCL. *Id.* at 384, 68 N.E.2d at 178.

92. 153 F.2d 501, 504 (2d Cir.), *cert. denied*, 328 U.S. 839 (1946). The landlord unsuccessfully argued that a trustee in bankruptcy was not really a tenant.

States Supreme Court declined to review either decision.⁹³

In the wake of the renewal of the Business Space Act in 1955, a landlord again challenged the constitutionality of the statute on the ground that the emergency that justified rent regulation had ended. Landlords had opposed unsuccessfully the extension of the Act in public hearings conducted by the New York Temporary State Commission. In *Charleston Corp. v. Sinclair*,⁹⁴ the United States Supreme Court had ruled that the courts reserved the right to determine if a rational basis existed for the legislative declaration of an emergency sufficient to invoke the police power for the public purpose of rent regulation.

The landlord presented the same evidence and witnesses that commercial landlords had presented earlier to the New York Temporary State Commission. The landlord attempted to prove that the emergency had ended because of the construction of substantial new office space and an adequate vacancy rate.⁹⁵ The court of appeals, relying upon the contention of the New York Attorney General who disputed the validity of the landlords' factual claims, concluded that the plaintiff had failed to overcome its heavy burden of proof—at least in 1955. The court added that whether and for how long the legislature lawfully could continue office rent control was a question open for future review.⁹⁶

That review came in 1960 in an action brought by the same landlord, following the legislature's 1959 extension of the commercial rent control law. Again, the landlord offered similar evidence, which the New York Temporary State Commission and the New York Attorney General had rejected. The court of appeals again concluded that the landlord failed to carry his heavy burden of proof.⁹⁷

93. *Finn*, 153 F.2d 501 (2d Cir.), *cert. denied*, 328 U.S. 838 (1946); *Twentieth Century Assocs.*, 294 N.Y. 571, 63 N.E.2d 177 (1945), *appeal dismissed*, 326 U.S. 696 (1946).

94. 264 U.S. 543 (1922).

95. See *Lincoln Bldg. Assocs. v. Barr*, 1 Misc. 2d 560, 566, 149 N.Y.S.2d 460, 467 (N.Y. Sup. Ct. 1956), *aff'd*, 1 N.Y.2d 413, 135 N.E.2d 801, 153 N.Y.S.2d 633, *appeal dismissed*, 355 U.S. 12 (1957).

96. 1 N.Y.2d 413, 420, 135 N.E.2d 801, 806, 153 N.Y.S.2d 633, 639 (1956), *appeal dismissed*, 355 U.S. 12 (1957). The following year the court of appeals rejected a similar challenge to the constitutionality of the continuation of hotel rent control. *Hotel Ass'n of New York City v. Weaver*, 3 N.Y.2d 206, 217, 144 N.E.2d 14, 20, 65 N.Y.S. 2d 17, 26 (1957).

97. *Lincoln Bldg. Assocs. v. Jame*, 8 N.Y.2d 179, 168 N.E.2d 528, 203 N.Y.S.2d 86 (1960). "The evidence presented by the landlord, as developed at trial, served only to

Additionally, the court pointed to the legislature's weakening of the law through a 1956 decontrol amendment as an indication of the implementation of a program of gradual relaxation of controls: "It is our opinion that such a process of gradual, rather than abrupt, cessation of controls, commensurate with the moderation in market conditions, effectuates a transition from controls to normal landlord-tenant relations in a rational and orderly manner, without economic disruption and dislocation."⁹⁸ Given its two preceding opinions on the subject and the weakening of commercial rent control through additional decontrol amendments, this conclusion is hardly surprising.

b. *Fair Return*

The New York Court of Appeals consistently upheld the constitutionality of the fair return formula of the commercial rent control laws and its application. The court upheld the validity of the statutory presumption that it guaranteed landlords a reasonable return without analyzing the eight percent return on current assessed value formula. Instead, the court's review generally concerned the application of the formula.

In *Relmar Operating Corp. v. Roffer*,⁹⁹ the court held that a commercial landlord was entitled only to a fair return from the entire building, but not to a pro rata share from each individual commercial tenant occupying space in the building. In *Hecht Broadway Corp. v. Ashenfarb*,¹⁰⁰ the court rejected the argument that the fair return formula unconstitutionally discriminated in favor of landlords with mortgages who were entitled to an eight percent return, while owners of nonmortgaged properties were entitled only to a six percent rate of

demonstrate that the intensity of the emergency which prevailed in 1955 [the period reviewed in the *Barr* case] has moderated to some extent, but not in substantial degree." *Id.* at 181, 168 N.E.2d at 529, 203 N.Y.S.2d at 88. See Note, *Rent Control—Review of Emergency Commercial and Business Space Rent Control Laws—Gradual Cessation of Controls*, 7 N.Y.L.F. 81 (1961).

98. 8 N.Y.2d at 182, 168 N.E.2d at 529-30, 203 N.Y.S.2d at 88-89. The court cited the right of the landlord to decontrol the unit after the expiration of a two year lease or immediately if the tenant refused to accept and the reduction of the applicable annual rent threshold from \$20,000 to only \$2,500 by 1960 after the commencement of this litigation. *Id.*

99. 297 N.Y. 609, 75 N.E.2d 626 (1947). The courts, however, were authorized to adjust the rents of any individual tenants in setting an overall fair return for the entire building. ECSRCL, *supra* note 65, § 8524(2); EBSRCL, *supra* note 66, § 8554(2).

100. 298 N.Y. 769, 83 N.E.2d 464 (1948).

return. Finally, in *Steinberg v. Forest Hills Golf Range, Inc.*,¹⁰¹ the court ruled that landlords were not entitled automatically to the statutory rate of return because the law only created a "presumption" that this was a fair return. In this case, the owner received a return of only three and one-half percent on unimproved property. The landlord's mortgage interest was double the rent. The fair return formula did not take debt service into account. If, on the other hand, the landlord already was receiving a return in excess of the statutory formula, the New York Supreme Court could deny a rent increase.¹⁰²

The court of appeals, New York's lowest appellate courts, and the trial courts addressed numerous procedural issues concerning the application of the return on assessed value formula. Under this formula, a landlord was entitled to petition for a rent increase, subject to the fifteen percent annual adjustment ceiling,¹⁰³ if the base rent plus allowable operating and maintenance cost pass through increases failed to provide the statutory fair return.¹⁰⁴ The statutory scheme required landlords to file a "bill of particulars" to establish their income and operating and maintenance expenses.¹⁰⁵ These figures then were sub-

101. 303 N.Y. 577, 105 N.E.2d 93 (1952). The same conclusion was reached in other circumstances. See, e.g., *In re Rego Park Houses*, 201 Misc. 126, 113 N.Y.S.2d 174 (N.Y. Sup. Ct. 1951) (where the property was condemned).

102. See *In re Cara Realty Corp.*, 282 A.D. 700, 700, 122 N.Y.S.2d 72, 74 (1953).

103. The court of appeals upheld this ceiling. See *A.E.F.'s*, 295 N.Y. 381, 68 N.E.2d 177 (1946). See also *In re Court & Remson Bldg. Corp.*, 303 N.Y. 358, 102 N.E.2d 696 (1951).

104. *In re Rutherford Estates*, 95 N.Y.S.2d 658 (N.Y. Sup. Ct.), *aff'd*, 301 N.Y. 767, 95 N.E.2d 821 (1950) (the tenants unsuccessfully argued that the landlord must pay these and any other expenses from net income based upon a fair and reasonable rental value); *In re 551 Fifth Ave.*, 197 Misc. 217, 97 N.Y.S.2d 266 (N.Y. Sup. Ct. 1949) (the cost of operation and maintenance are included impliedly in the formula applied in fixing rents).

105. This bill was required to set forth the gross income derived from the entire building or other rental area during the preceding year, the names and addresses of all tenants, the rental charged each tenant and how payable, the consideration paid by the landlord for the entire property including the land, if he be the owner thereof, or if he be a lessee the name and address of the lessor and the rent agreed to be paid; the assessed valuation of the property as shown by the latest completed assessment-roll of the city, separately showing the amount of the assessment on the building and the amount of the assessment on the land; the cost of maintenance and operation of the building or other rental area during the preceding year, the kind, quality and quantity of services furnished during such year; and such other facts as the landlord claims affect the net income of the entire building or other rental area, or the reasonableness of the rent to be charged.

ECSRCL, *supra* note 65, § 8524(1); EBSRCL, *supra* note 66, § 8554(1). In *In re Trustees of the Masonic Hall and Asylum Fund*, 1 N.Y.2d 616, 623, 136 N.E.2d 889, 896,

ject to tenant challenges and judicial review.¹⁰⁶

In numerous cases the courts readjusted income and expense data in determining what constituted "net annual return." In *Court Square Building, Inc. v. City of New York*,¹⁰⁷ the court of appeals ruled that gross income must be computed on the basis of actual income. In *In re Trustees of the Masonic Hall and Asylum Fund*,¹⁰⁸ the court of appeals revised a landlord's income by including imputed income from tax savings from its charitable status.

If maintenance costs actually constituted capital improvements, the courts reserved the right to consider their probable life and prorate these costs, because the statutes made no specific provision for capital improvements.¹⁰⁹ Courts also could add the value of capital improvements to the assessed value in determining value.¹¹⁰

The statutes made no specific provision for depreciation. Landlords claimed this constituted an operating expense. In *In re Fifth Madison Corp.*,¹¹¹ the court of appeals held that the statutory fair return formula for operating and maintenance costs was limited to actual costs. Because depreciation constituted a theoretical cost, landlords were not entitled to any reimbursement for it unless they proved actual physical deterioration of the building.

In several cases, the courts took the actual physical condition of the

154 N.Y.S.2d 937, 943-44 (1956), the court of appeals ruled that the trial court may consider changes in landlords' income and expenses between the filing of the petition and the trial. See also *In re Alibel Corporation*, 285 A.D. 140, 136 N.Y.S.2d 344 (1954) (post-petition changes in income are proper facts for consideration in computing reasonable rent income).

106. See *In re Frankel*, 269 A.D. 531, 533, 56 N.Y.S.2d 316, 318 (1945) (case remanded because the trial judge failed to indicate what allowances he made for the landlord's operating and maintenance expenses).

107. 298 N.Y. 380, 83 N.E.2d at 843 (1949). The court disallowed inclusion of a 15% rent adjustment to which the landlord might be entitled in gross rent. As a result, the City of New York's proportional rent—for occupancy by the municipal court—was increased to provide the landlord with the statutory fair return. Income from residential tenants in mixed-use buildings was deducted from gross income. See, e.g., *In re Birrell*, 13 Misc. 2d 165, 169-70, 175 N.Y.S.2d 449, 453-54 (N.Y. Sup. Ct. 1958).

108. 1 N.Y.2d 616, 623-24, 136 N.E.2d 889, 897, 154 N.Y.S.2d 937, 944-45 (1956).

109. See *Schack v. Handel*, 277 A.D. 1, 62 N.Y.S.2d 407 (1946) (must consider probable life of improvements in determining reasonable rents).

110. See, e.g., *In re Trustees of the Masonic Hall and Asylum Fund*, 1 N.Y.2d 616, 624-25, 136 N.E.2d 889, 897, 154 N.Y.S.2d 937, 945-46 (1956) (cost of utility conversion improvements added to assessed value).

111. 297 N.Y. 155, 77 N.E.2d 134 (1948) (without the inclusion of depreciation, the landlord only received a 5.23%, instead of the statutory 6%, return).

building into account. The statutes allowed the courts to consider the kind, quality, and quantity of services furnished.¹¹² When the building substantially violated code standards, the courts reduced the rate of return below the statutory standard.¹¹³ In determining a fair and reasonable rent, the courts noted that landlords could not cast additional burdens or expenses chargeable to the maintenance of the building upon the tenants of the business space for any inadequacy of the rent.¹¹⁴

Landlords often disputed whether the assessed value represented the fair market value. The courts held that this was a rebuttable presumption. Landlords often introduced evidence in the form of real estate appraisers' opinions in their attempts to overcome this presumption and challenge assessed value. Generally, the most recent assessed value provided the basis for determining fair return.¹¹⁵ The fact that the landlord had applied for a tax assessment reduction was not considered conclusive as to the actual value.¹¹⁶ In *In re Trustees of the Masonic Hall and Asylum Fund*,¹¹⁷ the court of appeals held that a tax exempt landlord's tax savings constituted imputed income and could not be added to assessed value. The courts allowed consideration of the improvements when value was in dispute.¹¹⁸ As previously indicated, consideration was given, where appropriate, to the physical condition of the building. The courts, as required by the statutes,¹¹⁹

112. ECSRCL, *supra* note 65, § 8524(1); EBSRCL, *supra* note 66, § 8554(1).

113. *See, e.g., In re Murphy*, 278 A.D. 814, 104 N.Y.S.2d 500 (1951) (the building was 60 years old, unheated, rundown, and rat-infested); *In re Broaduane Corp.*, 137 N.Y.S.2d 112 (N.Y. Sup. Ct. 1952) (a very old and neglected building).

114. *See, e.g., In re Sewdon Realty Corp.*, 31 N.Y.S.2d 427, 431 (N.Y. Sup. Ct. 1948).

115. The use of a prior figure was disfavored. *See, e.g., In re 104 Bleeker St.*, 284 A.D. 257, 131 N.Y.S.2d 408 (1954).

116. *See, e.g., In re Broaduane Corp.*, 384 A.D. 1034, 137 N.Y.S. 2d 112 (N.Y. Sup. Ct. 1952); *In re No. 1 West 39th St. Corp.*, 14 Misc. 2d 149, 178 N.Y.S.2d 141 (N.Y. Sup. Ct. 1958).

117. 1 N.Y.2d 616, 623-24, 136 N.E.2d 889, 895, 154 N.Y.S.2d 937, 945 (1956).

118. *See, e.g., Cedar-Temple Realty Corp. v. Astor*, 276 A.D. 2d 139, 93 N.Y.S.2d 259 (1949) ("fair and reasonable proportion of the gross rentals . . . [must] be determined upon the basis of the relative rental values of floor space"); *Schack v. Handel*, 271 A.D. 1, 62 N.Y.S.2d 407 (1946) ("probable life of improvements having some degree of permanency should be considered in fixing the amount to be charged as expenses").

119. ECSRCL, *supra* note 65, § 8524(1); EBSRCL, *supra* note 66, § 8554(1).

apportioned allowable rent increases based upon the tenants' pro rata occupancy of commercial space and the fair rents per square foot.

New York's history of commercial rent control offers several lessons. First, the courts consistently sustained the statutes against constitutional attacks based on alleged violations of landlords' contracts, due process, and equal protection rights.

Second, the courts rejected repeated landlord claims that the emergency justifying commercial rent control had concluded. The courts presumed that the New York Legislature, based upon periodic reviews by the Temporary State Commission, was justified in extending controls. Significantly, the New York Court of Appeals took this stance while pointing to the state's policy of gradual decontrol. Whether the courts would have treated a more stringent regulatory system differently is unknown.

Third, because of the system's structure, and the litigious nature of commercial landlords and tenants, the courts reviewed the application of the statutes on numerous occasions. This body of case law provides considerable insight into the issues that arose under the New York System.

Finally, the courts upheld the validity of New York's fair return formula and reviewed the major issues arising from its application. Unfortunately, no systematic evaluation of New York City's commercial rent control program was ever conducted. Therefore, its impact remains undocumented.

B. *Berkeley: 1978-1979*

1. Statutory Structure

Aside from New York City, Berkeley itself serves as the only other precedent for commercial rent control. On November 7, 1978, Berkeley voters approved an initiative ordinance entitled "Renter Property Tax Relief." This initiative was designed to provide a partial rebate to residential and commercial tenants of landlords' windfall gains from the property tax reductions that resulted from the June 1978 passage of Proposition 13.¹²⁰

The initiative required all landlords to reduce their 1979 rents by an amount equal to eighty percent of their Proposition 13 property tax savings. To prevent landlords with short-term leases from recapturing this rebate through rent increases, the initiative provided for control of

120. See *supra* note 26.

rent increases. The initiative permitted landlords to increase rents for operating expenses, maintenance cost increases, and capital improvements. The initiative failed to provide for an administrative enforcement mechanism. At its expiration date of December 31, 1979, the commercial rent regulation was not renewed. Residential rent controls, however, were extended, first by the Berkeley City Council and later by the Berkeley voters.

Several significant differences exist between the temporary initiative and Measure I. First and foremost, this regulation was not so much of a commercial rent control scheme as it was a limited form of property tax relief; its purpose was not to prevent the displacement of merchants. It was city-wide in scope and, furthermore, the regulation was self-enforcing. Finally, the regulation contained a sunset clause. In view of these significant differences, little similarity exists between the two Berkeley initiatives.

