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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FOURTH APPELLATE DISTRICT

DIVISION TWO

OCEAN AVENUE ASSOCIATES, LLC et
al.,

Plaintiffs and Appellants,

v.

CITY OF INDIO et al.,

Defendants and Respondents;

BERMUDA PALMS SENIOR
RESIDENTS ORGANIZATION,

Real Party in Interest and
Respondent.

E055509

(Super.Ct.No. INC088411)

OPINION

APPEAL from the Superior Court of Riverside County. John G. Evans, Judge.

Affirmed.

Law Office of Anthony C. Rodriguez and Anthony C. Rodriguez for Plaintiffs and
Appellants.

Richards, Watson & Gershon, Rochelle Browne, Ginetta L. Giovinco and
Roxanne Diaz, City Attorney, for Defendants and Respondents.

Law Office of Toni Eggebraaten and Toni Eggebraaten for Real Party in Interest and Respondent.

Bermuda Palms, LLC and Ocean Avenue Associates, LLC (collectively Owner) own and operate a mobilehome park in the City of Indio (City). The City has a mobilehome rent control ordinance, which takes what has been called the maintenance of net operating income (MNOI) approach. This means that it calculates maximum total rent by: (1) starting with the park's net operating income (NOI) in a specified base year; (2) adjusting for inflation; and (3) adding in the park's allowable operating expenses. Significantly, while some jurisdictions that use the MNOI approach adjust for inflation by multiplying base-year NOI by 100 percent of the change in the consumer price index (CPI), the City uses a multiplier of only 50 percent.

In this case, the Owner proved that the rent it was allowed under the City's ordinance was barely more than half of market rent and provided a lower rate of return on investment than such virtually risk-free alternatives as Treasury bonds and certificates of deposit. Moreover, the Owner proved that, precisely because the ordinance indexes NOI by less than 100 percent, its real NOI (i.e., NOI in constant dollars) does not keep pace with inflation and will eventually approach zero.

The United States Supreme Court and the California Supreme Court have consistently reiterated that price controls cannot deny a property owner a "fair return." At first glance, we were convinced that the rent the Owner had been allowed to charge did not provide a "fair" return (in the layperson's sense). We soon realized, however,

that the legal definition of a “fair return” is significantly different from the lay definition. And under this legal definition, the Owner did not even make a prima facie case that the rent allowed failed to provide a fair return.

Accordingly, we will affirm the denial of the Owner’s petition for a writ of mandate.

I

THE ORDINANCE

In 1984, the City adopted a “Mobilehome Fair Practices” ordinance. (Indio Ord. No. 892.) That ordinance, together with subsequent amendments (Indio Ord. Nos. 896, 1079, 1154, 1298, 1471, collectively Ordinance), is codified at sections 32.40-32.42 and 99.01-99.25 of the Indio Municipal Code. It has not been amended since June 21, 2006. (Indio Ord. No. 1471.) Thus, the current version has applied throughout these proceedings.

The Ordinance states, “It is the intent of this chapter to permit rents to be established at a level which will provide landlords with a fair return on their property, consistent with this chapter and the law and Constitution of the state.” (Indio Mun. Code, § 99.04(A).)

The Ordinance prohibits a park owner from unilaterally increasing the rent on a space above the rent charged on April 1, 1983, multiplied by 75 percent of the subsequent increase in the CPI. (Indio Mun. Code, § 99.02(A).) If a space is voluntarily vacated and

re-leased, the rent may be increased, but not beyond the average rental rate for comparable space in the park. (Indio Mun. Code, § 99.03(C).)

The Ordinance also establishes the Mobile Home Fair Practices Commission (Commission). (Indio Mun. Code, § 32.40.) The Commission may “[r]eceive, investigate, hear and determine petitions of landlords for hardship adjustment of rent” (Indio Mun. Code, § 32.40(H).) It may “[a]uthorize an increase in the maximum amount of rent otherwise permitted to be charged by a landlord per Chapter 99 in cases where the application of said chapter would result in undue hardship to the landlord, or would prevent a landlord from obtaining a just and reasonable return on the landlord’s property.” (Indio Mun. Code, § 32.40(I).)

The Commission may allow rent increases, “[u]pon filing of an individual hardship petition by a landlord, . . . such that the landlord’s net operating income will be increased by 50% of the increase in the Consumer Price Index (CPI) over [1982].” (Indio Mun. Code, § 99.04(G).) The Ordinance establishes a presumption “that the net operating income produced by a property during [1982] provided a fair return on property.” (Indio Mun. Code, § 99.04(C); see also Indio Mun. Code, § 99.04(B)(4).)¹

The Commission may “delegate . . . its power to hear individual rent adjustment petitions to . . . hearing examiners . . . appointed by the City Council” (Indio Mun.

