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PARK WATCH

LEGAL DEVELOPMENTS NEWSLETTER

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BERGER V. ESCONDIDO - -

Clarification of Administrative Hearing Requirements for Rent Boards; Why Vacancy Decontrols are the "End Game" of Rent Control; New Anxiety in the Continuing Saga of Property Rights Litigation.

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▲SYNOPSIS:

In an opinion not been certified for publication, the Court in *H.N. & Frances C. Berger Foundation (Petitioner) v. Escondido* (No. D043829, Super.Ct.No. GIN026569), reversed the decision of the Escondido Rent Board and remanded for further administrative proceedings to require adherence to the legal standards for deciding a rent increase. Scant attention was given to the larger issues concerning the "takings" arguments cursorily advanced by the park owners.

Petitioner owns a 55+ park. It challenged (1) the adequacy of a $31 rent increase authorized by the City of Escondido Mobilehome Rent Review Board (Board), and (2) the court's dismissal of summary judgment on the additional complaint for damages on theories of inverse condemnation and violation of civil rights (due process). Petitioner contended the Board failed to adequately account for inflation as a factor affecting the fair return analysis. This is not the first time for challenging the Board for inadequate consideration of inflation. In 1999 the court issued an opinion reversing the Board's decision which was to grant two increases, part of a cumulative $41.39 increase granted over a period of nearly six years, concluding that the Board placed undue emphasis on among other things, failure to adequately account for inflation. In this case, the court agreed inflation was inadequately considered, but affirmed dismissal of the inverse condemnation claims.

The Escondido Ordinance: The Escondido Code designates the City Council as the Board, and requires park owners to obtain approval for any rent increase. The Ordinance, unremarkably, provides that the Board "shall approve such rent increase as it determines to be just, fair and reasonable." The Ordinance specifies no method or formula for determining rents, but it enumerates nonexclusive factors the Board shall consider, including changes in the Consumer Price Index (CPI), comparable rents and capital improvements. The Ordinance provides no guidance on how the Board should weigh the factors.

The Rent Application: The average rent was $360 at time of the application. Petitioner claimed various valuation approaches justify a rent increase of between $65 and $140; with a requested increase of $90. Escondido's expert (one of the "usual suspects" increasingly used in defending against rent increases) recommended a rent increase of between $38.44 and $56.36. The Board adopted a resolution authorizing a $31 increase. Petitioner sued, alleging the rent increase did not properly account for inflation. The court held there was enough evidence to support Escondido's decision and also dismissed the due process claims.

The court is supposed to consider all relevant evidence in the record, but begins with the presumption the record contains evidence to sustain the board's findings. Thus, a rent board challenge is stacked against the park owner at inception. Any relevant evidence that a reasonable mind might accept as adequate to support a finding against a park owner will spell defeat of the challenge as a rule. However, rent control must generally permit profits to be adjusted over time for inflation so that profit does not shrink to a vanishing point, for if the fixed amount of profit remains the same year after year the return will, in time, diminish in real value. Therefore, the ordinance may not indefinitely freeze the dollar amount of profits without eventually causing confiscatory results.

Escondido's expert, Ken Baar, advocated a maintenance of net operating income (MNOI) standard. Baar explained that the Ordinance mandates consideration of the types of factors that are considered in an MNOI formula. Baar calculated that the should be increased by $13.87. He also recommended increases of $10.56 for two capital expenses and $2.07 to cover the $3,800 long-form application fee. Baar included an alternate MNOI standard that adjusted NOI by various percentages of CPI, or increase of 14.66 percent in the CPI between the date of the last application and the end of 2001. Baar calculated that indexing of 40 percent, 70 percent and 100 percent would require additional rent increases of $11.94, $20.90, $29.86, respectively. He said total increases using 40%, 70% and 100% indexing would be $38.44, $47.40