2. Judicial Interpretation

In *Rue-Ell Enterprises v. City of Berkeley*,¹²¹ the only case involving a challenge to the ordinance's validity, the California Court of Appeal posthumously upheld the ordinance's constitutionality. A commercial landlord challenged the application of the initiative to two of his ten commercial properties. The leases involved provided for cost-of-living rent adjustments. The ordinance reduced the combined monthly rents of \$2,158 of the commercial tenants by \$199.

The landlord asserted that the ordinance violated the contract clauses of the United States and California Constitutions and that the California property tax law preempted the ordinance. The landlord's contract clause argument assumed that the ordinance substantially impaired his pre-existing leases and that an emergency, which did not exist, was required to justify the contract impairment. The court rejected the argument because the law only partially recaptured windfall gains and only then for the one year that it was in effect.¹²² After it reached that conclusion, the court found it unnecessary to pursue the additional analytical steps applied recently by the United States Supreme Court in contract impairment cases.¹²³

121. 147 Cal. App. 3d 81, 194 Cal. Rptr. 919 (1983).

122. *Id.* at 85-86, 194 Cal. Rptr. at 924.

123. See, e.g., *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400 (1983); *Exxon Corp. v. Eagerton*, 462 U.S. 176 (1983). In *Energy Reserves Group*, the Supreme Court set out a three step inquiry for review under the contract clause:

Furthermore, the court noted that an "emergency" was no longer required to justify contract regulations. Instead, the United States Supreme Court has held that these regulations "must have a significant and legitimate public purpose . . . such as remedying . . . a broad and general social or economic problem."¹²⁴ This is in accord with *Birkenfeld v. City of Berkeley*,¹²⁵ in which the California Supreme Court held that an emergency was no longer needed for the regulation of residential rents. The court did not review the trial judge's consideration of evidence introduced by the City of Berkeley to prove that a shortage of commercial rental space existed.¹²⁶

Finally, the court rejected the claim that California law preempted this type of regulation, citing the California Supreme Court's prior decision regarding state preemption of residential rent control.¹²⁷

Rue-Ell, however, provides little guidance as to how the courts will view Measure I, both on its face and as applied by the BBA since June 1982.

IV. THE IMPLEMENTATION OF COMMERCIAL RENT STABILIZATION IN BERKELEY: 1982-1984

A. Administration

Berkeley provided for the implementation of Measure I by appointing a member of the City's Planning and Community Development staff as the program coordinator. The Mayor and City Attorney's staff provided additional administrative support to the BBA.

B. Administrative Regulations

The BBA issued its initial regulations implementing Measure I in

1) whether the state enactment operates substantially to impair a contractual relationship; 2) if so, whether the state has a significant and legitimate public purpose behind the regulation; and 3) if so, whether the adjustment of the rights and responsibilities of the contracting parties is based upon reasonable conditions and is of a character appropriate to the public purpose justifying the law's adoption. 459 U.S. 410-12. See generally Note, *Rediscovering the Contract Clause*, 97 HARV. L. REV. 1414 (1984).

124. *Energy Reserves Group*, 459 U.S. at 411-12.

125. 17 Cal. 3d 129, 146-50, 550 P.2d 1001, 1018-23, 130 Cal. Rptr. 465, 481-86 (1976).

126. *Rue-Ell*, 147 Cal. App. 3d at 88, 194 Cal. Rptr. at 926.

127. *Id.* (citing *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 163, 550 P.2d 1001, 1026, 130 Cal. Rptr. 465, 490 (1976)).

October 1982. These regulations require Elmwood's commercial landlords to notify tenants of prevailing rents, any rent increases, petitions to the BBA for extraordinary rent increases, and their right to challenge these by petition to the BBA. The regulations also establish a process for the filing and reviewing of these petitions and set forth an amortization schedule for capital improvements. Since the issuance of these regulations, the BBA has authorized Elmwood's commercial landlords to raise rents for their increased operating and maintenance expenses, and amortized capital improvements, without having to notify or seek the consent of the BBA.

C. *Fair Return*

Measure I guarantees landlords a "fair and reasonable return on investment."¹²⁸ None of these terms is defined. If landlords believe that their rents under Measure I, including any base rent adjustments, increases for increased operating and maintenance expenses, and amortized capital improvements, fail to provide them with a fair return, Measure I allows them to petition the BBA for "extraordinary" rent increases.¹²⁹ Measure I requires the BBA to issue fair return regulations.¹³⁰

Exactly what constitutes a fair return under rent control has been a leading issue since the inception of American-style rent control. The courts often have attempted to define a fair return under residential rent controls. To date, the legal standards applicable to fair return remain inconsistent and confused. Since the advent of contemporary state and local rent controls outside New York in 1969, the California, Massachusetts, and New Jersey appellate courts have attempted repeatedly to solve this puzzle. These state residential rent control cases have precedential value for determining the validity of the BBA's fair return formula for Elmwood's commercial landlords and tenants.

Several factors influenced the BBA when it initiated the Measure I program. First, in *Birkenfeld*, the California Supreme Court failed to define what it meant when it enunciated a fair return standard for residential rent control which required that landlords be guaranteed "a just and reasonable return on their property."¹³¹ In California, no de-

128. MEASURE I, *supra* note 45, §§ 6(a), (c).

129. *Id.* § 6(b).

130. *Id.* § 6(c).

131. *Birkenfeld*, 17 Cal. 3d at 165, 550 P.2d at 1026-27, 130 Cal. Rptr. at 491.

finite legal guidelines existed to guide the BBA.

Second, five competing fair return standards, which are listed in Table 2, existed from which the BBA could choose. All of these have been applied to residential landlords and are applicable to commercial landlords.¹³²

Table 2
Fair Return Standards

1. Cash Flow

gross rent = operating expenses + mortgage payments

1a. return on gross rent (a variant of the cash flow standard)

gross rent = x (operating expenses + mortgage payments)

2. Return on Equity

gross rent = operating expenses + mortgage payments
+ x (cash investment)

3. Return on Value

gross rent = operating expenses + x (value)

4. Percentage Net Operating Income

gross rent = x (operating expenses)

5. Maintenance of Net Operating Income

gross rent = base date gross rent + (current operating expenses - base date operating expenses)

Under the cash flow standard, a landlord is entitled to rents that are sufficient to cover operating expenses and mortgage payments. The impact of this formula varies according to landlords' financing arrangements. Recent purchasers whose higher interest mortgages have resulted in negative cash flow may be entitled to large rent increases under this standard.

The fair return on gross rent formula utilizes the same variables as the cash flow standard, but differs because it guarantees that the rent

132. For an excellent discussion of these fair return standards, see Baar, *Guidelines for Drafting Rent Control Laws: Lessons of a Decade*, 35 RUTGERS L. REV. 721, 781-817 (1983).

will yield a cash flow equal to a specified percentage—for example, six to eight percent—of the sum of operating expenses and mortgage payments.

The fair return on equity formula usually defines equity as the landlord's original cash investment. This often is adjusted when refinancing and capital improvements have occurred and also may be adjusted for inflation. A percentage return is chosen, and often is tied to prevailing mortgage interest rates. The rents required to provide a fair return vary considerably depending on the timing and nature of a landlord's investment and financing arrangements.

The return on value standard does not take into account a landlord's investment and financing. A percentage return is based upon the value of the property. Value may be defined as assessed value. The New York commercial rent laws, which set current assessed value as the fair value, took this approach.¹³³ The shortcomings of the property tax assessment system pose serious problems in applying this standard.¹³⁴

Alternative standards for determining value include: 1) purchase price; 2) historic value—that is, the market value prior to the adoption of rent control; 3) comparable value in a balanced or equilibrium market; and 4) replacement costs. Each of these standards, however, poses serious problems. Purchase prices may not be a valid indicator of current value, may discriminate against long-term owners while rewarding recent purchasers, and are subject to manipulation by purchasers. Historic value may incorporate an inflated pre-rent control market and institutionalize artificially high values reflecting spiralling rents. Values in an equilibrium market require a determination of hypothetical values based upon comparable rents. This exercise is virtually impossible, making this standard unworkable in practice because the standard would require the calculation of the value of all regulated properties. Finally, replacement cost is not a valid indicator of current value. Replacement value based upon construction costs usually exceeds current value.

In addition to these problems, the most important conceptual problem with the return on value standard is its circularity. Because the value of regulated property is determined by its projected income stream, and rent controls determine rents, value is determined in a cir-

133. See *supra* text accompanying notes 79-81.

134. Baar, *supra* note 132, at 799-800.

cular fashion. If unregulated rents, as opposed to regulated rents, are used to determine value, then the purpose of regulation is thwarted.

Under the percentage net operating income standard, a rent increase is warranted if the net operating income is less than a designated percentage of its gross rental income. The purpose of this standard is to provide landlords with a guaranteed minimum net operating income to gross rent ratio that provides adequate income for debt service and profit.

There are major advantages to the percentage net operating income standard. It avoids the circularity associated with return on value standards. In addition, the owner's particular purchase price, investment, or financing arrangements are not variables in the calculation. The primary disadvantage of the standard is that it establishes a fair uniform net operating income to gross rental income ratio, when, in fact, landlords' net operating income to gross rent ratios vary widely.

Under the maintenance of net operating income standard, landlords are entitled to rent increases sufficient to cover increased operating and maintenance expenses, exclusive of debt service. Landlords' net operating income (NOI) may be fully or partially adjusted for inflation. This formula avoids the problems associated with the other fair return standards and guarantees the maintenance of the landlords' pre-rent control NOI. The formula has been criticized for failing to guarantee landlords a positive cash flow and for its acceptance of landlords' differing individual NOI.

Rather than analyze the arguments for and against these fair return formulas, their adoption under residential rent controls, and their judicial treatment, the reader is referred to an exhaustive treatment of this subject.¹³⁵ The arguments for and against alternate fair return formulas made by Elmwood landlords and tenants, and the legal issues raised by the fair return formula adopted by the BBA, are considered below.

A third factor that influenced the BBA's formula decision was Berkeley's residential Rent Stabilization Board's (BRSB) adoption of a maintenance of net operating income (MNOI) fair return standard for residential housing. Landlords could apply for adjustments if their adjusted base rent did not maintain their individual NOI on a dollar-for-dollar basis¹³⁶ as of May 1980—the base rent date. Landlords are entitled to annual general adjustments based upon city-wide increases in

135. *Id.* at 781-817.

136. Berkeley, Cal., Rent Stabilization Board Regulations, §§ 1262-66 (1981).

operating and maintenance costs.¹³⁷ Like Measure I, Berkeley's 1980 residential rent control initiative delegated the formulation of a fair return formula to an appointed board, which adopted the formula on the basis of legislative criteria.¹³⁸ In the debate over the adoption of this standard, landlord representatives on the BRSB unsuccessfully argued that the BRSB should not only maintain residential landlords' NOI at its pre-1980 level, but also should partially or fully adjust the NOI for inflation. Commercial landlords hold the same views.

Fourth, the BBA had no useful commercial rent control precedents. The New York formula was not applicable because the BBA could not presume that assessed value represented a fair value. Proposition 13, which went into effect in 1978, had artificially reduced assessed values to their 1975 levels. With few exceptions—for example, a current full market value assessment immediately following a bona fide transfer—the assessment of most California commercial property did not reflect current market value. Berkeley's short-lived predecessor initiative regulating commercial rents had no fair return formula.

Finally, Measure I already guaranteed that Elmwood's commercial landlords would maintain their NOI because Measure I entitled them to pass through immediately all increases in operating and maintenance expenses. Because Measure I entitled landlords to "extraordinary" additional rent adjustments if necessary to provide a fair and reasonable return on investment, the measure seemed to preclude the BBA from adopting the simple dollar-for-dollar MNOI standard that the BRSB had adopted for residential rent control.¹³⁹

To address these questions, the BBA appointed a Fair Return Subcommittee and hired the same consultants that had assisted the BRSB in the formulation of its fair return standards.¹⁴⁰ The BBA and its Fair Return Subcommittee deliberated for approximately one year before

137. BERKELEY, CAL., RENT STABILIZATION AND EVICTION FOR GOOD CAUSE ORDINANCE § 11(b) (1980). The California Supreme Court recently upheld the constitutionality of this provision in *Fisher v. City of Berkeley*, — Cal. 3d —, 693 P.2d 261, 209 Cal. Rptr. 682 (1984). See *infra* text accompanying note 228 and the Epilogue at pp. 182-84.

138. The ordinance provides for individual rent adjustments when "necessary to provide the landlord with a fair return on investment." BERKELEY CAL., RENT STABILIZATION AND EVICTION FOR GOOD CAUSE ORDINANCE § 12(c) (1980). The board must consider all relevant factors, including ten listed factors. See *infra* note 230.

139. MEASURE I, *supra* note 45, §§ 5(c)(i), 6.

140. The author also has been a consultant to the Berkeley Rent Stabilization Board.

they adopted a fair return formula in October 1983, after several public hearings and extensive consultation with representatives of Elmwood's landlords and tenants. This lengthy deliberation process is detailed below as an illustration of the complexity of this critical issue.

Initially, the Subcommittee considered the relative advantages and disadvantages of the alternate formulas described earlier, with the exception of the return on assessed market value formula. The Subcommittee considered and rejected the alternative of proceeding on a case-by-case basis without a set formula. Measure I implicitly called for a formula, and even with the small number of units involved, it was administratively desirable to minimize the burden on the BBA in dispute resolutions occasioned by landlord petitions for rent increases. Therefore, the Subcommittee sought a single, set fair return formula understandable, if not entirely acceptable, to all Elmwood landlords and tenants.

While the Subcommittee considered alternative standards, the consultants conducted a survey of Elmwood's landlords and tenants to obtain information on lease provisions, rents, and landlord ownership and financing. Only a few landlords responded, and then only partially, to the survey, leaving the Subcommittee without information concerning landlord ownership and financing. In contrast, approximately sixty percent of the tenants provided information concerning rents, rent increases, and leases.¹⁴¹ The survey revealed a variety of types and terms of leases. Approximately one-third of the responding tenants had leases with escalator clauses tied to inflation and approximately half had long-term leases of four or more years. As Table 3 indicates, with the exception of property taxes, most commercial tenants were responsible for payment of the operating and maintenance expenses for their property.

141. See K. BAAR & W.D. KEATING, *supra* note 24, at 1.

Table 3
Landlord-Tenant Responsibility for Expenses¹⁴²

<u>Expenses</u>	<u>Paid by Owner</u>	<u>Paid by Tenant</u>	<u>Shared</u>
Electricity	2	40	0
Gas	2	38	0
Water	9	32	0
Sewer Treatment and Maintenance	9	26	0
Trash	5	37	0
Insurance (Fire and Liability)	15	37	0
Operating, Maintenance, and Repairs	12	21	5
Property Taxes	18	16	1

This pattern is not unusual for commercial leases. Many commercial tenants bear some, most, or all of the costs of maintaining and operating their business premises.¹⁴³

Moreover, it has become increasingly common for landlords to include inflation escalator clauses in commercial leases.¹⁴⁴ Two issues commonly arise in commercial lease negotiations over escalator clauses: first, which inflation index the parties will use and, second, whether the landlord will pass all or only part of the inflation, according to the index selected, on to the tenant.

Several price indices, both national and regional, can serve as the basis for inflation escalation clauses. The most commonly used indices are the all urban consumers price index (CPI-U), the urban wage earners index, and the producers price index.¹⁴⁵ Landlords and tenants use these indices in lieu of more precise localized indices applicable to the activities of commercial landlords.

Landlords seek the inclusion of escalator clauses to protect the reduction of their return under long-term leases when inflation can ex-

142. *Id.* table 2, at 3.

143. *See generally* Rahm, *Escalation Clauses in Urban Office Leases*, 12 REAL ESTATE REV., Summer 1982, at 55 (discusses urban office lease escalator clauses commonly used in New York City).

144. *Id.* *See also* Lewis & Nosari, *Consumer Price Index Escalation Clauses in Leases*, 10 REAL ESTATE REV., Fall 1980, at 101, 102; Note, *Lease Escalation Clauses Using the Consumer Price Index—How Well Do They Work?*, 7 OKLA. CITY L. REV. 489, 489 (1982).

145. For an explanation of the CPI-U, see BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, REPT. 517, *THE CONSUMER PRICE INDEX: CONCEPTS AND CONTENT OVER THE YEARS* (rev. ed. May 1978).

ceed rent increases, including the pass through of the landlords' operating and maintenance expenses to tenants. In contrast, tenants with sufficient bargaining power prefer that the landlord bear the risk of absorbing all, or at least part, of the impact of inflation over the lease term. This is true especially when tenants' rents are adjusted upward based upon increased sales and income in so-called "kicker" clauses or net percentage leases.