¹ The presumption can be rebutted by showing that in 1982, either the rent or the expenses were uncharacteristically high or low. (Indio Mun. Code, § 99.04(D)(1).) The Owner has never attempted to make such a showing.

Code, § 32.40(J); see also *id.*, § 99.25(B).) The Commission retains the power to “[m]ake final determinations based upon the findings of such independent hearings . . . by an examiner” (Indio Mun. Code, § 32.40(K).)

“The Commission, or designated hearing officer, shall make findings based on the evidence as to each fact relevant to the Commission’s decision on the petition. The decision of the Commission shall be based upon the findings” (Indio Mun. Code, § 99.23(D).)

“A party not satisfied with such decision may then seek [a] judicial remedy” (Indio Mun. Code, § 99.24.)

II

FACTUAL BACKGROUND

Bermuda Palms is a 185-space senior citizens’ mobilehome park in Indio. It was originally built in 1971. In 1994, it was sold for \$3,969,500. In 2004, it was sold again for \$5,917,500. In June 2006, the Owner purchased the park for \$9,004,950.

The Bermuda Palms Senior Residents Organization (Organization) is an association made up of the residents of the park.

A. *Testimony of Norton Karno.*

Norton Karno, the Owner’s managing agent, made the decision to purchase the park. He was an attorney who had purchased approximately 50 mobilehome parks, either on his own behalf or on behalf of clients.

Karno testified that a mobilehome park is a riskier investment than a certificate of deposit. The risks of operating a mobilehome park include vacancies, natural disasters, infrastructure deterioration, financing problems, employee problems, litigation, and regulatory changes.

Based on the purchase price of \$9,004,950, the park had a capitalization rate (cap rate)² of about five percent. In Karno's opinion, a purchase price that resulted in a five percent cap rate "was a fair . . . price to pay."

In considering whether to purchase a mobilehome park, Karno testified, a "primary and very important factor" is the potential for growth. He concluded that the park had high potential for growth because the existing rents were very low as compared to market rents at non-rent-controlled mobilehome parks. This was the single most important factor in his decision to buy the park.

Karno admitted reading the Ordinance before purchasing the park. However, he understood the Ordinance to mean that a park owner was entitled to a fair return, even if that would be in excess of the MNOI formula in the Ordinance. If he had understood that the park's NOI would be limited to 50 percent of the increase in the CPI, regardless of the actual rate of return on investment, he would not have purchased the park.

² A cap rate is equal to NOI divided by purchase price. Thus, it is essentially equivalent to a rate of return on investment (at least when the rate of return is based solely on income and does not include appreciation).

Karno owned three other mobilehome parks in California that were subject to rent control, and in all three, he had been able to obtain rent increases greater than the increase in the CPI.

B. *Testimony of John P. Neet.*

The Owner called John P. Neet as an expert on the appraisal of mobilehome parks.

It was stipulated that the fair market rental value, in the absence of rent control, would be \$600. According to Neet, as of 2006, the average rent at the park was \$331.60. Thus, it would take an increase of \$268.40 to bring the rent up to fair market rent.

The park was “at or near” 100 percent occupancy.

C. *Testimony of Dr. Richard Fabrikant.*

The Owner called Dr. Richard Fabrikant as an expert on fair rates of return for mobilehome parks.³

Dr. Fabrikant had a Ph.D. in economics; he had carried out more than 16 rent adjustment feasibility studies in California. He testified almost exclusively on behalf of park owners.

Dr. Fabrikant calculated a fair rate of return based on the actual rates of return on alternative investments. One alternative investment was publicly held real estate investment trusts (REITs) that owned and operated mobilehome parks. However,

³ When Dr. Fabrikant testified, the City’s recording equipment malfunctioned, so there is no transcript of his testimony. The parties stipulated to the admission of his testimony in the form of a declaration instead.

individual mobilehome parks are riskier than REITs, “because those REITs are diversified and shares in those REITs have greater liquidity than individual mobilehome parks.”

Another alternative investment was 20-year Treasury bonds, (T-bonds), which are essentially risk-free. Thus, to determine the fair rate of return, he increased the yield on T-bonds by a “risk premium” (derived by taking past REIT rates of return and subtracting past T-bond bond rates of return). He explained, “Investment in mobilehome parks . . . is significantly riskier than investment in treasury bonds [or] certificates of deposit As a result, the rate of return on mobilehome parks must be significantly greater than the return on those investments.” “It would be irrational to invest in a more risky investment, if the same rate of return could be achieved from a less risky investment. As risk increases, the rate of return must increase.”

Dr. Fabrikant concluded that the fair rate of return, in real terms, was 9.34 percent. Achieving this rate of return would require a rent increase of \$230.97.