and $56.36 increase. Baar recommended 40 percent indexing, stating that a $38 increase is required to provide a fair return under an MNOI standard. Baar said that no court has required 100% indexing; a number of ordinances use 40%. And note this: the Board's ruling applies to 142 of the 155 spaces. Baar used 153 spaces in his calculations because the rents of eleven spaces have already been raised to the level requested pursuant to changes in mobilehome ownership. Baar's report also spoke to increases based just on CPI applied to gross rent levels (the 14.66% CPI change since last application). Using 60 percent, 75 percent or 100 percent of the CPI increase, new rents would be $31.67, $38.59 and $52.78.He said that the written guidelines say that no more than 60% CPI is permitted, noting that the Board had an approach of granting 75% CPI increases in short form petitions.

Appraiser Jim Brabant addressed the Ordinance's 'comparable rents' factor. Brabant believed the Park's spaces had an overall rental value of $400, for an increase of $40. Baar criticized Brabant's inclusion of some spaces not subject to rent control (when a mobilehome is sold, vacancy decontrol applies).

Board's Findings: The Board rejected Baar's recommendation of a minimum increase of $38.44. It rejected Brabant's comparable rents analysis of $40. It granted a $31 rent increase by averaging three figures: an increase of $25 based on Dr. Baar's analysis of controlled rents; an increase of $31.67 based on an increase of existing rents by 60 percent of the increase in the CPI; and $38.44 based on an MNOI standard that indexes base year NOI at 40 percent of the increase in the CPI. The Board's averaging produced a $31.70 increase down to the nearest dollar.

The Appellate Court Reverses: The Board was not required to employ any specific formula, but averaging was faulty because there was no showing that two of the figures the Board relied on were within the range of reasonable rents. Several figures may be averaged but only if each of the figures is independently within the range of reasonableness.

$25: Baar neither recommended a $25 rent increase based on the single factor of comparable rents, nor stated such an increase would satisfy the fair return standard, he believed a minimum of $38.44 was required. The court said that as to comparability, the mobilehome park spaces must be comparable, not the manner in which rents are set, including newly leased spaces at decontrolled beginning rents.

$31.67: No evidence was presented that a rent increase of $31.67, based on a straight CPI increase at the 60 percent level, would constitute a fair return, taking the effect of inflation into consideration. The mere fact that an expert's report includes consideration of various single factors enumerated in the Ordinance does not show a rent increase based thereon would provide a fair return.

The City points out that "due process only requires a fair return on the mobilehome park as a whole, not a fair return on each discrete aspect of the park," such as each capital improvement. But Baar found that in this instance a fair return would cover increased operating expenses and capital improvements which the granted increase did not.

The Court rejected the argument that base year NOI must be indexed by no less than 100 percent of the CPI. For example, a park's operating expenses do not necessarily increase from year to year at the rate of inflation, and here the CPI increased 14.55%, but operating expenses increased only 9.4%. Also, owners derive a return not only from income but also from an increase in the value or equity; investors are motivated to acquire, retain and maintain mobilehome parks both for the yearly income and for appreciation in real estate. This of course ignores the notion that parks are mostly sold based on income stream with rent controls taken into account.

As to the due process and inverse condemnation claims, petitioner "did not properly raise the issue in its opening brief" said the court and abandoned the argument. In such event, the court may treat the points as "waived, or meritless, and pass them without further consideration." As the court explained in previous precedents, when the remedy of future rent adjustments is available as a matter of due process, as here, there can be no taking or other civil rights violation. This state court ruling merely reflects there is no remedy in state court's for due process takings, and that the federal courts are the only forum in which to seek relief. Indeed, one wonders if this approach was not a calculated one in light of the exciting prospects in the federal courts with the Cashman case which holds that rent controls and vacancy controls fail to advance legitimate state interests and are therefore unconstitutional (pending application for review by the Ninth Circuit ("en banc")) and the Chevron case to the same effect but factually different in some material respects (now before the U.S. Supreme Court).

VACANCY DE-CONTROL: *THE END GAME*

If a local jurisdiction has complete de-controls *(such as Escondido)*, the stage is set for long term lease negotiations to eliminate rent control jurisdiction.