When tenants must accept inflation escalator clauses, landlords most commonly choose either the national or the regional version of the CPI-U that is issued bi-monthly by the Bureau of Labor Statistics of the United States Department of Labor. Generally, the courts have upheld the validity of these commercial lease escalator clauses against challenges based upon tenant theories of unconscionability and unjust enrichment, if the applicable index is identified correctly and the method for the calculation of rent increases based on the index selected is workable and understandable.¹⁴⁶

Measure I uses the CPI-U index for the San Francisco-Oakland region as a standard of reasonableness for rent increases preceding its enactment.¹⁴⁷ The inclusion or exclusion of full or partial inflation adjustments in a fair return formula is a recurrent issue, which the BBA Subcommittee addressed. The BRSB residential rent stabilization regulations did not provide for inflation adjustment. Unlike many of Elwood's commercial tenants, however, most residential tenants, including those in Berkeley, have short term (often month-to-month) leases that do not include escalator clauses. In considering the use of the CPI-U, the Subcommittee was informed of an important pending change in its calculation.

In January 1981, the Commissioner of Labor Statistics announced that beginning in January 1985, the Bureau of Labor Statistics would revise the CPI-U.¹⁴⁸ The "housing" component, comprising approximately twenty-three percent of its weight, would no longer be based primarily upon changes in the prices of home purchases and mortgage interest rates. Instead, the Bureau developed a "rental equivalency" index to measure homeownership cost changes that reduce the impact of these two factors. This substitution has been much debated, was long considered by the Bureau, and was advocated by critics of the

146. See Note, *supra* note 144, at 493-504.

147. MEASURE I, *supra* note 45, §§ 4(f), 13(b).

148. N.Y. Times, Jan. 29, 1981, at 1, col. 1.

CPI-U.¹⁴⁹ Critics have argued that the increases in the costs of home purchases and mortgage interest rates have over-weighted the CPI-U. This change will affect the CPI-U and its future impact on Elmwood's tenants under the BBA's fair return formula.

In February 1983, the Subcommittee's consultants recommended that the BBA adopt a novel version of the NOI fair return formula designed to fulfill Measure I's purpose, comply with its language, and deal with the peculiar characteristics of Elmwood's regulated properties. The consultants recommended that the BBA require all landlords to register their mean 1981 base NOI—1981 base rent minus operating and maintenance expenses exclusive of debt service—on a per square foot basis. After the registration period and BBA resolution of any landlord-tenant disputes over registered rents, landlord expenses, NOI, or occupied rental space contained in the registration statements, the BBA would calculate the 1981 mean NOI per square foot for the entire Elmwood district.

The proposal would entitle landlords in compliance with the law, upon annual application to the BBA, to an automatic rent adjustment. The BBA would calculate this adjustment by applying the prior year's full increase, if any, in the San Francisco-Oakland CPI-U to the base 1981 mean NOI for the district. The BBA then would apply this pro rata to individual businesses based on the square footage.

The consultants' survey determined that the 1981 mean rent per square foot in Elmwood was fifty-eight cents.¹⁵⁰ Assuming that landlords' operating and maintenance expenses averaged twenty percent of gross rent, the mean NOI per square foot would be forty-six cents. If the San Francisco-Oakland CPI-U increased by ten percent during the year prior to the allowable adjustment, then all Elmwood landlords would be entitled to raise their rents by 4.6 cents per square foot. If a tenant's rent was forty cents per square foot, then the BBA would allow a rent increase of 4.6 cents—possibly rounded to five cents. If the tenant's space consisted of one thousand square feet, the landlord would increase the monthly rent from \$400 to \$446—or \$450 if rounded.

149. See Cagan & Moore, *Some Proposals to Improve the Consumer Price Index*, 104 MONTHLY LAB. REV., Sept. 1981, at 20; Gillingham & Lane, *Changing the Treatment of Shelter Costs for Home-Owners in the CPI*, 105 MONTHLY LAB. REV., June 1982, at 9; Mitchell & Triplett, *Does the CPI Exaggerate or Understate Inflation?*, 103 MONTHLY LAB. REV., May 1980, at 31; Norwood, *Two Consumer Price Index Issues: Weighing and Homeownership*, 104 MONTHLY LAB. REV., Mar. 1981, at 58.

150. K. BAAR & W.D. KEATING, *supra* note 24, table 3, at 3.

The consultants' rationale for this recommendation was that this either would reduce or at least not widen the gap between those businesses with the highest and lowest rents. Instead of adjusting the individual landlord's base NOI by a fixed percentage, all landlords would receive the same uniform inflation adjustment per square foot. The consultants designed the automatic nature of the adjustment to eliminate the problems associated with discretionary adjustments. The consultants did not believe that a full inflation adjustment of the mean NOI was unfair in view of the survey finding that, prior to the passage of Measure I, one-third of the tenants already had leases providing for rent escalators tied to inflation. The consultants believed that no ceiling on the inflation adjustment was required, at least initially.

The consultants further recommended the provision for an additional adjustment of the base rent when the rent was extremely low. The consultants' survey revealed that 1981 rents ranged as low as fifteen cents per square foot, compared to a high of one dollar thirty-two cents per square foot. Half of the rents reported were below the district mean of forty-eight cents per square foot.¹⁵¹ If the 1981 base rent for a unit was below the district mean rent, the consultants recommended an adjustment upward incrementally until the rent reached that mean, subject to a twenty percent annual ceiling on increases to prevent tenant hardship.

In the previous example, the hypothetical rent of forty cents per square foot was almost one-third below the 1981 district mean rent of fifty-eight cents per square foot. Therefore, an additional annual adjustment of eight cents (forty cents per square foot multiplied by twenty percent) per square foot would be allowed until this difference was eliminated. This would result in the following incremental monthly rental increases over a three year period:

Year 1	—	\$80	(1,000 square feet × \$0.08 per square foot)
Year 2	—	\$80	(1,000 square feet × \$0.08 per square foot)
Year 3	—	\$20	(1,000 square feet × \$0.02 per square foot)
Total Increase	—	\$180	(1,000 square feet × \$0.18 per square foot)

The Subcommittee also favored a "banking" provision allowing landlords to bank all or some of the fair return adjustments to which they were entitled if they chose to delay raising rents. Landlords exempt from coverage until the expiration of their pre-existing leases also

151. *Id.*

could bank any differences between the rent increases under their leases and the annual fair return adjustments and then charge the tenant the cumulative differential when Measure I took effect.

The BBA would entitle no landlord to any fair return adjustment until at least half of the landlords registered. Landlords would lose their right to any fair return increases during the period when they were not properly registered.

Finally, the consultants recommended against conditioning rent adjustments on full or substantial code compliance until the BBA and the city conducted a survey of the condition of Elmwood's buildings to determine their physical condition. Residential rent control statutes often condition rent increases on substantial code compliance, although Measure I contains no such requirement. In *Orange Taxpayers Council, Inc. v. City of Orange*,¹⁵² the New Jersey Supreme Court upheld the constitutionality of this type of policy.

In *Green v. Superior Court*,¹⁵³ the California Supreme Court recognized an implied warranty of habitability in residential leases. Whether commercial tenants retain the same right as residential tenants to withhold rent if substantial code violations exist has not yet been answered by the California appellate courts.¹⁵⁴ The survey of Elmwood's commercial tenants complicates this question. The survey indicates that

152. 169 N.J. Super 288, 302-04, 404 A.2d 1186, 1193-94 (App. Div. 1979), *aff'd*, 83 N.J. Sup. Ct. 246, 259, 416 A.2d 353, 360 (1980). See Baar, *supra* note 132, at 830-32.

153. 10 Cal. 3d 616, 629, 517 P.2d 1168, 1176, 111 Cal. Rptr. 704, 712 (1974).

154. In *Schulman v. Vera*, 108 Cal. App. 3d 552, 560, 166 Cal. Rptr. 620, 624 (1980), the Fourth District Court of Appeal held that, under *Green*, the implied warranty of habitability did not apply to commercial leases and, therefore, commercial tenants could not raise code violations as a defense to an eviction action. The court relied on *Arnold v. Krigbaum*, 169 Cal. 143, 146 P. 423 (1915), in which the California Supreme Court ruled that tenants do not have the right to counter-claim for damages for violation of a landlord's covenant to make repairs as a defense to a landlord's suit for eviction for nonpayment of rent. 108 Cal. App. 3d at 561, 166 Cal. Rptr. at 625. In *Schulman*, a commercial tenant attempted to raise the warranty of habitability defense, claiming \$10,000 in damages caused by a leaking roof. The lease required the tenants to maintain the premises except for the roof and other exterior areas.

In contrast, the First District Court of Appeal indicated in two prior cases that it might extend the implied warranty of habitability to commercial tenants even without a direct mandate from the California Supreme Court. In *Golden v. Conway*, 55 Cal. App. 3d 948, 962, 128 Cal. Rptr. 69, 78 (1976), Division 1 of the First District declared that the philosophy of the *Green* decision was "persuasive" if the premises "are considered as merely a small commercial outlet." In *Four Seas Inv. Corp. v. International Hotel Tenants Ass'n*, 81 Cal. App. 3d 604, 613, 146 Cal. Rptr. 531, 535 (1978), Division

almost two-thirds of the tenants are responsible under their leases for maintenance and repairs.

Predictably, the consultants' recommendation proved objectionable to both landlords and tenants. Landlords objected to the base rent adjustments, arguing that the BBA should increase all rents to 1981 or current "comparable" market rents instead of to the 1981 mean Elmwood rent. Landlords also urged the BBA not to adopt an incremental annual ceiling on base rent adjustments. Some landlords argued for a return on current market value formula with market value determined through standard appraisal techniques. Others argued for individualized treatment of owners' petitions without a general formula.

Tenants, represented by the Elmwood Measure I Merchants' Committee, set forth several objections to the formula. They opposed any adjustment of base rents other than that statutorily mandated by Measure I. Moreover, they argued that annual adjustments up to twenty percent would create hardship for many tenants. Tenants also objected to general automatic annual adjustments of landlords' NOI, arguing that the BBA should allow only discretionary and individualized adjustments. They opposed any inflationary adjustments, in particular a full inflation adjustment. Instead, they proposed that the BBA limit any inflation adjustment to no more than forty percent of the CPI-U, based upon a similar fair return formula developed by Santa Monica's residential rent control board.¹⁵⁵

Tenants charged that the use of a district-wide mean NOI dependent upon landlord-supplied registration data would lead to collusion among landlords to manipulate rental data to create an artificially high figure. They argued that the tenants' right to challenge landlords' registration statements and the penalties for nonregistration and fraud were inadequate to protect tenants.

As alternative approaches, tenants variously suggested: 1) a partial inflation adjustment of 1981 base year cash flow and an adjustment of low, fixed rent leases, with a ceiling on both types of adjustments; 2) a return on investment formula; and 3) discretionary adjustments on a

1 stated that "the warranty of habitability could, since *Golden*, extend to small commercial operations if the facts warranted. . . ."

Two commentators have argued that the courts should apply the warranty of habitability to commercial property. See generally Note, *Commercial Leases: Behind the Green Door*, 12 PAC. L.J. 1067 (1981); Note, *Landlord-Tenant—Should a Warranty of Fitness be Implied in Commercial Leases?*, 13 RUTGERS L.J. 91 (1981).

155. For a discussion of the Santa Monica formula, see Baar, *supra* note 132, at 779, 813.

case-by-case basis without the use of a set formula. As this synopsis suggests, there was as little agreement between Elmwood's commercial landlords and tenants over a fair return formula as there historically has been between residential landlords and tenants.

Faced with these conflicting views, the BBA and its Fair Return Subcommittee deliberated the alternatives proposed by Elmwood landlords and tenants. Meanwhile, the city's staff reviewed the legal and administrative issues involved. In October 1983, the BBA adopted fair return regulations for Elmwood. The BBA regulations largely reflect the consultants' original recommendations. The BBA adopted the recommended NOI formula with the following significant changes.

The district-wide median, rather than the mean, 1981 base year NOI per square foot serves as the basis for future fair return rent adjustments.¹⁵⁶ The consultants' survey indicated that the 1981 Elmwood median rent per square foot was forty-eight cents, as contrasted with the mean of fifty-eight cents.¹⁵⁷ The BBA will calculate this figure only after seventy, rather than fifty, percent of Elmwood's regulated businesses are properly registered and any tenant challenges to the landlords' registration statements are reviewed.¹⁵⁸

Thereafter, the BBA will adjust automatically the base median NOI annually for inflation—but only partially. The BBA will apply annual increases in the San Francisco-Oakland CPI-U up to seven percent, but by no more than half of the next seven percent. The BBA will not include inflation above fourteen percent in the adjustments.¹⁵⁹ Therefore, the BBA has set a ceiling of ten and one-half percent for inflation adjustment of NOI.

Using the previous example, the formula works as follows in the first year. The tenant renting one thousand square feet at forty cents per square foot—\$400 monthly—faces a rent increase of eight cents per square foot—\$80 monthly—to raise the rent to the 1981 district median. If the median base NOI is eighty percent of the 1981 district median, the median NOI would be thirty-eight cents per square foot. If the San Francisco-Oakland CPI-U increases by ten and one-half percent, the landlord would be entitled to a monthly rent increase of four

156. Berkeley, Cal., Board of Adjustments Fair Return Regulations under Elmwood Commercial Rent Controls § 611 (1983) [hereinafter cited as Elmwood Fair Return Regulations].

157. K. BAAR & W.D. KEATING, *supra* note 24, at 3.

158. Elmwood Fair Return Regulations, *supra* note 156, §§ 610, 611.

159. *Id.* § 612(a).

cents per square foot: one thousand square feet multiplied by thirty-eight cents multiplied by 0.105 percent equals \$40. The BBA would not adjust median NOI for inflation exceeding the ten and one-half percent ceiling.

The BBA limited all cumulative allowable rent increases to which landlords are entitled to the lesser of twenty-five percent or fifteen cents per square foot annually.¹⁶⁰ These include rent increases for operating and maintenance cost increases, amortized capital improvements, base rent adjustments, and NOI inflation adjustments.

In the above example, even if the tenant paid all operating and maintenance cost increases and the landlord made no capital improvements, the combination of the maximum allowable base rent adjustments and the maximum allowable fair return adjustment would total thirty percent (forty cents per square foot divided by eight cents per square foot plus four cents per square foot) equalling a cumulative monthly rent increase of \$120 (\$400 multiplied by 0.30). Under the cumulative annual ceiling, the BBA would limit all rent increases, including increases for increased operating and maintenance expenses incurred by the landlord and any capital improvements made by the landlord, to only \$100 (\$400 multiplied by twenty-five percent). Assuming that the tenant paid all operating and maintenance expenses and the landlord made no capital improvements, the BBA would postpone \$20 of the \$120 allowable monthly rent increase until the following year. Whether the BBA would apply the ceiling depends upon whether the landlord pays for certain costs, whether the costs increase, whether the landlord was entitled to a base rent adjustment to the 1981 median, and how much of an inflation adjustment is required.

The BBA retained the banking provision for NOI inflation adjustments, allowing landlords entitled to automatic annual adjustments that do not actually increase their rents to current tenants to pass them on later to new tenants.¹⁶¹

Both landlords and tenants won and lost contested issues. Landlords retained their right to base rent adjustments, but not to comparable rents. Landlords retained their right to an inflation adjustment of NOI, but not to a full inflation adjustment. The tenants' most important gain was the imposition of the overall annual ceiling on adjustments, even though it was higher than they advocated. In comparison,

160. *Id.* § 615.

161. *Id.* at 614.

Berkeley's residential rent stabilization regulations limit individual rent adjustments for capital improvements, base rent adjustments, and maintenance of NOI excluding inflation, to fifteen percent annually.¹⁶² In addition, Berkeley's residential landlords are entitled to an annual general adjustment, which ranged from zero to nine percent from 1981 to 1984.

The BBA issued the administrative regulations implementing the fair return formula in July 1984. To date, no parties have filed legal challenges contesting the formula's validity.

V. PROPOSED MUNICIPAL COMMERCIAL RENT CONTROL ORDINANCES

A. *San Francisco*

The possible adoption of commercial rent stabilization to protect neighborhood-serving businesses in San Francisco, where commercial gentrification is a controversial question, first arose in public hearings in 1981. Commercial rent stabilization legislation, however, has not yet been introduced or considered by San Francisco's Board of Supervisors.

B. *New York City*

In New York City, the revival of commercial rent control became a city-wide issue beginning in 1980. Small neighborhood-serving businesses in gentrifying neighborhoods complained that landlords forced them to leave or liquidate their businesses in order to make way for businesses able to afford higher rents. These new businesses provide goods and services to a higher-income population of newcomers.¹⁶³ In response, local commercial rent control legislation entitled "The Small Business Preservation Act" (SBPA)¹⁶⁴ was introduced in the New York City Council that year.