Alternatively, Dr. Fabrikant also provided a “look-forward analysis.” (Capitalization altered.) This assumed that the park would be sold in 2025 for an amount equal to the purchase price, adjusted for inflation.⁴ For each year from 2006 through 2025, it adjusted both rent and expenses for inflation. It indicated that maintaining the same fair rate of return (9.34 percent) would require a rent increase of \$313.60.

⁴ Dr. Fabrikant testified that his look-forward analysis took appreciation into account. While this is technically true, it assumed zero real appreciation; it allowed only nominal appreciation.

Dr. Fabrikant criticized an MNOI approach in general. He testified: “In order to determine a ‘rate’ of return, including a fair rate of return, it is necessary to have a numerator and a denominator. The numerator is generally the net operating income of the park, while the denominator is generally the investment in the park It is not possible to determine whether a mobilehome park is generating a fair rate of return by examining only the numerator, or net operating income” “There is no empirical or theoretical support for the proposition that all mobilehome parks are generating a fair rate of return at any particular point in time. To the contrary, both empirical evidence and economic theory suggest that at any particular point in time, some mobilehome parks will be generating a fair rate of return, while others are not.”

He also specifically criticized an MNOI approach that adjusts for inflation by using an indexing factor of less than 100 percent of the CPI (fractional indexing). In his view, the MNOI formula in the Ordinance could never provide a fair rate of return because it provided less than 100 percent indexing for inflation; over time, an owner’s real rate of return would approach zero.

D. *Testimony of Dr. Kenneth Baar.*

The Organization called Dr. Kenneth K. Baar as an expert on fair return analysis for purposes of rent control laws.

Dr. Baar was an attorney with a Ph.D. in urban planning.⁵ He consulted with cities on drafting rent control laws and regulations. He testified almost exclusively for cities and tenants.

In his opinion, defining a fair return in terms of return on current fair market value was “circular.” Defining it in terms of return on investment was similarly circular. He explained that a new purchaser would be able to increase rents simply by paying a high purchase price — “the more you pay, the more you get.” A return on investment approach was also problematic because it irrationally discriminated between long-time owners and recent purchasers. Hence, it ““would merely encourage property owners to transfer their property each time its value rose, in order to secure . . . that appreciation which could otherwise be taken by the government without compensation””

Dr. Baar concluded that defining a fair return in terms of MNOI was the “most rational and workable” approach. It operates independently of the purchase date and the purchase price. It assumes that an owner’s actual NOI before rent control provided a fair return; it then allows the owner a certain rate of growth of NOI to account for inflation.

He explained that the rationale for fractional indexing was that real estate offers appreciation. Moreover, “real estate is typically a leveraged investment,” so any appreciation as a percentage of equity may be much greater than appreciation as a percentage of the purchase price.

⁵ The Owner points out that Dr. Fabrikant was a Fulbright scholar. It omits to mention that Dr. Baar was also a Fulbright scholar.

He testified that the 21 California cities and counties that use an MNOI approach use a range of indexing figures from 40 to 100 percent. He admitted that these figures are not based on any empirical data.

Using the MNOI formula specified in the Ordinance, the Owner would be entitled to a rent increase of \$9.45.⁶ In his opinion, this was a fair return “under the ordinance.” He admitted that the Ordinance itself determined his calculation of a fair return: “[I]f this ordinance had . . . provided for 100 percent indexing, the outcome of my fair return analysis would have been different, and instead of \$360,000 being a fair net operating income today, . . . it would be about \$450,000.” He also admitted that he assumed that indexing by 50 percent provides a fair return and is constitutional.

He added that a “fair return” is a purely legal concept: “[M]y opinion about fair return is . . . based on court opinions [I]f the courts said tomorrow that 100 percent indexing is constitutional, and nothing less was constitutional, then my opinion about what a fair return is would change because I can’t have a fair return opinion in the absence of what the courts say”

⁶ Actually, Dr. Baar testified that the appropriate increase was either \$9.45 or \$2.39, depending on whether certain legal costs were properly treated as an operating expense. In his opinion, the legal costs were not a genuine operating expense, so he recommended using the \$2.39 figure. Ultimately, however, the Commission used the \$9.45 figure.

Dr. Baar criticized Dr. Fabrikant's reliance on REIT rates of return, because REIT rates of return include appreciation as well as rental income. He also pointed out that a mobile home park, unlike a T-bond, offers capital appreciation.

He conceded that there were risks to owning a mobile home park, although the "rental risk" — i.e., the risk of vacancies — was "extremely low."

III

PROCEDURAL BACKGROUND

In November 2006, Bermuda Palms, LLC filed a petition for a rent increase. The Organization filed an opposition to the petition. Pursuant to the Ordinance, the City appointed retired Justice Edward Wallin of JAMS, Inc. as a hearing officer.