Why? Park owners will never seek rental adjustments above market; tenant dislocation will result. Tenants will take their homes elsewhere. But tenants face the risk that owners will "go to market" on sale of the mobilehome at unrestricted rates in such a "de-control"/"re-control" environment. In that case, the park owner has but one chance to re-index rents at market levels.

On the other hand, if a long term lease is offered which sets a fixed turnover rent adjustment, it may be less than the *ad hoc* market adjustment imposed if the tenant stays under rent controls. The smart tenant will opt for the long term lease because of its certainty. The long term lease also establishes annual adjustments with pass-throughs which are fair, reasonable and realistic for the park owner as well, and that eliminates some of the pressure to go to market in one step. If leases are in place, there is no need for general rent adjustments and the considerable expense for rent hearings (attorneys, accountants, appraisers, economists). In other words, once there is full vacancy decontrol, the "end game" of rent control is within easy reach.

CHEVRON AND CASHMAN SAGA CONTINUES:

The Chevron case was recently argued before the U.S. Supreme Court. Many believe it may have ramifications for the Cashman case still languishing in the Ninth Circuit on request for further review (en banc). *Why is Chevron important?* Well, first a brief review of the Cashman case, holding that vacancy controls are unconstitutional.

Cashman owns a park subject to Cotati rent control which has no vacancy decontrol (the right to increase rents on tenant sale of a mobilehome). Cashman sued, claiming the law was unconstitutional because it failed to advance the City's interests in protecting affordable housing-- the law allows a tenant to capture a "premium" upon the sale of a mobilehome

that corresponds to its increased value as a result of the low rents restricted by rent control. Thus, the incoming tenant pays full market value for the housing because of the premium commanded for the under-market leasehold. That value is reflected in an inflated price for the mobilehome. This market reality totally frustrates continued affordable housing. The effect of the law is to therefore transfer a valuable property interest of the park to departing tenants. The Court of Appeal agreed with Plaintiffs, without the necessity of providing empirical evidence of the actual taking, stating that there is no dispute that the law fails to prevent tenants from capturing a premium. *"There is separate ownership of the mobilehome coaches and the underlying land, controlled rent, and the ability of incumbent tenants to sell their mobilehomes subject to this controlled rent. This creates the possibility of a premium, which undermines the City's interest in creating or maintaining affordable housing"* said the court. No evidence was needed for this holding. It was plain as a matter of indisputable reality. The only result substantially advanced by the law was to enable a one time wealth-transfer from park owners to the incumbent tenants of their rent-controlled mobile home parks.

The Chevron Case: In Chevron, Plaintiff alleged the facial unconstitutionality of state restrictions on the rent gasoline companies could charge lessee dealers of retail service stations. The purpose was to curb spiraling retail prices for gasoline. The restrictions limited the amount of lease rent payable to service station lessees. *But the law did not prevent a lessee from selling his service station lease or the retail price of gasoline.*

The trial court agreed that the rent cap provision of the law allowed incumbent dealers to capture the value of the decreased rent in the form of a premium. The court explained that the existence of the rent cap makes a leasehold interest more valuable, and this added value can be captured by the selling lessee on sale. The rent cap provision enables these dealers to sell their stations at a premium. But a trial was needed respecting two issues: whether the statute enabled incumbent dealers to capture a premium, and whether oil companies will raise fuel prices. There was evidence of mechanisms which not only might permit Chevron to prevent its lessee-dealers from capturing a premium on the sale of their dealership, but could enable Chevron itself to capture this premium.

For example, Chevron might capture the premium by increasing the wholesale price of fuel, and dealers would then be forced to raise the retail price charged to the public, which price increase would offset the effect of rent control and thereby defeat the purpose of the Act to lower gasoline prices. *This is one of the differences between vacancy control and the Chevron case.* There is another equally important difference between Cashman and Chevron. In Cashman case all that is needed to prevent Cotati's ordinance from substantially advancing its objectives is the likelihood of capitalization and sale of the benefits of living under the Ordinance by incumbent mobile home coach owners. Whether the Ordinance will facilitate such transfers can be logically inferred from examining the face of the ordinance itself.

