Policy Options for Addressing Loss of Affordable Rental Housing in Downtown Minneapolis
Housing Preservation Project
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INTRODUCTION.

After reviewing a variety of approaches, we have identified, for further possible consideration, four policy options, that may be effective and feasible from a political, practical and legal point of view: 1) a one for one (1:1) replacement requirement imposed on owners removing affordable housing; 2) a right of first refusal for affordable properties facing sale or demolition; 3) an Inclusionary Zoning (IZ) requirement for new rental housing which might be either mandatory or voluntary; 4) a tax increment district that collects increment from new market rate apartments for an affordable housing fund. Each policy has its own set of issues, outlined below. This memo provides a preliminary discussion as a basis to decide whether to move forward, in which case we can provide more depth on use of these policies around the country, issues in structuring the policies, and potential legal issues.

In general, a voluntary IZ policy with increased incentives to participate as outlined in section 3.C. below, a downtown tax increment district, and/or a right of first refusal ordinance would probably be less controversial locally and less likely to generate significant legal challenges than a mandatory IZ or 1:1 replacement policy. It's not clear, however, that they could be as effective.

These proposals are likely to be enacted only if demonstrated to be necessary to address a serious threat to a valuable shrinking resource downtown. A separate companion memo addresses what we have been able to determine to date about the nature of the downtown affordable housing supply, and we will likely need to discuss how to develop this analysis further. We do not yet have enough information on the supply to make out a compelling case. It should also be noted that for any of these options to be effective, the City will need to take on an ongoing administrative, and perhaps financial, burden.

1. ONE FOR ONE REPLACEMENT REQUIREMENT.

A. The core concept is that a developer who is removing affordable housing or rendering it no longer affordable, must replace the affordable units, either by building replacement units without public resources, or paying a fee into a fund for the units to be replaced. The Minnesota Legislature adopted a replacement housing law in 1989, imposing replacement obligations upon cities, Minn. Stat. § 504.33-504.35, repealed in 1995. The City of Minneapolis had a replacement housing ordinance in place as of 1986 also covering city removal of affordable housing, later repealed. These laws required cities to replace lost housing; compliance involved cities using all of the usual resources to do so. What we want is to impose the replacement burden on the developer, without the use of the usual public resources. The one somewhat similar replacement policy currently in place that we are aware of is a City policy requiring replacement of SRO units by a developer when the developer receives city assistance and loss of the

units is unavoidable. Affordable Housing Resolution 2004R-260, Sec. 3. In this situation, unlike what we are proposing, the City assistance helps pay for the replacement units.

The only other replacement housing ordinance we know of that places the burden on the developer is that in the City and County of San Francisco.[i] It's not clear whether this ordinance denies the developer the use of public resources to pay for the replacement. Somewhat similar, and probably analogous legally, are linkage fees, imposed by a number of cities nationally. They are typically imposed on new commercial developments to help cover the cost of new affordable housing needed as a result of the increased supply of lower wage workers generated by the commercial development. Similarly, a replacement ordinance would impose on developers a fee to cover part of the cost of new affordable housing needed as a direct result of the development.

B. Determining the elements of a replacement housing policy

i. Circumstances requiring replacement:

1. Within defined DT geography

2. Kind of rental housing covered. Just affordable, and at what level? Specialized housing such as rooming houses, group homes, shelters? see def. in former Minn. Stat. § 504.33 sub 6. We're assuming not meant to cover condos currently being rented—correct?

3. Where developer is proposing to demolish, acquire for or convert to a use other than affordable rental housing (including increasing rents beyond affordable levels)

4. Where developer seeks any of the following from the city:

a. Financial Assistance

b. Land

c. Zoning Change

d. CUP/ PUD (would be useful to know how often the kind of developments we're concerned about DT need CUPs/ PUDs, or zoning changes for that matter)

e. In theory, developers could be obligated to replace even when seeking nothing from the city, but the policy would be in the strongest position to withstand a legal challenge if it was tied to a request from the developer for something from the city. (This is why it would be important to know how often the threat we are concerned about is accompanied by something the developer needs from the city.)

ii. Nature of the replacement obligation (if actual replacement is required rather than payment of a replacement fee.)