In May 2008, Justice Wallin held an evidentiary hearing. In December 2008, he issued a written decision. By and large, he accepted Dr. Fabrikant's methodology. For example, he agreed that he should take return on investment into account. However, he concluded that Dr. Fabrikant's recommended fair rate of return — 9.34 percent — was "too high in the current economic climate." He found that the rent for current tenants should be increased by a total of \$189.⁷ However, he also found that the increase should

⁷ Aside from saying that Dr. Fabrikant's figure was too high, and that no increase whatsoever would be too low, Justice Wallin did not explain how he arrived at the figure of \$189.

Significantly, however, it represents a rate of return of 8.34 percent — i.e., exactly one percentage point less than the 9.34 percent that Dr. Fabrikant had recommended — rounded to the nearest dollar.

be phased in by \$50 per year. Finally, he found that, on vacancy, the rent for new tenants should be \$600 (the market rent).

In February 2009, the Commission held a hearing to review Justice Wallin's decision. In April 2009, it held a further hearing. On April 23, 2009, the Commission adopted a resolution allowing a rent increase, calculated pursuant to the MNOI formula in the Ordinance, of \$50.76.⁸ This represented a real rate of return on investment of roughly around 4 percent.⁹

The Commission rejected Dr. Fabrikant's methodology and accepted Dr. Baar's. It found that defining a fair return in terms of "return on value" "has been rejected by many rent control jurisdictions and the courts for being circular and for abrogating rent control."

It acknowledged that the Owner was urging it to define a fair return in terms of return on *investment*, rather than return on *value*. However, it described this as a "modified 'return of value' approach." It concluded that, just like a "return on value"

⁸ The Commission's figure of \$50.76 represented Dr. Baar's figure of \$9.45, after correcting certain mathematical errors and adjusting for subsequent inflation.

⁹ According to the Owner, the Commission's decision represented a real rate of return on investment of 4.1 percent. However, this was the rate of return under the formula in the Ordinance, applied *as of October 2006*.

At one point, the City calculated that the real rate of return under the formula in the Ordinance, *applied as of June 2007*, was 4.03 percent.

In its final decision, however, the Commission applied the formula in the Ordinance *as of March 2009*. The record does not clearly indicate what real rate of return the Commission's final decision actually represents.

approach, the Owner's "return on investment" approach was "circular upon the transfer of the park to subsequent purchasers" It also concluded that a "return on investment" approach would allow park owners to "defeat rent control by buying and selling parks to establish a new basis over which to calculate a fair return."

In July 2009, the Owner filed a petition for writ of mandate against the City and the Commission. The petition named the individual residents of the park as real parties in interest. However, it does not appear that they were ever served. The Organization was allowed to intervene instead.

The Owner claimed, among other things, that:

1. The Commission did not allow it a fair rate of return, as required by the Ordinance and the federal and state constitutions.
2. The Commission failed to consider some of the evidence that Justice Wallin had considered.
3. The Commission erred by considering the personal views of Commissioner Mitch Moldenhauer.

After a hearing, the trial court issued a written statement of decision denying the petition. It found that, to the extent that the Commission had failed to consider any of the exhibits that were before Justice Wallin, the Owner had not shown prejudice. It also found no evidence that the Commission had relied improperly on any of Commissioner Moldenhauer's views. Finally, it found substantial evidence that the Commission had allowed the Owner a fair rate of return. It entered judgment accordingly.

IV

STANDARDS OF REVIEW

This case involves three separate levels of review.

A. *The Commission's Review of Justice Wallin's Decision.*

First, the Commission had to review Justice Wallin's decision. "There is no general or definitive source of law for local agency administrative adjudication procedure other than constitutional due process principles and the local agency's own regulations or other rules." (Cal. Admin. Hearing Practice (Cont.Ed.Bar 2d ed. 2013) Understanding Administrative Adjudication, § 1.29, p. ____.) Thus, to find the standard of review applicable at this level, we would look to the Ordinance. "'Interpretation of an ordinance presents a question of law that we review de novo.' [Citation.]" (*Tower Lane Properties v. City of Los Angeles* (2014) 224 Cal.App.4th 262, 268.)

It is at least arguable that, under the Ordinance, a hearing examiner's findings are binding on the Commission. The Ordinance allows the Commission to delegate its power to hear a rent adjustment petition to a hearing examiner. (Indio Mun. Code, § 32.40(J); see also *id.*, § 99.25(B).) The hearing examiner is to "make findings based on the evidence" (Indio Mun. Code, § 99.23(D).) The Commission retains the power to "[m]ake final determinations *based upon the findings* of such independent hearings . . . by an examiner" (Indio Mun. Code, § 32.40(K), italics added.) The Ordinance then reiterates that "[t]he decision of the Commission shall be *based upon the findings*" (Indio Mun. Code, § 99.23(D), italics added.)