Chevron Argument in the U.S. Supreme Court: The reports of the oral argument at the U.S. Supreme Court are frankly disappointing. While oral argument often presents little opportunity to advance a position, it does present the risk of doing considerable damage.

The reports are that the Chevron attorneys could have made a number of key points but let opportunities slip away. There was no talk about 'premiums.' And when asked, the attorney agreed that the fairly complex commercial rent control scheme at issue in Chevron is pretty much the same as ordinary residential rent control. However, the Hawaii Attorney General did little better. He spoke for 10 minutes, without perceptible damage to Chevron. It appeared that neither side was prepared with a clear theme. Neither side offered any useful rule to apply.

So the outcome of Chevron, and the effect on vacancy decontrol litigation, remains a matter of sheer speculation. If not clearly decided, however, the Ninth Circuit is seen as likely to proceed with *en banc* rehearing of Cashman.

While all hope remains for the eventual finality of the proposition that vacancy controls are unlawful, for most park owners the battle with local agencies for rent increases will certainly continue.

COMPLYING WITH FTC'S "SAFEGUARDS RULE"

▲SYNOPSIS: *Management collects personal information from prospective tenants, such as bank and credit card account numbers; income and credit histories; and Social Security numbers. The Gramm-Leach-Bliley (GLB) Act requires financial institutions to ensure the security and confidentiality of this type of information. As part of its implementation of the GLB Act, the Federal Trade Commission (FTC) has issued the Safeguards Rule. This Rule requires park owners to secure customer records and information. Basically all credit information must be kept under lock and key.*

How to Comply

The Safeguards Rule requires financial institutions *(a park owner qualifies here)* to develop a written information security plan that describes their program to protect customer information. The plan must be appropriate to the sensitivity of the information it handles. As part of its plan, each financial institution must:

1. Designate one or more employees to coordinate the safeguards;

2. Identify and assess the risks to consumer information in each relevant area of the company's operation, and evaluate the effectiveness of the current safeguards for controlling these risks;

3. Design and implement a safeguards program, and regularly monitor and test it;

4. Select appropriate service providers and contract with them to implement safeguards; and

5. Evaluate and adjust the program in light of relevant circumstances, including changes in the firm's business arrangements or operations, or the results of testing and monitoring of safeguards.

These requirements are designed to be flexible. Each owner should implement safeguards appropriate to its own circumstances. For example, some owners may choose to describe their safeguards programs in a single document, while others may memorialize their plans in several different documents (a written policy, an employment manual, an employment contract).

Similarly, a company may decide to designate a single employee to coordinate safeguards or may spread this responsibility among several employees who will work together. In addition, a firm with a small staff may design and implement a more limited employee training program than a firm with a

large number of employees. And a financial institution that doesn't receive or store any information online may take fewer steps to assess risks to its computers than a firm that routinely conducts business online.

Securing Information

When a firm implements safeguards, the Safeguards Rule requires it to consider all areas of its operation, including three areas that are particularly important to information security: employee management and training; information systems; and managing system failures. Firms should consider implementing the following practices in these areas.

The success or failure of your information security plan depends largely on the employees who implement it. You may want to:

● Check references prior to hiring employees who will have access to customer information.

● Ask every new employee to sign an agreement to follow your organization's confidentiality and security standards for handling customer information.

● Train employees to take basic steps to maintain the security, confidentiality and integrity of customer information, such as:

● Locking rooms and file cabinets where paper records are kept;

● Using password-activated screensavers;

● Using strong passwords (at least eight characters long);

● Changing passwords periodically, and not posting passwords near employees' computers;

● Encrypting sensitive customer information when it is transmitted electronically over networks or stored online;

● Referring calls or other requests for customer information to designated individuals who have had safeguards training; and

● Recognizing any fraudulent attempt to obtain customer information and reporting it to appropriate law enforcement agencies.