Unlike its World War II predecessor, this proposal was targeted at "long-established neighborhood small businesses." The proposed legis-

162. Berkeley, Cal., Rent Stabilization Board Regulations § 1274(b) (1981).

163. See C. HARTMAN, W.D. KEATING & R. LEGATES, *DISPLACEMENT: HOW TO FIGHT IT 87-88* (1982); Gorlin, *Open Season on Small Business Tenants*, 9 CITY LIMITS, May 1984, at 5.

164. Proposed New York City Local Law No. 658 (Sept. 27, 1983) [hereinafter cited as SBPA]. Other versions of similar legislation were introduced earlier in the New York City Council.

lative findings recognize the importance of controlling rent levels to make possible the continued existence of the small businesses essential to New York neighborhoods.¹⁶⁵ To accomplish this anti-displacement goal, the SBPA would regulate only the rents of the following types of "commercial premises": 1) retail stores occupying ten thousand square feet or less at street level or one floor above street level; 2) professional, service, or other offices occupying ten thousand square feet or less; and 3) manufacturing, assembling, or processing premises occupying twenty-five thousand square feet or less.¹⁶⁶ The proposal does not exempt newly constructed premises.

The proposed legislation entitles protected small business tenants to renew existing leases for a minimum term of seven years.¹⁶⁷ The proposal limits annual rent increases to the lesser of ten percent or the prime mortgage interest rate plus three percent.¹⁶⁸ If a landlord had not raised a tenant's rent within three years prior to the expiration of the lease, then an adjustment of five percent for each year prior to this three year period is provided and is not subject to this limitation.¹⁶⁹ No additional operating and maintenance cost pass throughs are permitted, except for real property tax increases that landlords must apportion according to each affected tenant's space.¹⁷⁰

The proposal guarantees landlords a "reasonable rate of return."

165. *Id.* § 1.

[T]he viability of a neighborhood, and the welfare of the people who live and work there, may be largely dependent on the on-going businesses serving the neighborhood. The [New York City] council further finds that an emergency exists as a result of the shortage of commercial space for rent in many neighborhoods and that said shortage has caused profiteering, speculation and other economically disruptive practices causing hardship, dislocation and the exaction of unjust, unreasonable and oppressive commercial rents. Often, long-established neighborhood small businesses are, therefore, displaced or forced to go out of business. This not only imposes a hardship on the business affected, but deprives the community of a valued source of essential goods and services and often results in the imposition of inflated charges for the provision of the very same goods and services by a successor business. Therefore, in recognition of the aforementioned public emergency, the council finds that the rentals charged for such properties must be limited to insure the economic stability, neighborhood viability and the general public welfare.

Id.

166. *Id.* § 2 (adding § YYY 51-1.0(a) to the New York City Administrative Code).

167. *Id.* § YYY 51-2.0(b).

168. *Id.* § YYY 51-2.0(a).

169. *Id.* § YYY 51-1.0(f).

170. *Id.* § YYY 51-6.0.

This is defined alternately as the lesser of either: 1) the rent sufficient to pay all actual operating, maintenance, and repair costs and a return on capital value equal to seven percent of the previous tax year's total assessed value plus an additional three percent if improvements had been made; or 2) a net annual return of three percent plus the prevailing annual New York interest rates on new first mortgages based on the landlord's equity investment, defined as the down payment plus any repayment of mortgage principal.¹⁷¹

A vacancy decontrol provision is provided under which landlords can charge market rents for new leases for vacated space. Severe penalties are provided for any landlord found guilty of tenant harassment that causes the tenant to vacate.¹⁷² Landlords may refuse to renew a tenant's lease if they wish to occupy the premises to expand their own business when they have owned a majority interest in that business for at least four years and it has been located nearby for at least two years.¹⁷³

The proposed law limits security deposits¹⁷⁴ and provides penalties for illegal overcharges.¹⁷⁵ The proposal makes any lease provisions waiving tenant rights unenforceable.¹⁷⁶

The proposed law is partially self-enforcing because there is no requirement that landlords register or seek prior approval for rent increases. Landlords are not required to notify tenants of their rights under the law. Administrative remedies are provided if a tenant claims that a landlord intentionally overcharged,¹⁷⁷ harassed the tenant into vacating,¹⁷⁸ re-occupied the premises in bad faith,¹⁷⁹ or if a landlord applied for a hardship rent increase and claims that the rent is insufficient to provide a reasonable rate of return.¹⁸⁰ New York City's Department of Housing Preservation and Development (HPD), which

171. *Id.* § YYY 51-8.0.

172. *Id.* § YYY 51-2.0(e). The landlord is subject to damages of the greater of either \$50,000 or 10 times the average of the proposed rent of the new tenant.

173. *Id.* § YYY 51-3.0.

174. *Id.* § YYY 51-2.0(f). Security deposits are limited to a maximum of three months rent.

175. *Id.* § YYY 51-4.0(a).

176. *Id.* § YYY 51-6.0(a).

177. *Id.* § YYY 51-4.0(a).

178. *Id.* § YYY 51-2.0(e).

179. *Id.* § YYY 51-3.0(a).

180. *Id.* § YYY 51-8.0.

has administered the city's residential rent control and stabilization programs in the past would administer these provisions.¹⁸¹ Tenants and landlords could seek judicial review of the Department's administrative decisions and alleged violations of the law. This legislation would not apply retroactively. The proposed law would affect only those lease renewals occurring after its adoption.¹⁸²

In 1984, companion legislation authorizing local option commercial rent controls was introduced in the New York State Legislature.¹⁸³ The major difference between this proposed state legislation and the New York City proposal is that the former proposal would protect small businesses defined according to the number of employees—one hundred or fewer.

To date, neither proposal has been enacted in the face of opposition from the real estate industry and the incumbent Mayor of New York City. In the face of the Mayor's adamant opposition, the New York City Council's Committee on Economic Development did not vote on the bill after conducting a public hearing in February 1984. The New York State Legislature's Assembly Housing Committee approved the bill in March 1984, but it made no further progress.¹⁸⁴

Real estate industry's opposition to the contemporary revival of commercial rent controls is based on the same arguments that the industry invoked to oppose the post-World War II commercial rent controls.¹⁸⁵ This debate is likely to continue as long as evidence exists of continuing commercial gentrification and as long as alternative approaches, such as zoning controls, remain inadequate to protect small neighborhood-serving businesses from displacement.

The potential introduction of city-wide commercial rent control targeted to small neighborhood-serving businesses in major cities like New York City and San Francisco, which suffer from commercial gentrification, raises important issues concerning the application of Berke-

181. In 1983, the administration of New York City's residential rent control and rent stabilization systems was transferred to the New York State Division of Housing and Community Development, effective April 1, 1984. Rent Control—Tenant Protection—New York City, ch. 403, §§ 22-23, 1983 N.Y. Laws 752.

182. SBPA, *supra* note 164, § YYY 51-1.0(c).

183. A.B. 6983 & S.B. 6983.

184. N.Y. Times, Mar. 18, 1984, at R7, col. 1. See also Gorlin, *supra* note 163.

185. See Rosenberg, *You Can't Afford to Ignore Commercial Rent Controls*, 17 REAL ESTATE TODAY, June 1984, at 34. The office industry successfully opposed federal commercial rent control during World War II. See SCHULTZ & SIMMONS, OFFICES IN THE SKY (1959).

ley's Elmwood experiment. Measure I and New York City's proposed SBPA differ in several significant respects.

C. *Measure I and SPBA Compared*

1. Coverage

Measure I covers all businesses, large or small, within the geographical confines of a neighborhood district. The SBPA is limited only to the protection of small businesses, defined primarily by size (square footage) and location, or, alternately, by the number of employees. The city-wide SBPA is not restricted to neighborhoods where displacement is particularly severe. Measure I retroactively modified some, but not all, pre-existing leases. The SBPA only applies prospectively to lease renewals.

2. Vacancy Decontrol

Measure I does not provide for vacancy decontrol. The BBA's fair return regulations provide that landlords may pass "banked" rent increases on to new tenants. The SBPA, unlike its predecessor, provides only for limited vacancy decontrol. Vacant units, once re-rented at market rents, are subject again to controls.

3. Notice and Registration

Measure I requires all landlords to notify tenants of their rights as a condition for rent increases and explain the basis for all rent increases. The SBPA does not require notice. The BBA requires landlord registration as a condition for eligibility for fair return rent increases. While the SBPA requires landlords to petition the HPD for hardship rent increases, it does not require registration.

4. Rent Adjustments

Neither statute provides for automatic annual general rent adjustments. Measure I and the SBPA both allow landlords to increase rents at their discretion within the statutory guidelines. Measure I strictly limits rent adjustments to pass throughs of operating, maintenance, and amortized capital improvement costs. The SBPA does not limit maximum rent adjustments to these cost pass throughs and provides for the additional automatic pass through of increased property taxes. Both statutes provide for differing five percent base rent adjustments when rents had not been raised recently.

5. Fair Return

Measure I does not contain a fair return formula. The SBPA contains a fair return formula. The BBA adopted a MNOI formula partially tied to inflation and limited by the twenty-five percent annual ceiling for all cumulative rent increases. The SBPA formula provides for a guaranteed percentage return on investment in which equity is defined either as the lesser of assessed value or the landlord's down payment and mortgage principal repayment. There is neither an inflation adjustment nor a ceiling in this formula.

6. Just Cause Evictions

Within the minimum seven year control period, the SBPA allows only one basis for lease nonrenewal: a landlord retains the limited right to use the premises for the expansion of his own nearby business. Measure I provides eight just causes for eviction, which do not include the landlord's right to reclaim the premises for his own commercial use.

7. Expiration

Measure I could expire only by repeal through voter referendum. The SBPA, as emergency regulatory legislation, would be subject to periodic renewal by the New York State Legislature and the New York City Council.

8. Administration

Both measures provide for partial administrative enforcement by city agencies, as well as judicial review. New York City's HPD retains broader jurisdiction than the BBA because of the SBPA's vacancy decontrol and eviction provisions.

Perhaps the most significant structural policy issue posed by Measure I for much larger cities like New York City and San Francisco is whether the cities should limit commercial rent controls, designed to protect small, neighborhood-serving businesses against displacement, only to those neighborhood commercial districts where the cities can identify serious problems such as low vacancy rates, extraordinarily high rent increases, or the eviction of existing small businesses that cause or threaten displacement. If so, city planning departments could study and identify these districts. In San Francisco, the City Planning Department identified neighborhood-serving commercial districts when it undertook its rezoning process.

In 1983, New York City's Department of City Planning conducted a similar study of two neighborhoods undergoing gentrification: the Upper West Side of Manhattan and Park Slope in Brooklyn. Based upon its interpretation of 1970 and 1980 census data, the Department concluded that little evidence existed of harmful residential displacement caused by gentrification. The Department also determined that the institution of commercial rent controls to protect neighborhood retailers was unnecessary because neighborhood commercial patterns had not changed markedly.¹⁸⁶ Critics have disputed both the accuracy of the study and its conclusions concerning the extent of displacement and the need for preventive regulation.¹⁸⁷

The Elmwood experience does suggest that, before city-wide adoption of commercial rent control, cities of this size should consider experimental adoption in one or more neighborhoods when it is particularly necessary to allow for an evaluation of the program's impact, administration, and effectiveness. Berkeley's evaluation of the Elmwood experiment and its possible expansion to other Berkeley neighborhood commercial districts serves as a useful model for other cities facing this dilemma.

VI. THE IMPACT OF MEASURE I

To date, the Berkeley Department of Planning and Community Development has not yet completed its initial evaluation of Measure I's impact. Several issues deserve consideration.

First and foremost is the short-term impact on rents and the continued occupancy of those tenants renting space in Elmwood in June 1982. If tenants vacate subsequently, the Department should explore the reasons for their departure and their possible relationship to Measure I. These reasons could include retirement of the owner, an attractive offer from a buyer, relocation to a better location outside Elmwood, unprofitability, and bankruptcy. The Department should profile the type of replacement tenants to determine what effect Measure I, as opposed to Elmwood's zoning, has on this substitution process.

A related issue is the distribution of benefits to Elmwood's tenants.

186. See NEW YORK CITY DEPARTMENT OF CITY PLANNING, PRIVATE REINVESTMENT AND NEIGHBORHOOD CHANGE (1984).

187. See Marcuse, *Measuring Gentrification's Impact*, 9 CITY LIMITS, May 1984, at 26.

The Department must track all rent increases to determine how Measure I's rent controls benefit different types of tenants.

The Department should analyze Measure I's impact on sales and transfers by landlords and any subleases by tenants. Transfers by landlords indicate Measure I's impact on investment in a regulated market. Subleases by tenants could pose administrative and legal problems. Measure I's controls apply equally to tenants, subtenants, lessees, sublessees, and any other persons entitled to the use or occupancy of any units.¹⁸⁸ If tenants negotiate subleases, the Department should determine whether the terms of the sublease comply with the terms of Measure I and the BBA regulations. Illegal subleases, whether negotiated by landlords or tenants, would violate the purpose and undermine the impact of Measure I.

The Department should study the impact of Measure I on new construction, substantial rehabilitation, and conversions to measure its impact on investment and tenure. Because Elmwood already is fully developed and the 1984 rezoning restricts density, little space remains for the construction of new commercial rental space. Substantial rehabilitation is much more likely.¹⁸⁹

Irrespective of whether landlords remodel existing commercial space, tenure conversion is a more likely phenomenon. Reportedly, the owners of several stores, including those remodelling vacant space, intend to convert these stores into commercial condominiums. While owners have developed commercial condominiums in the San Francisco market, this is a relatively new development in Berkeley. Like the debate concerning residential rent control, the causal connection between rent control and condominium conversions remains unproven. The impact on Elmwood tenants depends upon whether they purchase or vacate their premises and on the terms of either alternative.¹⁹⁰

In view of the possible conversion of commercial rental space into condominiums, if Berkeley decides to prevent the displacement of commercial tenants that cannot afford to purchase their building space, then the city must consider the regulation of commercial condominium conversions. While numerous California communities, including

188. MEASURE I, *supra* note 45, § 4(e).

189. Measure I regulates the creation of new units through the subdivision and consolidation of existing space. *Id.* § 5(d).

190. For an analysis of the comparative costs and benefits of office rental versus ownership by small business, see Tracy, *Ownning v. Renting Office Space: A Financial Comparison*, 11 REAL ESTATE REV., Winter 1982, at 86.

Berkeley, have regulated residential condominium conversions,¹⁹¹ no American city has regulated the conversion of commercial rental space into commercial condominiums.

The alternative to regulation, if Berkeley desires to encourage building ownership by Elmwood's small neighborhood-serving businesses, exists in some form of subsidized purchase financing or loan guarantees. In the absence of state or federal subsidy programs for this purpose, however, it is unlikely that the city alone could undertake such a program in view of its extremely limited budgetary resources.

The number and reasons behind the filing of petitions with the BBA and their outcome should shed light on any administrative problems that arise during implementation of Measure I, including the fair return formula adopted in October 1983. Berkeley should calculate the financial and personnel costs to the city for the administration of Measure I.

Finally, the city should analyze the number and cause for evictions to determine a pattern for evictions and landlord compliance with Measure I's eviction controls. Study of these matters should provide valuable data with which to study the effectiveness of existing and proposed commercial rent control plans.

VII. POTENTIAL LEGAL CHALLENGES TO MEASURE I COMMERCIAL RENT CONTROL

Measure I, like other rent control statutes including New York's former commercial rent control laws, is susceptible to legal challenge on various grounds. Potential issues subject to judicial review are reviewed below. The Article examines judicial precedents, including recent California appellate residential rent control decisions, to determine the likelihood that the courts will invalidate Measure I.

A. *Basis for Police Power Regulation*

Landlords may challenge the basis for the exercise of Berkeley's municipal police power for the regulation of commercial rents. Unlike New York's earlier statutes, Measure I is not based upon the existence of an emergency. In *Birkenfeld*, the California Supreme Court rejected

191. See Note, *Municipal Regulation of Condominium Conversions in California*, 53 S. CAL. L. REV. 225 (1979).

the emergency requirement for residential rent control.¹⁹² The court substituted a rational basis test under which the courts presume that residential rent controls are a legitimate exercise of the police power unless there is a "complete absence of even a debatable rational basis for the legislative determination . . . that rent control is a reasonable means of counteracting harms and dangers to the public health and welfare emanating from a housing shortage."¹⁹³ The California Supreme Court recently reiterated this presumption in *Carson Mobilehome Park Owners Association v. City of Carson*,¹⁹⁴ when it upheld the validity of local mobile home rent control.