The Owner, however, never argued below that the Commission could not reject the hearing examiner's findings. Quite the contrary — in the proceedings before the Commission, it conceded that the Commission could “modify” Justice Wallin's findings, as long as the Commission examined the evidence and issued written findings. Indeed, it asked the Commission to give it a *larger* rent increase than Justice Wallin had, arguing that this was “consistent with the evidence.”

Similarly, in the proceedings in the trial court, while the Owner asserted that the hearing examiner's findings were entitled to “great weight,” it conceded that the Commission could reject them, based on the evidence. It also argued that the Commission erred by failing to consider some of the exhibits that were before Justice Wallin.

Even in this appeal, the Owner does not claim that the hearing examiner's findings were binding on the Commission. We called for further briefing, asking, “What deference, if any,” the Commission was required to give to the hearing examiner's decision. In response, the Owner reiterated that the Commission could reject the hearing examiner's findings, as long as its new findings were supported by substantial evidence.

We therefore conclude that the Owner is bound by the standard of review that it has asserted throughout these proceedings, as a matter of equitable estoppel, judicial estoppel, and invited error. The City and the Organization concur that the Commission

owes the hearing examiner's findings no deference and can make findings of its own, as long as they are supported by substantial evidence.¹⁰

Accordingly, we assume, without deciding, that this is the correct standard of review.

B. *The Trial Court's Review of the Commission's Decision.*

Next, the trial court had to review the Commission's decision. In doing so, it had to determine "whether there was a fair trial; and whether there was any prejudicial abuse of discretion. Abuse of discretion is established if the respondent has not proceeded in the manner required by law, the order or decision is not supported by the findings, or the findings are not supported by the evidence." (Code Civ. Proc., § 1094.5, subd. (b).)

The test for whether the findings are supported by the evidence depends on the nature of the right involved. " . . . If the administrative decision substantially affects a fundamental vested right, the trial court must exercise its independent judgment on the evidence. [Citations.] . . . If, on the other hand, the administrative decision neither involves nor substantially affects a fundamental vested right, the trial court's review is limited to determining whether the administrative findings are supported by substantial

¹⁰ The City has asked us to take judicial notice of a document entitled "Procedural Rules for the Indio Mobile Home Fair Practices Commission" (Procedural Rules), arguing that it supported the City's position regarding the standard of review. Because we come to the same conclusion without needing to consider the Procedural Rules, we deny the request. (*Barham v. Southern Cal. Edison Co.* (1999) 74 Cal.App.4th 744, 755 [Fourth Dist., Div. Two].)

evidence.’ [Citations.]” (*ReadyLink HealthCare, Inc. v. Jones* (2012) 210 Cal.App.4th 1166, 1172.)

Most rent control cases do not implicate a fundamental vested right; accordingly, in the trial court, the substantial evidence test applies. (*Concord Communities v. City of Concord* (2001) 91 Cal.App.4th 1407, 1413-1414; *San Marcos Mobilehome Park Owners’ Assn. v. City of San Marcos* (1987) 192 Cal.App.3d 1492, 1500-1502.) There may be exceptional rent control cases in which the independent judgment standard would apply — for example, cases in which, if the administrative agency denied the requested rent increases, the property owner would go out of business. (*San Marcos Mobilehome Park Owners’ Assn. v. City of San Marcos, supra*, 192 Cal.App.3d at p. 1502.) The Owner, however, has never claimed, in the trial court or in this court, that the independent judgment standard applied. Accordingly, even assuming the trial court applied the wrong standard, the error was invited.

C. *Our Review of the Trial Court’s Decision.*

Finally, we must review the trial court’s decision. With respect to whether the Commission’s decision is supported by substantial evidence, our “task . . . is essentially identical to that of the trial court. [Citation.] Accordingly, ‘we review the agency’s actions directly and are not bound by the trial court’s conclusions. [Citations.]’ [Citation.]” (*Wollmer v. City of Berkeley* (2009) 179 Cal.App.4th 933, 939.)

With respect to whether the Owner received a fair hearing before the Commission and whether the Commission proceeded in the manner required by law, our review is

“ . . . de novo . . . because the ultimate determination of procedural fairness amounts to a question of law.’ [Citations.]” (*Gonzalez v. Santa Clara County Department of Social Services* (2014) 223 Cal.App.4th 72, 96.)

V

FAIR RETURN

The Owner contends that the fractional indexing formula in the Ordinance — and hence the \$50.76 rent increase that the Commission awarded, based on the fractional indexing formula — denied it a fair rate of return.