1. This could be a requirement to obtain a city permit for removal/conversion that is subject to satisfying certain requirements (set out below).

2. Equal number of units v. equal number of bedrooms. Former state statute allowed in some circumstances, e.g. replacement of ten 1-BR units with five 2-BR units.

3. Level of affordability for replacement units. Note that it might make sense to set a standard affordability level (such as 50%/60% AMI), independent of that of the units demolished, but with a requirement that with City assistance, the developer agree to lower rents.

4. The policy would need language that prevents developer from funding replacements with the usual housing subsidies, which would render "replacement" notion meaningless. An exception could be made for a developer's use of public subsidies to "deepen" affordability.

5. How long it has to remain affordable. If § 462.358 subd. 11 applies, there is a 20 year limit. (See legal challenges section, pg. 7)

6. Where it can be replaced. DT? Citywide?

7. Are there circumstances where rehabbed housing as opposed to new construction should satisfy obligation? The previous statute allowed replacement by rehabbing previously vacant and uninhabitable housing to make affordable units. What if developer makes existing unaffordable housing affordable? This would substantially reduce replacement costs.

8. In lieu payments. The Marimark situation illustrates that fully replacing actual units lost can be quite expensive. One option is a smaller fixed payment to partially replace, perhaps along the lines of the payment Westminster Church has committed. This might be more palatable politically, since it could reduce replacement cost.

9. A waiver option where imposition of the requirement would be clearly financially infeasible should be considered. Waiver provisions have occasionally proven helpful in overcoming legal challenges.

C. Addressing likely opposition. In addition to expected political opposition from developers, there is the possibility of a legal challenge. The potential legal issues with both a replacement requirement and an inclusionary zoning requirement are addressed together at the end of this memo.

2. RIGHT OF FIRST REFUSAL.

This would provide a preservation-oriented buyer with the ability to purchase a threatened property at market value. An example is a District of Columbia ordinance that provides tenant associations with an assignable right to purchase "before an owner of a housing accommodation may sell the accommodation, or issue a notice of intent to recover possession, or notice to vacate, for purposes of demolition or discontinuance of housing use." The price and terms are those "which represent a bona fide offer of sale." The residents have at least 120 days to negotiate a contract for sale and at least 120 days to close after that. Similarly, a Minnesota Statute provides manufactured home park residents the opportunity to purchase any park at the time of sale if the buyer intends to close the park, or within a year after the sale if the buyer later decides to close the park.

A downtown ordinance wouldn't have to be limited to immediately threatened properties. Like the D.C. ordinance, it could apply to any sale of affordable rental property. That would allow preservation buyers the opportunity to secure properties in advance of immediate threats.

To be most effective, a downtown ordinance would also provide the purchase right to public agencies. The D.C. ordinance has been in effect since 1980 and it appears that is used fairly frequently. The D.C. ordinance has withstood statutory and constitutional challenges; there have been none to the right of first refusal section of Minnesota MH Park statute.

An alternative to a 1:1 replacement ordinance, the right of first refusal might be less controversial politically and would be far less open to legal challenge. However, it would shift the financial onus for replacement to the preservation buyer. It might allow purchase of some properties at relatively low prices, but in other cases the price might reflect a significantly more intense proposed use.

Note that the Minnesota Statute relies on a sale occurring, making the first refusal price easy to identify. In the D.C. ordinance, it's not clear how the "bona fide" price and terms are determined when an existing owner proposes to demolish a property.