Courts should apply this presumption to commercial rent control. This means that landlords should have a very heavy burden of proof to overcome. Measure I's primary bases for enactment are to protect Elmwood's commercial tenants from rent increases that are not justified by cost increases and to enable those tenants to continue to provide services to residents of the district without undue price increases, expansion of trade, or liquidation.¹⁹⁵

Under the *Birkenfeld* test, landlords should have to prove that rent increases, both actual and proposed, were in fact reasonably related to landlords' actual cost increases and that Elmwood tenants were not threatened by rent increases, nonrenewal of leases, and trade expansion problems. The Elmwood tenant survey cited earlier, while not conclusive, indicates a pattern of rent increases between 1979 and 1981 that exceeds inflation. This pattern may provide, however debatable, a rational basis for the enactment of commercial rent control.¹⁹⁶

While Measure I does not include a low vacancy rate or shortage of space as relevant factors, evidence showing their existence in Elmwood as of 1982 could buttress further the presumption of validity of municipal regulation.¹⁹⁷ The 1956 and 1960 New York Court of Appeals decisions that rejected similar landlord challenges to New York's

192. 17 Cal. 3d 129, 146-50, 550 P.2d 1001, 1018-23, 130 Cal. Rptr. 465, 481-86 (1976). See *supra* note 125 and accompanying text.

193. 17 Cal. 3d at 161, 550 P.2d at 1024, 130 Cal. Rptr. at 488. Landlords failed to overcome this presumption of regulatory rationality. *Id.* at 164, 550 P.2d at 1026-27, 130 Cal. Rptr. at 490-91.

194. 35 Cal. 3d 184, 186 n.4, 672 P.2d 1297, 1299 n.4, 197 Cal. Rptr. 284, 286 n.4 (1983). The plaintiffs, mobile home park owners, did not challenge the basis for the adoption of the ordinance. *Id.*

195. MEASURE I, *supra* note 45, § 2.

196. See *supra* text accompanying notes 28-30.

197. The City of Berkeley attempted to prove a shortage of commercial space in

commercial rent control laws substantially weakened by decontrol,¹⁹⁸ and these California Supreme Court decisions on residential rent control, suggest that this type of challenge is unlikely to succeed.

B. *Impairment of Contracts*

Challengers may contest that Measure I unconstitutionally impairs pre-existing contracts. Measure I exempts leases executed prior to October 1, 1981, including those with renewal options that are exercised by either a landlord or tenant.¹⁹⁹ Measure I, however, modifies pre-existing leases if landlords increased rents between October 1, 1980, and October 1, 1981, in excess of the San Francisco-Oakland CPI-U. Measure I reduces the base rent to the prior rent plus the CPI-U increase "to preserve certain businesses which have recently received such high rent increases that they would—but for this subsection—find it necessary to take steps contrary to the purposes of this Ordinance."²⁰⁰

Additionally, Measure I rolls back all other increases that occurred from October 1, 1981, to the date of enactment—June 8, 1982. A rollback to a pre-existing base date was intended to preclude landlords with month-to-month leases from raising rents in anticipation of Measure I's enactment, which, if allowed, would frustrate Measure I's very purpose. Measure I's October 1, 1981, base date for this nine month rollback was selected because this was the approximate time that the campaign for commercial rent stabilization began in the Elmwood district.²⁰¹ Those landlords whose rollback period rent increases were revoked retroactively also may claim that their contracts were impaired unconstitutionally.

A long line of federal and state rent control precedents suggests that this argument will not prevail. *Twentieth Century Associates*²⁰² is a leading New York Court of Appeals case that rejected this claim when it upheld the constitutionality of New York's commercial rent control laws.

Berkeley in defense of Measure I's challenged predecessor. See *Rue-Ell*, 147 Cal. App. 3d at 91, 194 Cal. Rptr. at 926.

198. See *supra* text accompanying notes 95-98.

199. MEASURE I, *supra* note 45, § 13(a).

200. *Id.* § 13(b).

201. *Id.* § 5(b).

202. 294 N.Y. at 580-81, 63 N.E.2d at 177. See *supra* notes 88-91 and accompanying text.

New York's Commercial Space Rent Control Act took effect January 24, 1945, and rolled commercial rents back twenty-three months to March 1, 1943.²⁰³ The Business Space Rent Control Act took effect March 28, 1945, and rolled business space rents back nine months to June 1, 1944.²⁰⁴ Unlike Measure I, these two statutes provided landlords a fifteen percent adjustment over base rents.

In *Twentieth Century Associates*, the plaintiff, a commercial landlord, claimed that the commercial rent control rollback constituted an unconstitutional impairment of contracts. The court rejected this claim on two grounds. First, citing the statutory preamble, the court concluded that commercial leases were not freely bargained for contracts.²⁰⁵ Second, the court held that the system of temporary rent control enacted by the legislature, including the reduction of rents during the rollback period, represented a "reasonable and legitimate remedy."²⁰⁶ In upholding the statute, the court relied upon the prior decisions of the New York Court of Appeals and the United States Supreme Court that upheld the constitutionality of New York's 1920 emergency residential rent controls against landlord claims that they violated due process by substantially impairing pre-existing leases when they invalidated rent increases.²⁰⁷

State and federal appellate courts consistently have upheld residential rent control laws that have rolled rents back retroactively to a prior base date against contract impairment claims. For example, in *Huard*

203. ECSRCL, *supra* note 65, § 8522(e).

204. EBSRCL, *supra* note 66, § 8552(c).

205. *Twentieth Century Associates*, 294 N.Y. at 580-81, 63 N.E.2d at 180. The preamble stated:

Proceeding, as we must in this case, upon the assumption that the Legislature intended the act to be retroactive, we find in the material before the Legislature ample evidence that unjust, unreasonable, and oppressive leases and agreements in large volume had been exacted by landlords from tenants under the stress of prevailing conditions accelerated by the war for some time prior to the enactment of the statute.

Id. The court noted that:

The evils denounced in the statute flowed, not merely from leases which might thereafter be executed, but even more directly from leases already made, and these evils could not be remedied by regulations purely prospective in their application, although the regulations adopted were only retroactive in that they applied to future payments of rent under pre-existing leases.

Id. at 581, 63 N.E.2d at 180.

206. *Id.* at 580, 63 N.E.2d at 180.

207. *See supra* note 89.

v. *Forrest Street Housing, Inc.*,²⁰⁸ the Massachusetts Supreme Judicial Court upheld the nine month rollback of controlled rents in Cambridge in 1970, citing *Twentieth Century Associates* as precedent. In *Freeport Randall Co. v. Herman*,²⁰⁹ the New York Court of Appeals upheld the rollback provision of New York State's Emergency Tenant Protection Act against a contract impairment claim. In *Birkenfeld*, the California Supreme Court found a twenty month rollback "appropriate and reasonable."²¹⁰

As indicated in the *Rue-Ell*²¹¹ decision that upheld the validity of Berkeley's 1978 to 1979 property tax rebate initiative, the United States Supreme Court, in several recent decisions, has outlined a three-step analytical process for judicial review of contract impairment claims. *Rue-Ell* itself is distinguishable because the court found no substantial impairment of commercial leases.

Troy, Ltd. v. Renna,²¹² provides the best recent example of the application of this analysis to a regulatory statute. Condominium converters challenged the provisions of New Jersey's Senior Citizens and Disabled Protected Tenancy Act that retroactively extended protection against eviction to eligible elderly and disabled tenants. The challengers claimed that the Act unconstitutionally impaired their contracts. In rejecting this claim, the Third Circuit applied the analysis outlined by the United States Supreme Court in *Energy Reserves Group, Inc. v. Kansas Power and Light Co.*²¹³

The court concluded that, even if a substantial contract impairment existed, a significant and legitimate remedial public purpose existed for the regulatory legislation.²¹⁴ The court cited the legislative finding that detailed the harm resulting from relocation of elderly and disabled ten-

208. 366 Mass. 203, 207-08, 316 N.E.2d 505, 507-08 (1974) (citing *Twentieth Century Associates*, 294 N.Y. 571, 63 N.E.2d 177 (1945), *appeal dismissed*, 326 U.S. 696 (1946)).

209. 56 N.Y.2d 832, 834, 438 N.E.2d 99, 101, 452 N.Y.S.2d 566, 568 (1982).

210. 17 Cal. 3d at 165-66, 550 P.2d at 1022-28, 130 Cal. Rptr. at 491-92. *See also* *Oceanside Mobilehome Park Owners' Ass'n v. City of Oceanside*, 157 Cal. App. 3d 887, —, 204 Cal. Rptr. 239, 251-52 (1984) (court upheld mobile home park rent control ordinance's rollback provision as just and reasonable).

211. 147 Cal. App. 3d at 88-87, 194 Cal. Rptr. at 923. *See supra* notes 121-27 and accompanying text.

212. 727 F.2d 287 (3d Cir. 1984).

213. 727 F.2d at 297 (construing *Energy Reserves Group*, 459 U.S. 400, 410-12 (1983)). *See supra* note 123.

214. 727 F.2d at 297-98.

ants,²¹⁵ and concluded that the regulatory clause was a necessary and reasonable means to achieve this purpose.

Applying the Third Circuit's analysis to Measure I and assuming that a substantial impairment of at least some commercial leases in Elmwood exists, it is likely that a court will reject this argument. Measure I's stated purposes meet the test of *Energy Reserves* for a significant and legitimate remedial public purpose. Unless Measure I raises procedural due process problems, it is likely that the courts will find that Measure I's regulatory scheme is necessary and reasonable to achieve its purpose of protecting neighborhood-serving businesses from displacement.

In *Fleeman v. Case*,²¹⁶ the Florida Supreme Court held that a Florida statute designed to protect condominium owners could be applied prospectively, but not retroactively, because its retroactive application would impair pre-existing contracts. The Florida Legislature had barred the use of escalation clauses based on commodity or consumer prices in leases for recreational facilities or management contracts for condominiums.

Elmwood landlords may invoke *Fleeman* to argue that pre-existing leases with escalator clauses, including those tied to the CPI-U, cannot be modified retroactively. In view of the rent control precedents unanimously rejecting this view, it is unlikely that the courts will follow *Fleeman*.

C. General and Individual Rent Adjustments

Elmwood landlords may assert that the absence of a guaranteed annual general rent adjustment, such as that contained in Berkeley's residential rent stabilization ordinance, means that Measure I fails to meet the requirements set forth by the California Supreme Court in *Birkenfeld*. In *Birkenfeld*, the court invalidated Berkeley's 1972 residential rent control initiative in part because it required individual rent adjustments for all regulated units, estimated at approximately sixteen thousand, under an administrative system that the court found facially inadequate.²¹⁷

215. *Id.* at 298.

216. 342 So. 2d 815, 817 (Fla. 1976).

217. 17 Cal. 3d at 166-74, 550 P.2d at 1028-33, 130 Cal. Rptr. at 492-97. *See supra* notes 125, 192-198 and accompanying text.

In *Carson*,²¹⁸ however, the California Supreme Court held that a general rent adjustment mechanism is not constitutionally required. *Carson* addressed a mobile home rent control ordinance that provided that an appointed Mobilehome Park Rental Review Board could grant "just, fair, and reasonable" rent increases based on twelve statutory factors upon the petition of a mobile home park owner. Because only thirty-two regulated mobile home parks existed in the city, the court concluded that the Board could review annually any and all petitions within a statutory deadline mandating its final decision within a 105 day period from the submission of the landlord's application.²¹⁹

Unlike the mobile home rent control ordinance challenged in *Carson*, Measure I allows landlords to increase rents for increased operating, maintenance, and capital improvement expenses at their discretion without petitioning the BBA for prior approval. Under the BBA's fair return formula, although Elmwood landlords must petition the BBA for additional rent increases, the BBA will apply the formula automatically. This will make the BBA's review very efficient, provided that the landlord is properly registered.

Under the BBA's regulations, the BBA must reach a final decision on all petitions within 105 days from the receipt of a landlord's petition and the mailing of a notice to each affected tenant.²²⁰ The BBA can consolidate hearings for petitions involving units in the same building.²²¹ It is estimated that Elmwood's regulated commercial market includes only eighty-four units owned by twenty-three landlords. Under these circumstances, the courts should find no serious procedural defects that will deny landlords allowable rent adjustments within a reasonable period of time.

D. Taking

Landlords have argued unsuccessfully that the regulation of rental property is an unconstitutional taking without just compensation. This

218. 35 Cal. 3d at 194, 672 P.2d at 1302, 197 Cal. Rptr. at 289-90. See *supra* note 194 and accompanying text.

219. *Id.* at 193, 672 P.2d at 1301, 197 Cal. Rptr. at 288.

220. Berkeley, Cal., Board of Adjustment Elmwood Commercial Rent Stabilization and Eviction Protection Regulations §§ 852(a), (b), (c) & 858(a) (1983). Upon receipt of a landlord's petition and the mailing of notice of the petition to the tenant, the tenant is allowed up to 30 days to respond, the Board must schedule a hearing within 30 days after this deadline, and the Board must make its final decision not later than 45 days after the hearing.

221. *Id.* § 852(c).

argument is premised upon Justice Holmes' statement in *Pennsylvania Coal v. Mahon* that "while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking."²²² Recent United States Supreme Court decisions involving challenges to the regulation of real property based upon a taking theory suggest that commercial landlords may assert that Measure I constitutes an unconstitutional taking.²²³

In *Finn*, the Second Circuit rejected a taking argument in a challenge to the constitutionality of New York's Business Space Act.²²⁴ Under *Finn*, it is doubtful that courts will hold that Measure I constitutes an unlawful taking. Measure I guarantees landlords an automatic pass through of all operating and maintenance costs, and a fair return. The taking standards enunciated recently by the United States and California Supreme Courts require a permanent governmental physical occupation of the regulated property or, alternately, the denial of the reasonable use of an owner's property to the extent that its value is virtually eliminated.²²⁵ Measure I results in neither effect on Elmwood's commercial landlords.

In *Troy*, the Third Circuit rejected the regulatory taking argument based upon an analysis of the taking precedents.²²⁶ The court noted that the United States Supreme Court declared specifically in *Loretto v. Teleprompter Manhattan CATV Corp.*,²²⁷ that New York's original rent control laws did not constitute a taking. These precedents suggest that the courts will refuse to find that Measure I constitutes an unconstitutional taking.

222. 260 U.S. 393, 415 (1922).

223. See, e.g., Stoebuck, San Diego Gas: *Problems, Pitfalls and a Better Way*, 25 WASH. U.J. URB. & CONTEMP. L. 3 (1983) (discussion of recent developments in the taking doctrine and the resulting implications); Note, *Finding a Taking: Standards for Fairness*, 16 U.S.F.L. REV. 743 (1982) (analysis of the regulatory taking issue).

224. See, e.g., Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 126-27, 136-38 (1978) (government's regulation must be reasonably related to a substantial public purpose; Court found no taking).

225. See, e.g., *Agins v. City of Tiburon*, 24 Cal. 3d 266, 277, 598 P.2d 25, 31, 157 Cal. Rptr. 372, 378 (1979), *aff'd*, 447 U.S. 255, 263 (1980).

226. 727 F.2d 287, 301-03 (3d Cir. 1984). See *supra* notes 112-15 and accompanying text.

227. 727 F.2d at 301 (construing *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 441 (1982)).

E. *Equal Protection*

Elmwood's landlords may assert that, because they are the only commercial landlords singled out for regulation by the City of Berkeley, neighborhood-based rent control violates their right to equal protection. Because Measure I is the first American municipal rent control law limited to a particular neighborhood, no direct precedents exist.

The courts, however, repeatedly have rejected similar landlord contentions based on the exemption of certain classes of residential landlords from controls.²²⁸ As long as a rational basis exists for the classification of regulated and nonregulated properties, the courts defer to the legislative bodies' regulatory decisions. For example, the New York Court of Appeals summarily upheld the exemption of piers, docks, and wharf properties from the business space rent controls.²²⁹

Measure I contains a reasonable basis for the experimental regulation of commercial rents when a demonstrable problem exists. The courts probably will defer to the legislative choice to limit regulation on this basis.

F. *Fair Return*

1. Statutory Formula

Some rent control statutes, like the New York commercial rent control laws, define what constitutes a fair return. Others, including California's local residential rent statutes adopted since 1978, guarantee landlords a fair return, but do not define the term. Instead, administrative bodies like the BBA, or the courts are entrusted with this task. For example, Berkeley's residential rent stabilization law guarantees landlords "a fair return on investment," but delegates responsibility for its definition and application to the BRSB. In reviewing landlords' applications for individual rent adjustments, the BRSB was mandated statutorily to consider all relevant factors, including ten specified

228. See Baar, *supra* note 132, at 756-58. The California appellate courts have upheld the exemption of certain owner-occupants in Berkeley and luxury rental housing in Los Angeles against equal protection challenges. See *Fisher v. City of Berkeley*, 148 Cal. App. 3d 267, 271, 195 Cal. Rptr. 836, 839 (1983), *aff'd*, — Cal. 3d —, 693 P.2d 261, 209 Cal. Rptr. 682 (1984); *Palos Verdes Shores Mobile Estates, Ltd. v City of Los Angeles*, 142 Cal. App. 3d 362, 190 Cal. Rptr. 866, 872-73 (1983).