A. *Judicial Review of Price Controls.*

The government can constitutionally regulate prices, including rents. (*Pennell v. San Jose* (1988) 485 U.S. 1, 11-12.) “Such regulations are generally found to pass constitutional muster ‘so long as the law does not deprive investors of a “fair return” and thereby become “confiscatory.” [Citations.]” (*Galland v. City of Clovis* (2001) 24 Cal.4th 1003, 1021.) This fair return requirement “if not present in an ordinance will be implied therein” (*City of Berkeley v. City of Berkeley Rent Stabilization Bd.* (1994) 27 Cal.App.4th 951, 984.)

“Although the term ‘fair rate of return’ borrows from the terminology of economics and finance, it is as used in this context a legal, constitutional term. It refers to a constitutional *minimum* within a broad zone of reasonableness [W]ithin this broad zone, the rate regulator is balancing the interests of investors . . . with the interests of consumers [Citation.]” (*Galland v. City of Clovis, supra*, 24 Cal.4th at p. 1026.)

“[W]hen considering whether a price regulation violates due process, a “court must determine whether the [regulation] may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection for the heart of relevant public interests, both existing and foreseeable.” [Citation.] In other words, rent regulation must not prevent an efficient enterprise from ““operating successfully”” [Citation.]” (*Galland v. City of Clovis, supra*, 24 Cal.4th at pp. 1021-1022.)

Along the same lines, it has been said that “[a] ‘just, fair and reasonable’ return is characterized as sufficiently high to encourage and reward efficient management, discourage the flight of capital, maintain adequate services, and enable operators to maintain and support their credit status. However, the amount of return should not defeat the purpose of rent control to prevent excessive rents. [Citation.]” (*Carson Harbor Village, Ltd. v. City of Carson Mobilehome Park Rental Review Bd.* (1999) 70 Cal.App.4th 281, 288-289.)

“In order to satisfy this standard, rent control laws incorporate any of a variety of formulas for calculating rent ceilings. [Citation.] ‘Rent control agencies are not obliged by either the state or federal Constitution to fix rents by application of any particular method or formula.’ [Citation.] Rather, ‘selection of an administrative standard by which to set rent ceilings is a task for local governments . . . and not the courts.’ [Citations.]” (*Kavanau v. Santa Monica Rent Control Bd.* (1997) 16 Cal.4th 761, 768.)

“Price control is ‘unconstitutional . . . if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt’ [Citation.]” (*Permian Basin Area Rate Cases* (1968) 390 U.S. 747, 769-770.)

“Though due process protections generally focus on method, not result, in the context of price regulation ‘it is the result reached not the method employed which is controlling. [Citations.] It is not theory but the impact of the [price regulation] which counts.’ [Citation.]” (*Kavanau v. Santa Monica Rent Control Bd.*, *supra*, 16 Cal.4th at p. 772.)

Thus, “an otherwise reasonable rate is not subject to constitutional attack by questioning the theoretical consistency of the method that produced it The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties. Errors to the detriment of one party may well be canceled out by countervailing errors or allowances in another part of the rate proceeding. The Constitution protects the [property owner] from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the . . . property if they are compensated by countervailing factors in some other aspect.” (*Duquesne Light Co. v. Barasch* (1989) 488 U.S. 299, 314.)

“[A state price-control] regulation is presumptively constitutional under the due process clause. [Citation.] ‘The burden of proving’ otherwise ‘rests on the party asserting the violation’ [Citation.]” (*20th Century Ins. Co. v. Garamendi* (1994) 8

Cal.4th 216, 292.) “[H]e who would upset the rate order . . . carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.’ [Citation.]” (*Id.* at pp. 318-319.)

B. Typical Rent Control Methods.

Ordinarily, as Dr. Fabrikant testified, the very concept of a “rate” of return presupposes a numerator and a denominator.

The United States Supreme Court has “disavowed” the view that the denominator must be the current “fair value” of the property. (*Verizon Communications, Inc. v. F.C.C.* (2002) 535 U.S. 467, 483-484; see generally *Duquesne Light Co. v. Barasch, supra*, 488 U.S. at pp. 308-309.) “[F]air value’ is the end product of the process of rate-making not the starting point The heart of the matter is that rates cannot be made to depend upon ‘fair value’ when the value of the going enterprise depends on earnings under whatever rates may be anticipated.” (*Federal Power Com. v. Hope Natural Gas Co.* (1964) 320 U.S. 591, 601, fn. omitted.)

One approach that has been upheld is the “return on investment” (or “historical cost”) approach. This approach looks at the actual price paid for the property (typically adjusted downward for depreciation and adjusted upward for inflation). (*Palomar Mobilehome Park Ass’n. v. Mobile Home Rent Review Com.* (1993) 16 Cal.App.4th 481, 487.) The return on investment approach, however, is not constitutionally required. (*Duquesne Light Co. v. Barasch, supra*, 488 U.S. at pp. 315-316.)