Instruct and regularly remind all employees of your organization's policy - and the legal requirement - *to keep customer information secure and confidential.* You may want to provide employees with a detailed description of the kind of customer information you handle (name, address, account number, and any other relevant information) and post reminders about their responsibility for security in areas where such information is stored - in file rooms, for example.

Limit access to customer information to employees who have a business reason for seeing it. For example, grant access to customer information files to employees who respond to customer inquiries, but only to the extent they need it to do their job. Impose disciplinary measures for any breaches.

● Store records in a secure area. Make sure only authorized employees have access to the area. *For example:* **store paper records in a room, cabinet, or other container that is locked when unattended;**

● Ensure that storage areas are protected against destruction or potential damage from physical hazards, like fire or floods;

● Store electronic customer information on a secure server that is accessible only with a password - or has other security protections - and is kept in a physically-secure area;

● Don't store sensitive customer data on a machine with an Internet connection; and

● Maintain secure backup media and keep archived data secure, for example, by storing off-line or in a physically-secure area.

Provide for secure data transmission (with clear instructions and simple security tools) when you collect or transmit customer information. Specifically:

● If you collect credit card information or other sensitive financial data, use a Secure Sockets Layer (SSL) or other secure connection so that the information is encrypted in transit;

● If you collect information directly from consumers, make secure transmission automatic. Caution consumers against transmitting sensitive data, like account numbers, via electronic mail; and

● If you must transmit sensitive data by electronic mail, ensure that such messages are password protected so that only authorized employees have access.

Dispose of customer information in a secure manner.

For example:

● Hire or designate a records retention manager to supervise the disposal of records containing nonpublic personal information;

● Shred or recycle customer information recorded on paper and store it in a secure area until a recycling service picks it up;

● Erase all data when disposing of computers, diskettes, magnetic tapes, hard drives or any other electronic media that contain customer information;

● Effectively destroy the hardware; and promptly dispose of outdated customer information.

Use appropriate oversight or audit procedures to detect the improper disclosure or theft of customer information. For example, supplement each of your customer lists with at least one entry (such as an account number or address) that you control, and monitor use of this entry to detect all unauthorized contacts or charges.

Effective security management includes the prevention, detection and response to attacks, intrusions or other system failures. Consider the following suggestions:

● Maintain up-to-date and appropriate programs and controls by following a written contingency plan to address any breaches of your physical, administrative or technical safeguards;

● Checking with software vendors regularly to obtain and install patches that resolve software vulnerabilities;

● Using anti-virus software that updates automatically; maintaining up-to-date firewalls, particularly if you use broadband Internet access or allow employees to connect to your network from home or other off-site locations; and

● Providing central management of security tools for your employees and passing along updates about any security risks or breaches.

Take steps to preserve the security, confidentiality and integrity of customer information in the event of a computer or other technological failure. For example, back up all customer data regularly.

Maintain systems and procedures to ensure that access to nonpublic consumer information is granted only to legitimate and valid users. In park operations, never provide credit information to a dealer or broker. For example, use tools like passwords combined with personal identifiers to authenticate the identity of customers and others seeking to do business with the financial institution electronically.

Notify promptly if their nonpublic personal information

is subject to loss, damage or unauthorized access.

Basically, it is suggested that one employee have responsibility for safeguarding tenant and prospective tenant information and applications, that such information be stored in a fireproof safe, and that the safe be kept under lock and key except when access is required.