229. *A.E.F.'s*, 295 N.Y. at 381, 68 N.E.2d at 177. See *supra* note 91.

factors.²³⁰

Landlords have asserted that a rent regulation ordinance like Measure I that lacks a statutory fair return formula is constitutionally deficient. Measure I simply delegates the duty of defining and applying a fair return on investment to the BBA.²³¹ In *Birkenfeld*, the California Supreme Court rejected a similar argument. The court concluded that “[b]y stating its purpose and providing a nonexclusive illustrative list of relevant factors to be considered, the charter amendment provides constitutionally sufficient legislative guidance to the Board for its determination of petitions for adjustments of maximum rents.”²³²

In *Carson*, landlords asserted that the challenged mobile home rent control ordinance unconstitutionally delegated legislative power to a citizens’ board because it contained no specific fair return formula. The ordinance guaranteed landlords “just, fair, and reasonable” rents and provided the board with a nonexclusive list of twelve relevant factors to consider in reviewing landlord petitions.²³³ The California Supreme Court reasoned that the ordinance was not rendered unconstitutional because it failed to articulate a formula for determining what constitutes a just and reasonable return. The court reasoned that rent control agencies are not obliged by either the state or federal constitution to fix rents by application of any particular method or formula.²³⁴

Under *Birkenfeld* and *Carson*, Measure I is not unconstitutional on its face merely because the definition of a fair return is delegated to the BBA. Unlike its Berkeley and Carson residential counterparts, no list of relevant factors exists for the BBA to consider. Challengers may assert that the lack of statutory fair return standards provides insufficient guidance. As long as the BBA defines a fair return formula that meets Measure I’s purpose and provides landlords with a fair return, Measure I should pass constitutional muster as applied.²³⁵

230. See *Fisher*, 148 Cal. App. 3d at —, 195 Cal. Rptr. at 841-42 n.4 (10 factors listed).

231. MEASURE I, *supra* note 45, § 6(c).

232. 17 Cal. 3d at 168, 550 P.2d 1028-29, 130 Cal. Rptr. at 492-93. See *supra* notes 125, 192-98, & 217 and accompanying text.

233. 35 Cal. 3d at 188, 672 P.2d at 1298, 197 Cal. Rptr. at 287. See *supra* notes 194, 218-19 and accompanying text.

234. 35 Cal. 3d at 191, 672 P.2d at 1300, 197 Cal. Rptr. at 287.

235. *Palos Verdes*, 142 Cal. App. 3d at 370, 190 Cal. Rptr. at 872-73, supports this view. See *supra* note 228.

2. The NOI Formula

a. *Market Value versus NOI*

Landlords have argued repeatedly that the only permissible fair return rent control formula is a return on market value formula. If this opinion is correct, the BBA's adoption of a NOI formula may be vulnerable. A majority of appellate courts that have considered this fair return issue, however, have rejected this assertion. As the California Supreme Court stated in *Carson*, the federal constitution does not require the adoption of any particular formula.²³⁶

In *Helmsley v. Borough of Fort Fee*,²³⁷ the New Jersey Supreme Court rejected the return on market value approach as "circular". Several California and Massachusetts appellate courts have reiterated this view.²³⁸ Little likelihood exists that courts will treat challenges to Measure I any differently.

b. *Inflation Indexing*

A more serious challenge to the BBA's NOI formula is the argument that, in order to provide a fair return to landlords, the BBA must not only maintain NOI, but that it must fully index NOI for inflation.

In *Fisher v. City of Berkeley*,²³⁹ the California Court of Appeal held that Berkeley's residential rent stabilization ordinance was facially invalid because it did not expressly guarantee residential landlords an inflationary adjustment through annual general cost pass through rent

236. 35 Cal. 3d at 191-92, 672 P.2d at 1300, 197 Cal. Rptr. at 287. See *supra* notes 194, 233-34 and accompanying text.

237. 78 N.J. 200, 213-14, 394 A.2d 65, 71 (1978). See Baar, *supra* note 132, at 798.

238. See *Oceanside Mobilehome Park Owners' Ass'n v. City of Oceanside*, 157 Cal. App. 3d 887, —, 204 Cal. Rptr. 239, 246-47 (1984); *Palos Verdes Shores Mobile Estates, Ltd. v. City of Los Angeles*, 142 Cal. App. 3d 362, 370-71, 190 Cal. Rptr. 866, 871 (1983); *Cotati Alliance for Better Hous. v. City of Cotati*, 148 Cal. App. 3d 280, 287-88, 195 Cal. Rptr. 825, 829-30 (1983); *Niles v. Boston Rent Control Admin.*, 6 Mass. App. Ct. 135, 143-44, 374 N.E.2d 296, 301 (1978). But see *Gregory v. City of San Juan Capistrano*, 142 Cal. App. 3d 72, 91, 85 Cal. Rptr. 47, 56 (1983) (citing *Helmsley* as constitutionally requiring a return on value fair return formula). The courts in the *Oceanside* and *Cotati* cases rejected *San Juan Capistrano*, noting that it had misconstrued *Helmsley*—a case that rejected the market value approach. *Oceanside*, 157 Cal. App. 3d at —, 204 Cal. Rptr. at 247; *Cotati*, 148 Cal. App. 3d at 288, 195 Cal. Rptr. at 830-31.

239. 148 Cal. App. 3d at 267, 195 Cal. Rptr. at 836 (1983), *aff'd*, — Cal. 3d —, 693 P.2d 261, 209 Cal. Rptr. 682 (1984). See *infra* Epilogue, at pp. 182-84 for a discussion of the California Supreme Court decision.

increases. The California Supreme Court is reviewing this decision. No governing precedent exists on this issue.

In *Helmsley*, the New Jersey Supreme Court indicated that, if a "steady erosion" of NOI occurred under rent control, the court may find the law unconstitutionally confiscatory if landlords could not easily obtain individual rent adjustments. The court, however, did not mandate full inflation indexing of regulated rents to guarantee a fair return.²⁴⁰ In *Cotati Alliance for Better Housing v. City of Cotati*,²⁴¹ a California appellate decision upholding the validity of a local residential rent control ordinance that guaranteed a landlord's "fair and reasonable return on investment," the court noted that if the amount of the landlord's net operating profit remains the same over time, the landlord's return diminishes and rent control eventually becomes confiscatory. Like the New Jersey Supreme Court, this court did not hold that the NOI must be fully indexed against inflation to provide landlords a fair return.

In *Oceanside Mobilehome Park Owners' Association v. City of Oceanside*,²⁴² the California Court of Appeal upheld the use of a maintenance of NOI fair return formula when NOI is adjusted partially for inflation. The challenged mobile home rent control ordinance provided for annual adjustments of the lesser of the increase in the CPI or eight percent. If that did not provide park owners a fair return, the mobile home rent control ordinance entitled landlords to a NOI adjustment equal to the lesser of the increase in the housing component of the CPI or forty percent of the CPI since the 1979 base year. The court upheld this formula as facially constitutional. The court rejected the challenger's assertions that only a fair return on value formula is constitutional and that the NOI formula with only a partial inflation adjustment is confiscatory.²⁴³

Assuming that the California Supreme Court upholds *Fisher*, the case is unlikely to serve to invalidate Measure I. *Fisher* is premised upon the procedural problems raised by *Birkenfeld*—requiring all of Berkeley's residential landlords to seek inflation adjustments through individual petitions to the BRSB. Because Measure I's fair return formula provides an automatic, mandatory inflation adjustment and

240. *Helmsley*, 78 N.J. at 223, 394 A.2d at 76.

241. 148 Cal. App. 3d 280, 293, 195 Cal. Rptr. 825, 834 (1983).

242. 157 Cal. App. 3d 887, —, 204 Cal. Rptr. 239, 251-52 (1984).

243. *Id.* at —, 204 Cal. Rptr. at 245-53.

only involves at most eighty-four hearings annually, the courts should not apply the *Fisher* procedural rationale.

Two issues remain. Is Measure I facially invalid because it does not guarantee expressly an adjustment for inflation? *Fisher* implies an affirmative answer.²⁴⁴ In *Birkenfeld* and *Carson*, however, the California Supreme Court rejected the argument that a rent control law must contain a set fair return formula. Therefore, the courts must examine an ordinance as applied.

Unlike Berkeley's residential rent stabilization fair return regulations, the BBA not only has provided landlords with an inflation adjustment of NOI, but has made it automatic. This eliminates the question of whether landlords can obtain discretionary adjustments within a reasonable period. Left unanswered is the query whether landlords are entitled constitutionally to full inflationary adjustments. No court has yet upheld this assertion. Under the BBA's formula, the BBA will adjust fully Elmwood landlords' median base NOI if the applicable CPI-U rises less than ten and one-half percent annually. This is subject to the twenty-five percent overall annual adjustment ceiling. Landlords are not entitled to an inflation adjustment beyond that ceiling. Under the New Jersey Supreme Court's reasoning in *Helmsley*, inflation must rise significantly beyond allowable general rent adjustments for an extended period of time, therefore steadily eroding NOI, before landlords can prove factually that their return is no longer fair.

Moreover, if a majority of Elmwood landlords failed to include inflation escalator clauses in their leases before the adoption of Measure I, it is difficult to see how landlords can assert forcefully that Measure I should guarantee what the unregulated market did not provide.

c. *Individual NOI versus Base Median NOI Adjustment*

Landlords may assert that, regardless of the inflation adjustment that the BBA allows, the BBA must adjust their individual base NOI rather than the Elmwood district's base median NOI. No precedent exists for review of this novel NOI formula. Nevertheless, it is unlikely that the courts will recognize that the Constitution guarantees regulated landlords a right to individualized treatment because rent control statutes invariably involve uniform, rather than individualized, fair return formulas.

244. 148 Cal. App. 3d at 301, 195 Cal. Rptr. at 840.

3. Speculative Financing

Measure I prohibits landlords from passing on to tenants the costs of purchase financing or refinancing, except for capital improvements.²⁴⁵ This provision is intended to prohibit speculative landlords from passing on to tenants the costs of debt service during a period when rising mortgage interest rates and rising real estate prices would result in huge rent increases.

In *Fisher*, the court of appeal upheld the validity of a similar provision in Berkeley's residential rent stabilization law. Landlords asserted that this prohibition violated California's statutory prohibition against restraints on alienation of real property.²⁴⁶ Courts have interpreted this prohibition to mean that only unreasonable restraints are invalid.²⁴⁷ The *Fisher* court held that this statute does not apply to municipalities.²⁴⁸ Assuming that it applies, the court found that the ordinance's guarantee of a fair return on investment provides an adequate "safety valve."²⁴⁹ The court's reasoning and conclusion apply equally to Measure I to dispose of this contention.

4. Ceiling

The BBA imposed a twenty-five percent annual ceiling on all rent adjustments, including NOI inflation adjustments.²⁵⁰ The BRSB imposed a fifteen percent ceiling on individual rent adjustments, including those based upon the maintenance of NOI for a fair return.²⁵¹ Both boards allow landlords to collect any rent increases in excess of these ceilings incrementally in successive years until the landlords receive fully the adjustment to which they are entitled.

Landlords may assert that the imposition of this ceiling denies them a fair return because it delays their actual enjoyment of their fair return. They may point to the California Court of Appeal decision in

245. MEASURE I, *supra* note 45, § 5(c)(i).

246. See CAL. CIVIL CODE § 711 (Deering 1971).

247. See, e.g., *Wellenkamp v. Bank of Am.*, 21 Cal. 3d 943, 948, 582 P.2d 970, 973, 148 Cal. Rptr. 379, 382 (1978). See generally Note, *Wellenkamp v. Bank of America: Invalidation of Automatically Enforceable Due-on-Sale Clauses*, 67 CALIF. L. REV. 886 (1979).

248. *Fisher*, 148 Cal. App. 3d at 300, 195 Cal. Rptr. at 839.

249. *Id.* at 301, 195 Cal. Rptr. at 839-40.

250. See *supra* note 160.

251. See *supra* note 162.

Pernell v. City of San Jose.²⁵² In *Pernell*, the court invalidated a provision in San Jose's residential rent control ordinance that allowed hearing officers to consider tenant hardship as a discretionary factor in reviewing landlord petitions for special rent increases. The court ruled that this provision denied landlords constitutional guarantees of a fair return, equal protection, and amounted to a prohibited taking.²⁵³

The BBA's twenty-five percent annual ceiling also is designed to prevent tenant hardship. Unlike the San Jose hardship clause, however, this ceiling does not eliminate rent increases over the ceiling, but postpones them. Additionally, the ceiling applies to all tenants. Landlords, therefore, cannot argue that the BBA discriminatorily aimed the ceiling only at certain favored tenants.

The New York Court of Appeals upheld the New York annual ceiling of fifteen percent on fair return rent increases for commercial tenants.²⁵⁴ In view of this precedent, the purpose of Measure I, and the establishment of a twenty-five percent overall ceiling subject to administrative change, the BBA ceiling should survive constitutional challenges unless a landlord can prove drastic hardship attributable to the ceiling.

G. Antitrust

Until 1978, municipal government enjoyed an implied exemption from the coverage of federal antitrust laws under the "state action exemption" that the United States Supreme Court established in *Parker v. Brown*.²⁵⁵ In *City of Lafayette v. Louisiana Power and Light Co.*,²⁵⁶ the Supreme Court cut back on the *Parker* doctrine substantially when it held that the state action exemption does not apply automatically to anticompetitive municipal activity. In *Community Communications Co. v. City of Boulder*,²⁵⁷ the Court held that a municipality must prove that its activity constitutes action of the state in its sovereign capacity

252. 154 Cal. App. 3d 1019, 201 Cal. Rptr. 728 (1984).

253. *Id.* at —, 201 Cal. Rptr. at 730-32.

254. *A.E.F.'s*, 295 N.Y. at 385, 68 N.E.2d at 179. *See supra* note 91.

255. 317 U.S. 341, 351 (1942).

256. 435 U.S. 389, 408 (1978).

257. 455 U.S. 40, 48-51 (1982). *See generally* Comment, *Municipal Antitrust Liability: Community Communications Co. v. City of Boulder*, 25 WASH. U.J. URB. & CONTEMP. L. 297 (1983). Whether active state supervision of municipal action is required may be decided in *Town of Hallie v. City of Eau Claire*, 700 F.2d 376 (7th Cir. 1983), *cert. granted*, 104 S. Ct. 3508 (1984).

or is in furtherance or implementation of a clearly articulated and affirmatively expressed state policy to justify its antitrust exemption. These decisions may lead to landlord antitrust challenges to Measure I and the rezoning of Elmwood.

1. Rent Stabilization

If municipal rent control exists by virtue of state authorization of local option rent control, the *Parker* doctrine exempts municipal rent control from the federal antitrust laws.²⁵⁸ California has not directly authorized municipal rent controls, including Berkeley's Measure I. California, in fact, consistently has rejected proposed legislation to regulate local rent regulation.²⁵⁹ In *Fisher*, the California Supreme Court presently is considering the antitrust issue.

Rent control opponents assert that local rent control constitutes illegal price fixing, which has not and cannot be exempt from antitrust prohibitions through state authorization. Proponents counter that municipal price regulation, as distinguished from anticompetitive activity of public enterprises, is not an illegal restraint of trade subject to the antitrust laws. Even so, proponents contend that a voter initiative does not constitute a price-fixing conspiracy and that local rent control does not burden interstate commerce. Finally, opponents contend that, even if these arguments fail, an indirect statutory authorization exists for local rent control sufficient to invoke the *Parker* doctrine.²⁶⁰

The outcome of any antitrust challenge to Measure I depends upon the California Supreme Court's response in *Fisher*. Irrespective of the outcome, however, the courts may view commercial rent stabilization, which protects businesses, as more susceptible to antitrust challenges

258. See *Brontel, Ltd. v. City of New York*, 571 F. Supp. 1065, 1070-72 (S.D.N.Y. 1983). The court held that New York City's local rent control regulations were exempt from federal antitrust laws under *Boulder* because they were "in furtherance or implementation of clearly articulated and affirmatively expressed state policy." *Id.* at 1071. The court also found that active state supervision was present. *Id.* at 1072 n.31. Subsequently, the State of New York assumed responsibility for administering New York City's local rent controls. See *supra* note 181.

259. See W.D. KEATING, *supra* note 11. In 1984, the California Assembly passed rent control legislation preempting local residential rent controls (A.B. 3808), but the California Senate failed to vote on the bill.

260. Opponents rely primarily on the state statutory mandate for local housing elements to promote affordable housing. See CAL. GOV'T CODE §§ 65,580-81, 65,583 (Deering Supp. 1984). See generally Note, *State and Federal Housing Policy vs. Local Land Use Regulation: The New Conflict Between State and Municipal Powers in California*, 15 U.S.F.L. REV. 509 (1981).

than residential rent controls, which protect noncommercial tenants. This question never arose during the life of New York's state-authorized commercial rent controls enacted after *Parker*.