An alternative approach that has also been upheld is the MNOI approach. This avoids selecting any denominator by presuming that the landlord's NOI immediately before rent control provided a fair return. (*Kavanau v. Santa Monica Rent Control Bd.*, *supra*, 16 Cal.4th at p. 768.) Typically, the landlord may rebut the presumption by showing that the base-year NOI was atypical — because, for example, base-year operating expenses were unusually high, or base-year rents were unusually low. (See *id.* at p. 769)

“Of course, if the law holds net operating income constant, inflation will erode the real value of that income. Thus, many maintenance of net operating income formulas permit a periodic inflation adjustment. [Citations.]” (*Kavanau v. Santa Monica Rent Control Bd.*, *supra*, 16 Cal.4th at p. 769.) As Dr. Baar testified, a few of the California cities that use an MNOI approach provide that the base-year NOI may be multiplied by 100 percent of the CPI. Most, however, set fractional CPI multipliers from 40 to 85 percent.

C. *The Ordinance as Establishing a Presumption.*

The Owner contends that the Commission erroneously assumed that the Ordinance established a conclusive presumption that its MNOI formula necessarily produces a fair return, whereas, in the Owner's view, the Ordinance merely establishes a rebuttable

presumption to this effect. Moreover, the Owner claims to have rebutted the presumption.¹¹

We agree that the Ordinance allows for rent increases in excess of the MNOI formula, when necessary to provide a just and reasonable return. Section 99.04(G) of the Indio Municipal Code, standing alone, purports to provide that, even when a landlord files a hardship petition, any rent increase is limited by the MNOI formula. However, section 32.40(I) of the Indio Municipal Code gives the Commission the power to “[a]uthorize an increase in the maximum amount of rent otherwise permitted to be charged a landlord per Chapter 99 in cases where the application of said chapter . . . would prevent a landlord from obtaining a just and reasonable return” In any event, as already noted, even when a rent control ordinance does not expressly require a just and

¹¹ There is some room for confusion here, because the Ordinance actually creates two presumptions — one explicit and one implicit.

First, it explicitly creates a presumption “that the net operating income produced by a property during [1982] provided a fair return on property.” (Indio Mun. Code, § 99.04(C).)

Second, however, it also provides that, to obtain a rent increase in excess of the MNOI formula, a landlord must show that the MNOI formula “would prevent [it] from obtaining a just and reasonable return” (Indio Mun. Code, § 32.40(I).) This is, in effect, a presumption that the MNOI formula does provide a just and reasonable return. (Cf. *TG Oceanside, L.P. v. City of Oceanside* (2007) 156 Cal.App.4th 1355, 1373 [mobilehome rent control ordinance included express presumption that application of its indexed MNOI formula produced a just and reasonable return].)

In this case, the Owner has never disputed that the 1982 NOI was a fair return *at the time*. However, it claims that it overcame the presumption that the application of the indexed MNOI formula to the 1982 NOI *still* produces a fair return.

reasonable return, this requirement must be implied. (*City of Berkeley v. City of Berkeley Rent Stabilization Bd.*, *supra*, 27 Cal.App.4th at p. 984.)

We do not agree, however, that the Commission treated the MNOI formula as a conclusive presumption. The Owner does not cite any particular finding by the Commission to that effect. Rather, it claims that (1) it introduced evidence that the MNOI formula did *not* provide a fair return; and (2) there was “[n]o [e]vidence” that the MNOI formula *did* produce a fair return. It concludes that the only way the Commission possibly could have ruled against it was if it treated the MNOI formula as conclusive.

In its final decision, however, the Commission noted the Owner’s evidence that a fair rate of return, calculated as a rate of return on investment, was 9.34 percent. It then proceeded to discuss — in detail — its reasons for finding it inappropriate to use a “return on investment” approach. In other words, it found the Owner’s evidence unpersuasive. This is different from finding the evidence persuasive but relying on a conclusive presumption anyway.

We therefore turn to whether the Commission’s decision was supported by substantial evidence.

D. *The Sufficiency of the Evidence.*

We emphasize the procedural posture of the case, particularly as framed by the Ordinance. The Ordinance did not simply direct the Commission to set rent at a level that provided a “fair” or a “just and reasonable” return. (Cf. *Yee v. Mobilehome Park Rental Review Bd.* (1993) 17 Cal.App.4th 1097, 1101-1102.) Had it done so, it would be

at least arguable that the Commission would have the burden of proving that the rent it set did, in fact, provide a fair return, and in the absence of any evidence to that effect, the rent could not stand. (See *id.* at pp. 1106, 1108-1109; but see *20th Century Ins. Co. v. Garamendi*, *supra*, 8 Cal.4th at pp. 318-319 [“[H]e who would upset the rate order . . . carries the . . . burden of . . . showing that it is invalid” [Citation.]”]; *Federal Power Com. v. Hope Natural Gas Co.*, *supra*, 320 U.S. at p. 602.)