EASEMENTS AND LOT LINES - A SUGGESTED PROVISION

▲**SYNOPSIS**: *As mobilehomes age, they are often replaced. If the largest expected mobilehome cannot be sited due to easements or encroachments, there may be a direct impact on profitability: a larger home is more valuable than a smaller one. To avoid claims based on an implied covenant that the lot lines define the largest possible home that can be sited, appropriate disclaimers and disclosures should be included in residency documents. This issue continues to emerge as a legal development as parks and the housing within them continue to age.*

Sometimes a tenant (or dealer) seeks to replace a mobilehome with a new home, to the maximum size allowed by the lot lines. This indeed may be a requirement of the rules and regulations. However, the largest possible home may not be allowable if there are underground easements or utilities over which a mobilehome may not be placed. This possibility should be described in the disclosure statement given to each prospective purchaser. This information should also be set forth in lease agreements, rental agreements, or the rules and regulations. Further, if there are separate architectural guidelines, such a disclosure should also be included.

Additionally, sometimes lot lines are not properly marked. To avoid the thorny problem of lot line mis-markings and resulting impact on use, occupancy and the size of a new mobilehome that can be sited on a space, a provision which sets forth that the "apparent and actual use" defines the expectation of use and occupancy to be enjoyed, not the lot lines themselves which are present for just 'health and safety' reasons. These provisions may assist in minimizing liability when the actual lot lines encompassed by the mobilehome space are not, in reality, as it may appear.

Sample provisions might be as follows. Of course, the following are for sample and illustrative use and are not advised to be implemented without actual consultation and approval of counsel.

> *"All mobilehomes in the Park shall conform in size to the requirements of the lot on which they are placed as established by the Park's management. Only double-wide mobilehomes will be permitted to occupy double-wide homesites where legally conforming to lot installation requirements. Placement of mobilehomes shall be determined by the Park's management. The homesite leased to resident is subject to all easements, encroachments, and limitations on use and occupancy of record and as exist in fact. The homesite may or does contain underground easements, rights of way, utilities or other encumbrances which may limit the maximum size of any mobilehome, accessory structure or equipment which may be installed on the homesite otherwise defined by the lot lines. In some locations in the park, potentially including the homesite, there are underground utility lines, encroachments or easements, some of which may exist beneath the mobilehome. However, all regulatory requirements for conforming installation of all mobilehomes in the park have been satisfied based on such requirements as existed at the times of installation, reflected by either certificates of occupancy or statements of installation acceptance which are issued by the local enforcement agency to approve habitation within the approved mobilehome. It is possible that new larger homes, or re-habilitation of an existing mobilehome, may not be permissible based on such legally mandated restrictions. Any or all such eventualities may result in limitations on installation of new mobilehomes, or inconvenience or expense to the resident."*
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> *"Actual and apparent use of a homesite defines the expectations of occupation which Resident may use and enjoy. Resident is responsible for homesite maintenance within the area defined by the lot line markers. You shall maintain your lot line markers as they currently exist and you will promptly notify us if your lot line markers are lost, moved or destroyed. The foregoing defines the enforceable expectations of use, occupation and enjoyment to which Resident is entitled. The lot line markers and lot lines in the park are for the purpose of establishing the separation and set-backs for installation of mobilehomes, accessory structures and equipment, utilities and appliances as defined by applicable codes and standards and for no other purpose. Therefore, Resident may not rely on the lot line markers to define the area of use and enjoyment to be expected. Owner reserves the right to modify any lot line at any time provided that such modification does not violate any applicable law. If Resident or any prior resident of the space or any adjoining space has installed landscaping or other improvements that have been discovered to encroach across a lot line over a course of time of previously-established consistent usage, then residents of any adjoining spaces agree to continue to allow the use of the area encroached upon as was expected before such discovery. This use of the encroached-upon area will not, however, affect the location of the lot line markers. Resident shall maintain the lot line markers as they currently exist. Resident agrees to indemnify and hold harmless owner and owner's agents, employees, representatives, assigns and successors, against any loss, cost, damage, expense (including attorneys' fees) or other liability incurred or imposed by reason of any person, association, firm or corporation claiming to have an interest in the event that the lot line markers are lost, moved or destroyed."*

PLEASE FEEL FREE TO CALL TERRY R. DOWDALL FOR QUESTIONS OR COMMENTS ABOUT THE FOREGOING ISSUES.