2. Zoning

Challengers also may contend that Berkeley's rezoning of Elmwood violates the antitrust laws on the ground that the density and development controls, in combination with the quotas established for types of businesses, constitute an illegal conspiracy between Elmwood merchants and the city to establish a neighborhood monopoly for existing merchants. Such a challenge is unlikely to succeed.

Several pre-*Lafayette* and *Boulder* California cases rejected antitrust challenges to local zoning. For example, in *Ensign Bickford Realty v. City Council of Livermore*,²⁶¹ the California Supreme Court upheld zoning restrictions on the expansion of business on the ground that the municipality's primary purpose was to regulate rational land use rather than to create a business monopoly. Whether these cases retain precedential value, however, remains unknown.

Because California cities receive their zoning power from the state, the state delegation alone may satisfy the test propounded in *Boulder*.²⁶² Moreover, the state has actively supervised local planning and zoning by, for example, mandating various elements of local master plans, reviewing these elements, and requiring consistency between local zoning and general plans.²⁶³ Because the rezoning of Elmwood is consistent with the goal of protection of neighborhood-serving commercial districts in Berkeley's amended master plan, the rezoning appears to fall within this exemption.

The outcome of *Fisher* and post-*Boulder* antitrust challenges may decide whether either Measure I or the Elmwood rezoning are susceptible to antitrust challenges. Assuming that Measure I and the rezoning of Elmwood are susceptible to antitrust challenges, landlords still

261. 68 Cal. App. 3d 467, 479-80, 137 Cal. Rptr. 304, 311 (1977). See generally Mandelker, *Control of Competition as a Proper Purpose in Zoning*, 14 ZONING DIG. 33 (1962); Note, *Antitrust and Zoning—How Much Respect for Local Government?*, 22 SANTA CLARA L. REV. 901 (1982).

262. See CAL. GOV'T CODE § 65,100 (Deering Supp. 1984). The State requires every city and county to establish a planning agency. The State requires them to prepare and adopt a comprehensive, long-term general plan. *Id.* § 65,300.

263. For example, the state specifies the content of the Housing Elements of local general plans and mandates their review by the California Department of Housing and Community Development. CAL. GOV'T. CODE §§ 65,580-85 (Deering Supp. 1984).

must overcome the heavy burden of proving the anticompetitive intent, conduct, and impact of the city's regulatory actions in Elmwood. An alternate outcome depends upon the success of the lobbying campaign of municipalities seeking express exemption from the reach of federal and state antitrust laws.²⁶⁴

VIII. CONCLUSION

A. *The Significance of the Elmwood Experiment*

The significance of the Elmwood experiment lies in its test of the efficacy of localized rent controls as a municipal antidisplacement strategy. Elmwood, however, does not present the case of a gentrifying neighborhood shopping district symptomatic of the gentrification of surrounding residential neighborhoods. While the lower-income population of these areas increasingly may be priced out of Elmwood if Measure I fails, this alone is unlikely to decide the fate of their housing pattern. It is more likely that their income, the price of that housing, and other related factors such as the effectiveness of Berkeley's residential rent controls, are much more crucial. Indeed, it is reasonable to hypothesize that commercial gentrification will begin only once a market, either neighborhood-based or based regionally, is established. If this is the case, commercial gentrification is most likely a symptom, rather than a cause, of residential displacement. Assuming that commercial rent control slows or stops commercial displacement in gentrifying shopping districts, its adoption still will not affect residential displacement in Berkeley or elsewhere.

Whether the neighborhood is rich, poor, mixed, or in transition, the Elmwood example illustrates the issues raised by the disappearance of basic small, neighborhood-serving businesses vulnerable to disproportionate rent increases. Conventional planning techniques, including zoning controls and historic preservation, often are inadequate to save these businesses. Commercial rent stabilization may be a better public policy if this is a city's goal. The Elmwood example provides insight into the enormous complexities involved in the adoption and implementation of such a policy, even if in one tiny neighborhood. Selective city-wide application of commercial rent stabilization, either by dis-

264. In October 1984, Congress granted local governments protection against monetary damages and attorneys fees in actions brought against them or their officials acting in an official capacity under the Clayton Act. See Local Government Antitrust Act of 1984, Pub. L. No. 98-554 (Oct. 24, 1984).

trict, by type of business, or by both, presents even more complexities. It remains to be seen whether much larger cities like New York City and San Francisco will follow Berkeley's example.

Perhaps the most fascinating unanswered questions raised by the Elmwood experience concern the political and economic motivations, and the behavior of Elmwood's commercial tenants. The political ideology of American small business owners has been very conservative and antiregulatory. Berkeley is no exception. Whether merchant support for Measure I represents an exception, or is merely a temporary expedient embraced solely for survival by some shopkeepers, is unknown.

Likewise, it remains unknown to what extent the rent savings provided by Measure I have saved not only marginal small businesses from involuntary relocation or liquidation, but also have resulted in reduced prices or price increases, maintenance or improvement of services, or other tangible benefits to the immediate customers of these businesses, in addition to their survival in their present location. If Berkeley continues rent regulation, some tenants, particularly older proprietors nearing retirement and unprofitable businesses, may sublet or sell to new tenants and capitalize their rent savings. It remains unknown how this will affect Elmwood's overall character.

B. *Elmwood's Unanswered Questions*

In addition to these questions and the unanswered legal issues analyzed above, the Elmwood experiment raises other unanswered questions. If Berkeley's future evaluations provide answers to these questions, proponents and opponents of commercial rent stabilization as a regulatory policy will be well-served.

Given the small scale involved, the feasibility of this approach is important, especially if it is expanded on a city-wide basis to other gentrifying neighborhood commercial areas. Feasibility issues include: 1) the rate of landlord compliance with the registration, rent increase, and other regulatory requirements; 2) the success of BBA implementation of its novel fair return formula and its impact on landlords and tenants; 3) landlords' use and the impact on existing and new tenants of the banking provision for rent increases; 4) the impact on tenant turnover, including subleases; 5) the impact on ownership, including sales and transfers; 6) the impact on type of ownership, especially conversion of commercial rental space to commercial condominiums; 7) the impact on rehabilitation and subdivision of existing space; 8) the

BBA's administration of the law, its efficiency, and success in dispute resolution; and 9) the city's cost of administration.²⁶⁵

Over time, a careful evaluation of this experiment should provide insight into these important issues. Measure I's success in saving Elmwood's smaller neighborhood-serving businesses will be known only after it has been in existence for several years.

C. Recommendations

Cities where neighborhood commercial displacement has become an issue should consider carefully the Elmwood experiment and its lessons. The Elmwood experience suggests that land use controls alone are insufficient to protect existing neighborhood-serving businesses. They only discourage, and do not directly prevent, the entry of businesses that displace current tenants. Conversely, commercial rent stabilization without density and land use controls is insufficient to achieve this goal. Therefore, a tandem regulatory approach is recommended.

If condominium conversions grow and threaten to displace tenants unable to purchase their rented space, commercial condominium conversion controls then may be required. While an absolute, permanent ban may be unconstitutional, a variety of lawful conversion controls should be considered.²⁶⁶ These include: 1) an annual ceiling on the number or percentage of conversions; 2) special ameliorative requirements—for example, payment of relocation costs—if certain types of businesses are displaced;²⁶⁷ and 3) inclusionary requirements—for example, below-market purchase prices for long-term tenants unable to

265. Measure I empowers the BBA to charge fees. MEASURE I, *supra* note 45, § 8(b). The BBA has established a petition filing fee of \$100 for the first unit and \$20 for each additional unit in the same building.

266. For an analysis of various residential condominium conversion controls, see generally Day & Fogel, *The Condominium Crisis: A Problem Unresolved*, 21 URBAN L. ANN. 3 (1981); Judson, *Defining Property Rights: The Constitutionality of Protecting Tenants from Condominium Conversion*, 18 HARV. C.R.-C.L. L. REV. 179 (1983); Schlein, *Government Regulation of Condominium Conversion*, 8 ENVTL. AFF. L. REV. 919 (1980); Note, *Displacement in Gentrifying Neighborhoods: Regulating Condominium Conversion Through Municipal Land Use Controls*, 63 B.U.L. REV. 955 (1983); Comment, *The Regulation of Rental Apartment Conversions*, 8 FORDHAM URB. L.J. 507 (1979-1980).

267. California courts have upheld the validity of requiring relocation payments. See, e.g., *Kalaydjian v. City of Los Angeles*, 149 Cal. App. 3d 690, 693, 197 Cal. Rptr. 149, 151 (1983) (imposition of tenant relocation fees on landlords that convert apartments to condominiums or other specified uses was within power of city).

afford market prices.²⁶⁸

The adoption of a policy to encourage nonmarket ownership provides an alternative approach. Cooperatives provide one possibility. Berkeley already has several retail cooperatives. Community Land Trusts (CLTs) are one form of cooperative ownership.²⁶⁹ CLTs have been created to promote neighborhood-based, non-profit community ownership.²⁷⁰ In 1982, for example, the Northern California Land Trust created a neighborhood CLT to purchase a five unit commercial building in a gentrifying area of south Berkeley.²⁷¹ A city not only can promote this as a policy, but also can provide critical "seed" financing and loan guarantees to make it more financially feasible for small businesses to form neighborhood cooperatives and CLTs.

If commercial rent stabilization is adopted, a targeted approach is recommended. While geographical targeting is justifiable, it makes little sense to regulate all landlords and tenants in a district like Elmwood. For example, Measure I gives the same protection to a branch of California's largest and wealthiest commercial bank as it does to small, family-owned businesses. This indiscriminate protection is neither appropriate nor necessary.

A targeted approach, as illustrated by New York's proposed SBPA, should protect only those small, neighborhood-serving businesses that need protection most. The criteria for protection should include all or some of the following: The type of neighborhood-serving business; the size of rentable space; the number of employees; gross sales; and the type of ownership.

Residential rent control precedent exists for this type of targeted regulatory approach. Luxury rental housing and landlords that own only a few units typically are exempted from rent control regulation on the grounds that wealthy tenants need no protection and that small-scale landlords should remain unregulated.²⁷² Landlords and tenants may manipulate targeted exemptions and coverage provisions, and, therefore, cause administrative problems. These problems, however, are not insurmountable, particularly at the Elmwood scale of regulation.

268. *See supra* note 34.

269. *See generally* California Consumer Cooperative Corporations, CAL. CORP. CODE §§ 12,200-704 (Deering Supp. 1984).

270. *See* INSTITUTE FOR COMMUNITY ECONOMICS, THE COMMUNITY LAND TRUST HANDBOOK (1982).

271. Berkeley Gazette, Sept. 15, 1982, at 1, col. 1.

272. *See supra* note 228.

More answers to the questions raised here will be forthcoming as more is known about the use and impact of commercial rent stabilization on neighborhood-serving businesses in gentrifying urban neighborhoods like Berkeley's Elmwood district.

EPILOGUE

On December 27, 1984, the California Supreme Court decided *Fisher v. City of Berkeley*, — Cal. 3d —, 693 P.2d 261, 209 Cal. Rptr. 682 (1984). In a six-to-one decision the court upheld the constitutionality of Berkeley's residential rent control law (Measure D). The court addressed many of the issues concerning the legality of Measure I discussed in this Article and resolved some of these issues.

Antitrust

The court held that Measure D did not violate sections 1 and 2 of the Sherman Act. After reviewing *Lafayette* and *Boulder*, *id.* at —, 693 P.2d at 273-75, 209 Cal. Rptr. at 694-96, the court applied neither the rule of per se illegality nor the rule of reason to the section 1 challenge. Instead, the court adopted a commerce clause test. The court stated that municipal regulations are valid under section 1 if the regulations are "rationally related to the municipality's legitimate exercise of its police power and operates in an even-handed manner . . . unless the plaintiff demonstrates that the city's purposes [can] be achieved as effectively by means that [will] have a less intrusive impact on federal antitrust policies." *Id.* at —, 693 P.2d at 286-87, 209 Cal. Rptr. 707-08.

Applying this test, the court concluded that municipal rent control has a proper purpose and is rationally related to the legitimate exercise of the municipal police power. *Id.* at —, 693 P.2d at 287, 209 Cal. Rptr. at 708 (citing *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 550 P.2d 1001, 130 Cal. Rptr. 405 (1976)). The court concluded that the ordinance's exemptions did not constitute unreasonable discrimination. *Id.* at —, 693 P.2d at 287-88, 209 Cal. Rptr. at 708-09. Finally, the court decided that the landlord-plaintiff suggested no equally effective alternative to accomplish these legitimate local regulatory purposes by means that would have a less intrusive impact on federal antitrust policies. *Id.* at —, 693 P.2d at 288, 209 Cal. Rptr. at 709. The court applied the same test to the section 2 challenge and found no facial violation of the Act. *Id.* at —, 693 P.2d at 288-89, 209 Cal. Rptr. at 709-10. The court did not examine the extent of active state supervision of local rent control.

Application of this test to Measure I most likely will result in a similar conclusion. As previously discussed, the alternatives to commercial rent control will not achieve the purposes of Measure I, which appear to meet the court's initial test. It is doubtful that the court will accept the argument that its application to a single neighborhood is unreasonably discriminatory as long as it is applied in an even-handed manner.

Fair Return

First, the court announced that the "just and reasonable return on property" requirement stated in *Birkenfeld* was not intended to articulate a constitutional fair return standard. *Id.* at —, 693 P.2d at 291 n.35, 209 Cal. Rptr. at 712 n.35 (construing *Birkenfeld*, 17 Cal. 3d 129, 550 P.2d 1001, 130 Cal. Rptr. 465 (1976)). Second, the court repeated its conclusion in *Carson* that no particular fair return formula is constitutionally mandated. *Id.* at —, 693 P.2d 290, 209 Cal. Rptr. at 711. Third, it rejected the landlord's contention that a return on market value formula is constitutionally required for a fair return. *Id.* at —, 693 P.2d at 290-91, 209 Cal. Rptr. at 711-12. Fourth, the court rejected the facial challenge to measure D's fair return on investment standard. *Id.* at —, 693 P.2d at 295, 209 Cal. Rptr. at 716. It concluded that the city could administer this standard to avoid confiscatory results. *Id.* The court based this conclusion on the following considerations: 1) while landlords' profits may not be frozen indefinitely, the BRSB was not prevented from adjusting landlords' base NOI for inflation; 2) disparate treatment of individual landlords' investment does not constitute discrimination that violates equal protection; 3) the investment standard can be applied flexibly to treat landlords' differing types of investment; and 4) a diminution of landlords' long-term appreciation in property value is not per se confiscatory. *Id.* at —, 693 P.2d at 291-95, 209 Cal. Rptr. at 712-16. The court found that Measure D's procedures for rent adjustments remedied the due process defects of its predecessor. *Id.* at —, 693 P.2d at 295-99, 209 Cal. Rptr. at 716-20.

The court's analysis virtually guarantees that Measure I's fair return on investment standard will pass constitutional muster on its face. As applied, Measure I appears to meet the court's essential fair return requirements: the procedural safeguards necessary to provide speedy review of landlord rent adjustment petitions and periodic general adjustment of landlords' NOI for inflation. Nevertheless, given the

unique status of Measure I, only future judicial review will determine the constitutionality of its fair return provisions.

Unreasonable Restraints on Alienation

The court upheld Measure D's antispeculative restriction on the pass through of post-rent control mortgage refinancing costs. *Id.* at —, 693 P.2d at 299-300, 209 Cal. Rptr. at 720-21. The court ruled that this provision was not within the purview of and did not violate California's statutory prohibition against unreasonable restraints against alienation. *Id.* Therefore, Measure I's identical restriction does not constitute an unreasonable restraint on alienation.

Retaliatory Eviction

The court held that California law preempted Measure D's evidentiary requirement for presumption of landlords' retaliatory violation of the just cause for eviction protection. *Id.* at —, 693 P.2d at 300-04, 209 Cal. Rptr. at 721-25. The just cause for eviction requirements were not affected. *Id.* The court's invalidation of the presumption will have no effect on Measure I because Measure I does not contain a similar provision.

Rent Withholding

The court upheld Measure D's provision allowing tenants to withhold rent if landlords violate the law. *Id.* at —, 693 P.2d at 304-12, 209 Cal. Rptr. at 725-32. Measure I has no such provision.

The court did not address the other issues previously discussed in this Article.

APPENDIX

Elmwood Commercial Rent Stabilization and Eviction Protection
Ordinance (No. 5468-N.S.):
Measure I

The people of the City of Berkeley do ordain as follows:

Section 1. Title:

This Ordinance shall be called the Elmwood Commercial Rent Stabilization and Eviction Protection Ordinance.