3. INCLUSIONARY ZONING DOWNTOWN.

A. Background on Inclusionary Zoning (IZ). IZ refers to local ordinances that require developers to include affordable units in new market rate developments. In most cases, IZ is paired with financial and other incentives offered by the city to assist in making inclusion of the affordable units financially feasible. IZ is generally viewed as an effective tool in strong market areas, and has been adopted in over 400 local jurisdictions across the country, most often in California, but also in many large cities

B. IZ ordinances are typically classified as mandatory (including affordable units is required) or voluntary (developers are offered incentives to include affordable units, like the current Minneapolis density bonus policy). The track record around the country is that voluntary IZ usually produces fewer units than mandatory IZ. Many jurisdictions eventually move from voluntary to mandatory approaches. There is a middle ground approach, which is to require inclusion only when the developer seeks something from the city, not just city funds, but also city zoning and land use approvals (Boston IZ ordinance). We recommend this latter approach, as it will be more likely to withstand a legal challenge under Minnesota law (see discussion below). In Minnesota, mandatory IZ ordinances are rare; we are aware of a relatively recent one in Forest Lake and an older one, since rescinded, in St. Cloud. Many cities have voluntary IZ in one form or another and a number of cities also require inclusion of affordable units when city funds are used.

C. In most cases IZ ordinances cover both rental and for-sale housing. We recommend limiting a downtown IZ ordinance to rental housing, since there is no need for new affordable ownership housing downtown at this time.

D. For an IZ ordinance, there are legal, practical, and political considerations:

i. Developers may mount legal challenges based on either of two Minn. Statutes, or on constitutional grounds—see below.

ii. Practical issues—not all IZ ordinances have worked as intended; they require careful design. For the developer to include affordable units, there may need to be some compensating incentives from the city, e.g. density bonuses, fee waivers, regulatory relief, streamlining of approvals.

iii. Developers typically mount a political challenge to the adoption of IZ, though historically once IZ is enacted, they usually manage to live with it.

E. Elements to include in an IZ ordinance:

i. Where/when it applies—similar criteria as 1:1 replacement above? Or apply to any market rate residential construction within DT? May want to set minimum project size before it applies.

ii. Just rental or ownership as well? There is less need to build new affordable ownership units, given the current market. Including ownership units would also create significant additional oversight and legal issues.

iii. What share of the units will be required to be affordable? Typically, between 10 and 20 % are required. Level of affordability? Most IZ ordinances call for units affordable to between 50% AMI and 80% AMI. How long must the units remain affordable? Maximum permitted by MN law is 20 years. In addition, tenant income limits are needed to ensure low income HHs benefit from creation of the affordable units.

iv. Defining the assistance the city will provide to make this feasible—zoning or CUP approvals, density bonuses, fee waivers, other regulatory relief, streamlining of approvals, tax abatements.

v. Allow an in lieu option, permitting developer to pay into a fund instead of including the units? The amount of the payment could be all or part of the cost of subsidy for an equivalent affordable unit. But, see possible legal challenges described below.

vi. This will involve significant administrative work by the city, including ongoing compliance monitoring.

vii. May be worth including a waiver option where imposing the requirement is clearly financially infeasible. This has helped some jurisdictions defend against legal challenges.

viii. Strong documentation in the ordinance of the need to take this action, which could help in legal challenges.

F. Note that if all that happens is the developer seeks already available housing subsidy funds to enable creation of developer's affordable units, we've just robbed Peter to pay

Paul. Therefore, similar to 1:1 replacement above, would need some language to ensure this doesn't happen.

G. Another option for Minneapolis, as an alternative to mandatory IZ, is to further expand the city's current affordable housing density bonus policy. There are at least two ways this policy could be made more attractive to developers and thereby more effective: (1) limit the current policy so that the density bonus is only available for inclusion of affordable housing and not for other desirable objectives such as structured parking; (2) combine the density bonus with other incentives such as fee waivers, regulatory relief, and expedited permitting.

In addition, the City might make the policy more effective by imposing disincentives to not include affordable units. As an example, it might be a developer obligation to report on the proposed development's impact on overall downtown housing affordability. The city council would review that report prior to any city approvals. The requirement would be waived for developments including affordable units.

4. AN AFFORDABLE HOUSING PRESERVATION TAX INCREMENT DISTRICT.

The idea here is to take advantage of the current intensive development of high-end housing in downtown to use tax increment (TI) generated to establish an affordable downtown housing development fund.

It seems that 20 years of TI collection on high-end might be enough to finance the subsidy for affordable units equal to 15-20% of the units in the high-end development. Village Green at 1367 Willow provides an example. For 2012, the project with 212 units pays a tax of $586,096. If 40% of that were increment collected for 20 years, it would support a bond sale of $2.7 million at 6%. If front end subsidies for affordable housing were $80,000/unit, that increment would support development of 34 affordable units – 16% of the number of units in the project generating the increment.

This sort of idea is certainly not unprecedented; Minneapolis has previously been able to pool TI from a number of districts to establish a similar housing fund. It would certainly require special legislation. Establishing a pressing need would probably be necessary for such legislation to have a chance, even in a legislature more sympathetic to Minneapolis than the current one.

POTENTIAL LEGAL CHALLENGES TO REPLACEMENT OR IZ POLICIES.

A. Legal challenges to either a replacement or mandatory IZ approach could conceivably be mounted on either constitutional or statutory grounds. There are different risks with each, and the risk depends in part on the details of the ordinance. Nevertheless, the City would need to be prepared for the possibility of litigation. Nationally, few challenges to IZ have been successful. There has been little experience with replacement ordinances, or with the somewhat analogous linkage fees; the few

challenges we are aware of have been unsuccessful. (The following is a summary of our legal analysis; we can provide a separate memo with a more complete discussion.)

B. There is relatively little case law addressing replacement housing requirements; the California *San Remo Hotel* case upholding the ordinance is the leading case.[ii] With IZ there has been more litigation. However, despite the fact that there have been over 400 IZ ordinances enacted across the country, there have been only three legal challenges which have been successful at an appellate level. Two of these were in states with statutes prohibiting rent control. (see below for discussion of Minnesota rent control statute.) A third was based on the Virginia State Constitution.[iii]

C. Constitutional issues. The US Supreme Court has repeatedly attempted to define the circumstances under which local government restrictions on private property amount to a "taking" requiring compensation to the property owner. This body of law is complex and not always clear. However, generally speaking, laws which (1) treat a category of property in a uniform manner, (2) do not deprive the property of all value, and (3) maintain a reasonable and proportional connection between the problem to be addressed and the obligation imposed, will be upheld. In the only case we are aware of challenging a replacement housing requirement, the California Supreme Court upheld a San Francisco replacement requirement in the *San Remo* case. Minnesota has developed one additional legal standard, based in part on different wording in the Minnesota Constitution, which imposes heightened scrutiny on at least some public actions carried out by government acting in an enterprise capacity. While one early Minnesota appellate decision relying on the government enterprise analysis raises some concern, this decision appears to be an anomaly not followed by the Court subsequently. The other Minnesota cases have involved land use regulation related to public airports. Most Minnesota case law has followed the more lenient standards of federal law.

The federal courts have applied a heightened scrutiny in cases generally involving cities engaged in individualized permit negotiations requiring donations of land. This heightened scrutiny requires a nexus between the exaction required from the developer and the problems created by the development which the city is addressing. With a replacement requirement, this is easy, as the developer is removing the housing so imposing the replacement obligation is logical. With IZ, the nexus challenge is greater, since it is not apparent why a market rate housing developer should be responsible for solving the affordable housing shortage. The California Court of Appeals avoided this nexus requirement in a challenge to the Napa IZ ordinance because the IZ requirement applied to all projects, and was not imposed on one developer in an individualized negotiation. In a recent case, a district court nullified a San Jose ordinance based on a lack of nexus, in apparent disregard of the appellate court precedent. Note, however, that the heightened scrutiny and the accompanying nexus requirement have in no other cases been applied to IZ or replacement requirements. The New Jersey Supreme Court in *Holmdel Builders*[iv] specifically rejected any such requirement.