Section 2. Purposes:

The purposes of this Ordinance are to protect commercial tenants in the Elmwood district from rent increases which are not justified by landlord's cost increases; to enable those tenants to continue serving residents of the Elmwood district without undue price increases, expansion of trade (which may exacerbate parking problems), or going out of business; and to test the viability of commercial rent stabilization as a means of preserving businesses which serve the needs of local residents in Berkeley neighborhoods, outside the downtown business district.

Section 3. Scope:

This Ordinance shall apply to all commercial premises (both office and retail), rented or available for rent, only in the Elmwood district of the City of Berkeley. The boundaries of this district are as follows: Stuart Street on the north, Webster Street on the south, Piedmond Avenue on the east, and Benvenue Avenue on the west.

Section 4. Definition:

In this Ordinance, the following words and phrases have the following meanings:

- (a) Landlord: Any owner, lessor, sublessor, or other person entitled to receive rent for the use or occupancy of any rental unit, or an agent thereof; provided, however, that the word "landlord" shall not include any governmental agency.
- (b) Rent: Any consideration (including any deposit, bonus, or gratuity) demanded or received in connection with the use or occupancy of any rental unit.
- (c) Rental Unit: Any property, building, structure, or part

thereof, or land appurtenant thereto, which is covered by Section 3 of this Ordinance, together with all services connected with the use or occupancy thereof.

- (d) **Services:** Those services and facilities which enhance the use of the rental unit, including but not limited to repairs, replacement, maintenance, painting, heat, hot and cold water, utilities, elevator service, security devices and patrols, furnishings, storage, janitorial and landscaping services, refuse removal, insurance protection, parking spaces, and services to and facilities in common areas of the building or parcel in which the unit is located.
- (e) **Tenant:** A tenant, subtenant, lessee, sublessee, or any other person entitled to the use or occupancy of any rental unit.
- (f) **Consumer Price Index:** The All Items Consumer Price Index for All Urban Consumers, San Francisco-Oakland, California, as published by the United States Department of Labor, Bureau of Labor Statistics.

Section 5. Maximum Rent:

- (a) No landlord of any rental unit covered by this Ordinance shall request, demand, receive, or retain more than the maximum rent allowed by this section. The maximum rent shall be the "base rent" plus any "allowable adjustments."
- (b) "Base rent": Except as provided herein, base rent shall be the lawful periodic rent in effect on October 1, 1981 (the approximate time the current campaign for commercial rent stabilization in the Elmwood district began).
 - i) If, on October 1, 1981, the rental unit was held under a lease which provided for fixed rental payment of varying amounts (e.g., rents escalating with a Consumer Price Index), then the base rent shall be the amount of the final lawful periodic rental payment required by such lease.
 - ii) If, on October 1, 1981, the rental unit was held under a lease which provided rental payments whose amounts were determined by gross sales, in whole or in part (whether or not there is a fixed minimum rent), the monthly base rent shall be the total amount of rent lawfully payable for the final 12 months of such lease, divided by 12 unless the landlord notifies the tenant in writing at least 30 days before the lease expires that the landlord chooses to continue the same provisions for determining rent as were provided by such lease. If the landlord so notifies the tenant, then such provisions shall continue, provided, however, (1) that the rent shall not be subject to the "allowable adjustment" allowed by this sec-

tion, (2) that the landlord may thereafter abandon this method of determining rent and use the other method provided by this subsection [(5)(b)(ii)] to determine the base rent (adding any "allowable adjustments" to determine the "maximum rent"), but only upon 90 days prior written notice to the tenant, and (3) that the landlord must abandon the gross sales method of determining rent and shall use the other method provided by this subsection [(5)(b)(ii)] to determine the base rent (adding any "allowable adjustment" to determine the "maximum rent"), if the rental unit fails to sell or produce substantially the same types of goods or services to the community as it did on October 1, 1981.

(iii) If, on the date this Ordinance becomes effective, the rental unit was held under a lease or rental agreement providing for fixed rental payments, and such rent has not been raised in the 12 months prior to that date, then the base rent shall be increased by the percentage of base rent which equals the following amount: 5% times the number of years (rounded off to the nearest year) between the date the rent on the rental unit was last raised (before enactment of this Ordinance) and the date this Ordinance becomes effective.

(iv) The base rent for any rental unit newly constructed after October 1, 1981, or not rented on October 1, 1981, shall be the lawful periodic rent actually charged for the first 12 months after the unit is rented. This method of establishing base rent shall not be allowed, however, if the parcel on which such new units is built contained, on October 1, 1981, a rental unit covered by this Ordinance, which a newly constructed unit has replaced.

(c) "Allowable adjustments":

(i) The allowable adjustments shall be the unit's proportionate share of increases in periodic costs, to the landlord, since the end of the period used for determining the base rent under subsection (b), or since the last allowable adjustment, whichever is later. Such costs shall include costs of maintenance and operating expenses, property taxes, fees in connection with the operation of the property, and improvements (amortized over the useful life of each improvement). Increased costs due to increased principal or interest charges on a loan shall not be allowed, however, where such increased charges result from a larger loan being taken on the property (as contrasted with increased charges resulting from increases in prevailing rates of interest), whether due to refi-

nancing by the landlord or purchase financing by a new landlord.

(ii) No allowable adjustment shall be based on increased costs incurred with the intent to evade any of the purposes of this Ordinance.

(iii) The allowable adjustment shall not include an increase in any cost which the tenant is already required to pay by the terms of the lease on the rental unit (such as property taxes and insurance).

(iv) Allowable adjustment shall become effective only if the landlord gives the tenant at least 30 days prior written notice that the landlord is imposing the adjustment and thereby raising the rent. Such notice shall be served according to the provisions of Code of Civil Procedure section 1162 or by any reasonable manner agreed upon by the parties. The notice must specify the base rent, the costs which have risen, including the amortization period used for any improvements, their amounts and the method of apportionment among the units. The notice must advise the tenant that, upon the tenant's request within 10 days, the landlord will furnish documentary evidence of the base rent and increased costs. If such request is made, the landlord shall furnish such documentary evidence within 10 days after such request. If the landlord fails to furnish such evidence within 10 days, the notice of allowable adjustment shall become null and void. The tenant's failure to request such evidence shall not be deemed a waiver of his right to later contest the validity of the rent increase.

- (d) If a rental unit is hereafter subdivided into 2 or more rental units, then the base rents of the new units shall be determined by apportioning the base rent of the old unit and any allowable adjustments among the new rental units according to the square footage of each unit. If 2 or more rental units are hereafter consolidated into 1 rental unit, then the base rent on the new unit shall be the total of the base rents and any allowable adjustments on the former units.

Section 6. Extraordinary Rent Increase:

- (a) If the application of this Ordinance, or any section or part thereof, would operate to violate the United States Constitution or California Constitution by denying a landlord a fair and reasonable return on investment or by confiscating the landlord's property, then such Ordinance, section, or part thereof shall apply to such landlord only to the extent that it

does not deny him a fair and reasonable return on investment or confiscate his property.

- (b) If a landlord believes a rent greater than is allowed by Section 5 is necessary to provide him with a fair and reasonable return on investment, such landlord shall petition for and obtain a declaration from the Board of Adjustments that such rent is permitted by this section, before increasing rent pursuant to this section.
- (c) The Board of Adjustments shall enact regulations relating to its duties under this Section, including the definition of "fair and reasonable return on investment."

Section 7. Services, Lease Provisions, and Assignments:

- (a) No landlord shall reduce or eliminate any service to any rental unit covered by this Ordinance, unless a proportionate share of the cost savings due to such reduction or elimination is passed on to the tenant in the form of a decrease in rent. Nor shall any landlord delete or modify any provision of any existing or proposed lease or rental agreement, to the disadvantage of a tenant, unless the fair value of such deletion or modification is passed on to the tenant in the form of a decrease in rent.
- (b) No lease entered into after the effective date of this Ordinance may contain any provision prohibiting or limiting the tenant's right to assign the lease to a purchaser of the tenant's business, except that a lease provision may condition such assignment on the purchaser being at least as capable of complying with the lease as the tenant, and a lease provision may condition such assignment on the payment to the landlord of any necessary and reasonable expenses caused the landlord by the assignment. No other payment to the landlord shall be required or made for his consent to the assignment. Any consideration paid to the tenant, directly or indirectly, for the transfer (by assignment, sublease, or otherwise) of any lease or sublease of any rental unit or part thereof shall be treated as part of the rent for the first month of occupancy after the transfer and, as such, shall be subject to the limitations on rent imposed by this Ordinance.

Section 8. Dispute Resolution:

- (a) In case of any dispute over the meaning or application of any provision of this Ordinance (except Section 9), a landlord, tenant, or any other interested party or neighborhood organi-

zation may petition the Board of Adjustments for resolution of the dispute. Where the City Attorney determines that the City of Berkeley or any neighborhood thereof is an interested party, the City Attorney may petition or otherwise appear on behalf of such party.

- (b) Within a reasonable time after the effective date of this Ordinance, the Board of Adjustments shall adopt rules and regulations designed to assure prompt and fair resolution of disputes which may arise under this Ordinance. Such rules and regulations shall include provisions assuring that timely notices of petitions and hearings shall be given to all affected parties. Such rules and regulations may include a schedule of reasonable fees to cover the cost of dispute resolution, and may indicate which party shall be responsible for such fees. The Board of Adjustments may thereafter amend, repeal, and supplement its rules and regulations as it deems appropriate to assure prompt and fair resolution of disputes.
- (c) The Board of Adjustments may delegate its powers to hold hearings and render decisions under this section to groups of one or more members of the Board, or to hearing officers, with or without the right to appeal to the full Board, if such delegation will help to assure prompt and fair resolution of disputes.
- (d) In any case in which the validity of any proposal or actual rent increase under the Ordinance is in dispute, the burden of proof shall be on the landlord to establish all facts which show that the rent increase is allowed by this Ordinance.
- (e) The Board of Adjustments may issue orders to enforce its regulations and decisions.
- (f) The decision of the Board of Adjustments shall be final, subject to the right of any party to seek judicial review in any court of competent jurisdiction. Such review may be sought by any affected landlord, tenant, the City of Berkeley, or any interested party or neighborhood organization, whether or not such party participated in the Board of Adjustments proceedings.
- (g) The Board of Adjustments may, from time to time as it deems appropriate, adopt regulations which interpret various provisions of this Ordinance.
- (h) If the Board of Adjustments becomes aware that any purpose of this Ordinance is being evaded or that it is not operating fairly toward landlords, tenants, or the community, the Board shall promptly notify the City Council and may recommend that appropriate amendments to this Ordinance be placed on the ballot.

- (i) The Board of Adjustments shall have the powers and duties necessary to fulfill the purposes of this Ordinance.

Section 9. Evictions:

In any action to evict any tenant from any rental unit covered by this Ordinance, the landlord shall plead and prove that the landlord is in compliance with Section 5(a) of this Ordinance, and that the action is being brought for one or more of the following reasons, which were stated in the notice of termination:

- (a) the tenant has failed to pay the lawful rent to which the landlord is entitled, and failed to comply with a valid notice to pay or quit served pursuant to Code of Civil Procedure section 1161;
- (b) the tenant has substantially violated an obligation imposed by the lease or rental agreement (other than an obligation to surrender possession at the end of a term or upon notice) and has failed to cure such violation within 10 days after having received written notice thereof from the landlord;
- (c) the tenant is committing or permitting to exist a nuisance in the building or parcel, or is causing a substantial interference with the comfort, safety, or enjoyment of the building or parcel by the landlord or other tenants;
- (d) the tenant is using the rental unit for some illegal purpose;
- (e) the tenant, who had a lease or rental agreement whose term has expired, has refused (after receiving a request in writing) to execute a written extension or renewal thereof for a further term of like duration, containing provisions which are not inconsistent with this Ordinance and are materially the same as those in the previous lease or rental agreement;
- (f) the tenant has refused to allow the landlord reasonable access to the premises to make necessary repairs or improvements, or to show the rental unit to a prospective purchaser, mortgagee, or tenant;
- (g) the landlord in good faith seeks to recover possession in order to remove the rental unit from commercial use, after having obtained all the necessary permits to do so; provided, however, that if the landlord evicts for this reason and, within one year thereafter, the rental unit is being used for any commercial use, it shall be presumed that the landlord's stated purpose in evicting was false, in any action by the tenant against the landlord for abuse of process or malicious prosecution of a civil action;
- (h) the landlord in good faith seeks to recover possession in order to repair code violations or improve the premises, after

all necessary permits have been obtained, if it is not feasible to perform such repairs or improvements while the tenant remains in possession; provided, however, that when the repairs or improvements are completed, the landlord shall so notify the tenant and allow the tenant 30 days in which to decide whether or not to return to the premises.

Section 10. Retaliation:

No landlord shall in any way retaliate against any tenant for the tenant's assertion or exercise of any right under this Ordinance. Such retaliation shall be a defense in any action to evict the tenant and shall be subject to suit for actual and punitive damages, injunctive relief, and attorney's fees. The tenant need not exhaust any remedy before the Board of Adjustments prior to raising such defense or filing such suit. In any action wherein such retaliation is at issue, where the action was filed within 6 months of the tenant's assertion or exercise of rights, the burden shall be on the landlord to prove that the dominant motive for the act alleged to be retaliatory was some motive other than retaliation.

Section 11. Remedies:

- (a) If a landlord attempts to increase rent under Section 5(c), and any of the information in the notice of rent increase or supporting documentary evidence is false, inaccurate, misleading, or incomplete in any material way, then the notice of rent increase shall be null and void. If, in addition, it is proved that the landlord acted knowingly and willfully in providing such false, inaccurate, misleading, or incomplete information or evidence, then the landlord shall pay the tenant, as penalty, three times the amount of rent demanded in the notice of rent increase.
- (b) Any affected tenant shall recover actual damages whenever the landlord receives or retains any rent in excess of the maximum amount allowed under this Ordinance, and whenever the landlord violates any eviction provision of this Ordinance. If, in addition, it is proved that such act was in bad faith, the landlord shall pay the tenant, as a penalty, three times the actual damages.
- (c) If a tenant fails to bring a civil or administrative action within 120 days of any violation of this Ordinance, then such action may be brought on the tenant's behalf by the City of Berkeley or any interested party or neighborhood organiza-

tion, which shall retain one-half of any amount awarded in such action or received in settlement of such action.

- (d) No exhaustion of the administrative remedies provided in Section 8 shall be required as a precondition to invoking any remedy provided by this section.
- (e) In any action wherein any party succeeds in obtaining any remedy, in whole or in part, under this section, such party shall be awarded reasonable attorney's fees. If a party asserts a remedy under this section and fails to obtain any relief whatsoever, then the prevailing party shall be awarded reasonable attorney's fees.

Section 12. Waiver:

No provision in any lease, rental agreement, or agreement made in connection therewith, which waives or diminishes any right of the tenant under this Ordinance, is valid.

Section 13. Application to Pre-[E]xisting Leases:

- (a) This Ordinance shall not operate to change any provision in any fixed-term (as opposed to month-to-month) lease executed before October 1, 1981, and in effect on the date this Ordinance is enacted. Whenever such a lease expires, however, this Ordinance shall thereupon apply to the affected rental unit; provided, however, that if such lease is renewable at the landlord's or tenant's option, and such option is exercised, this Ordinance shall not apply to the rental unit until the renewed lease expires.
- (b) Notwithstanding the provision of subsection (a) above, any lease in effect on the date this Ordinance is enacted, which lease was executed since one year prior to October 1, 1981, which increased the rent over the prior rent by more than the increase in the Consumer Price Index from the date the prior rent became operative to the date such lease was executed, shall have its rent reduced immediately to the prior rent, plus such increase in the Consumer Price Index. The purpose of this subsection is to preserve certain businesses which have recently received such high rent increases that they would-but for this subsection-find it necessary to take steps contrary to the purposes of this Ordinance, as set out in Section 2. This subsection shall not operate to deprive any landlord of a fair return on investment.

Section 14. Partial Invalidity:

If any provision of this Ordinance or any application thereof is held invalid, such invalidity shall not affect any other provision or application of this Ordinance which can be given effect without the invalid provision or application, and to this end the provisions of this Ordinance are declared to be severable.

Section 15. Effective Date:

This Ordinance shall become effective on the date it is enacted.

Section 16. Evaluation:

At the end of each year this Ordinance is in effect, the Comprehensive Planning Department shall report to the City Council on the effectiveness of this Ordinance in carrying out the purpose set out in Section 2. This report shall also identify any other positive or negative effects of the Ordinance and may make recommendations concerning whether the Ordinance should be left in operation or repealed and whether the scope of the Ordinance should be expanded to include other neighborhood shopping districts in the City of Berkeley, outside the downtown business district.