D. Minnesota statutory issues. There are two state statutes that could apply, Minn. Stat. § 471.9996 (rent control is prohibited unless adopted by the voters), and Minn. Stat. § 462.358 sub. 11 (authorization of inclusionary housing requirement). Developers have argued that § 462.358 sub. 11 requires that developers voluntarily agree to an agreement with the city on an IZ requirement, and that therefore the statute prohibits a mandatory IZ requirement. However, the Minnesota Attorney General issued an opinion in 2007 rejecting this argument, and opining that the statute does permit mandatory IZ. There are no court opinions to date that we are aware of construing subd. 11. An ordinance that only requires AH units in exchange for city assistance (money or an approval) should satisfy the "agreement" requirement of the statute, and not even need to go as far as the AG opinion went.

The applicability of the affordable housing provision at § 462.358 subd. 11 to a replacement requirement is unclear. If it does apply, it should not be a problem, particularly if the replacement obligation can be tied to something the developer seeks from the city, so that it can be characterized as an "agreement."

The primary concern for a replacement ordinance would be the rent control statute, since there would need to be affordability controls on the replacement units. There are three ways to address this—put the proposal on the election ballot, argue that the inclusionary housing statute trumps the rent control statute making it inapplicable, or avoiding the rent control statute altogether by requiring only the payment of fees rather than direct replacement of the units.

An IZ ordinance also imposes rent limits and the prohibition in Minn. Stat. 471.9996 must be avoided. (A similar statute in Wisconsin was the basis for a successful challenge to the Madison IZ ordinance). Unlike the situation in Madison, here § 462.358 sub. 11 (adopted after the rent control statute) specifically permits IZ.

E. Legal issues around "in lieu" payments. A common provision of many IZ ordinances, and a useful addition to or full requirement of a replacement ordinance, is an in lieu payment— a designated amount that the developer can choose to pay into a fund instead of including the affordable units in his new building or directly replacing the lost units. (Another option commonly included is defining circumstances where a developer may be permitted to fulfill his obligation by building the affordable units elsewhere.) The in lieu option makes a great deal of sense, but may present some legal issues. The New Jersey Supreme Court in *Holmdel Builders*[v] upheld a variety of mandatory and voluntary in lieu payment requirements, arguing that they were "the functional equivalent" of IZ set asides, which were, in turn valid exercises of police power. The Court relied heavily on state statutory and constitutional "fair share" principles very similar to those applying to Minneapolis through the Minnesota Land Use Planning Act. However, the California Supreme Court in the *San Remo Hotel* case applied a somewhat higher standard of review to San Francisco's replacement housing ordinance, holding that in lieu fees "must bear a reasonable relationship, in both intended use and amount, to the deleterious public impact of the development." The replacement ordinance passed that test, but it's not clear that an IZ in lieu fee could. Minnesota Courts have not addressed in lieu fee provisions.

The 2007 AG Opinion interpreting Minn. Stat. § 462.358 sub. 11 concluded that an in lieu payment provision is not authorized under Minnesota law. It's not clear that there is any basis for this assertion by the AG. However, it's possible that a Court could hold that by specifically approving a limited number of types of development fees, the Legislature has implicitly preempted local adoption of other types of development fees. In addition, there is some danger that a court would impose a "reasonable relationship" test on in lieu IZ payments rather than treating them as the New Jersey Supreme Court did.

F. Protecting these policy options from legal challenges. For the reasons set out above, we think a replacement ordinance should be structured in the form of a payment rather than a direct replacement obligation, whereas an IZ ordinance might well avoid a payment and just rely on the inclusionary requirement.

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[i] The ordinance requires replacement of certain residential hotel units converted to daily tourist rentals; it's not clear whether the owner can tap usual subsidy sources to develop replacements.

ii *San Remo Hotel L.P. v. City and County of San Francisco*, 41 P.3d 87 (Cal. 2002).

[iii] Also, a recent California district court nullified a San Jose IZ ordinance for lacking a sufficient justification for imposing an affordable housing obligation on a market rate housing developer. The decision is inconsistent with California court of Appeals precedent which is discussed below.

[iv] *Holmdel Builders Association v. Township of Holmdel*, 583 A.2d 277 (N.J. 1990)

v *Id.*