Instead, the Ordinance directed the Commission to calculate the Owner’s rent increase in accordance with its prescribed MNOI formula the Commission found, in proceedings on the Owner’s petition, that the MNOI formula would prevent the owner from obtaining a fair return. Thus, it is clear that the *Owner* had the burden of proving that the rent set did *not* provide a fair return. The Owner more or less concedes that it had the burden by characterizing the Ordinance as creating a “presumption” of a fair return.

Because the Owner had the burden of proof, we must affirm unless there was “indisputable evidence [in its favor,] evidence no reasonable trier of fact could have rejected” (*In re Sheila B.* (1993) 19 Cal.App.4th 187, 200.)

Basically, the Owner relies on three types of evidence. We discuss each of these types of evidence below.

1. *The fractionally indexed MNOI formula*

eventually reduces real NOI almost to zero.

First, the Owner argues that “ultimately,” the fractionally indexed MNOI formula in the Ordinance will reduce real NOI almost to zero, and thus it will become confiscatory.

According to Dr. Fabrikant, under any fractional indexing MNOI formula, “[i]t is a mathematical certainty” that “the *real* value of NOI will approach zero at some time in the future.” He submitted a formidable “mathematical proof” of this proposition. Indeed, it is clearly correct, as a matter of common sense. Dr. Baar even conceded that it was correct. In this appeal, the Owner indignantly protests that “the Commission is bound by the science of mathematics.” (Capitalization altered.)

As already mentioned, however, a constitutional challenge cannot be based on the *method* of rate-setting, no matter how flawed; it must be based on the actual rate that is set. (*Duquesne Light Co. v. Barasch*, *supra*, 488 U.S. at p. 314.) The Owner concedes that its real NOI is not zero *yet*. It further concedes that it is not bringing a facial challenge to the Ordinance.

The California courts have repeatedly rejected challenges to fractional indexing formulas as a *method* of setting mobilehome rents. For example, in *Colony Cove Properties, LLC v. City of Carson* (2013) 220 Cal.App.4th 840, a city granted a park owner a rent increase based on MNOI indexed at 75 percent. (*Id.* at p. 861.) The court stated, “The Supreme Court has made clear that a valid rent control system ‘must

generally permit profits to be adjusted over time for inflation so that the real value of that profit does not shrink toward the vanishing point.’ [Citation.] However, the contention that net operating profits must be adjusted by 100 percent of inflation has been repeatedly rejected. [Citations.] . . . ‘A mobilehome park’s operating expenses do not necessarily increase from year to year at the rate of inflation, and . . . a “general increase at 100% of CPI . . . would be too much if expenses have increased at a lower rate.”’ [Citation.] Moreover, ‘the use of indexing ratios may satisfy the fair return criterion because park owners typically derive a return on their investment not only from income the park produces, but also from an increase in the property’s value or equity over time.’ [Citations.]” (*Id.* at p. 876.)

Likewise, in *H.N. & Frances C. Berger Foundation v. City of Escondido* (2005) 127 Cal.App.4th 1, the court held that fractional indexing was not necessarily unconstitutional. (*Id.* at pp. 13-15.) It cited Dr. Baar’s testimony in that case “that 100 percent indexing is not required for the Park to achieve a fair return. A mobilehome park’s operating expenses do not necessarily increase from year to year at the rate of inflation . . . Moreover, . . . the use of indexing ratios may satisfy the fair return criterion because park owners typically derive a return on their investment not only from income the park produces, but also from an increase in the property’s value or equity over time. In other words, investors are motivated to acquire, retain and maintain mobilehome parks both for the yearly income and for appreciation in real estate.” (*Id.* at pp. 14-15, fn. omitted.)

We cannot say that a fractional indexing formula *necessarily* results in a confiscatory rate of return. Moreover, even assuming we could overturn a rent control ordinance if it was arbitrary or irrational, at this point, it is all too well-established under California case law than a fractional indexing formula is not *necessarily* irrational.

At the same time, however, we cannot say that a fractional indexing formula can *never* result in a confiscatory rate of return. The Organization notes that ordinances using a fractional indexing formula have been upheld; it leaps to the conclusion that a fractional indexing formula necessarily produces a fair return *as a matter of law* (except perhaps when the base year NOI did not provide a fair return to begin with).

This confuses a facial challenge with an as-applied challenge. “‘A statute may be invalid as applied to one state of facts, and yet valid as applied to another.’ [Citation.]” (*Ferrante v. Fish & Game Com.* (1946) 29 Cal.2d 365, 373.) As already mentioned, “‘it is the result reached not the method employed which is controlling. [Citations.] It is not theory but the impact of the [price regulation] which counts.’ [Citation.]” (*Kavanau v. Santa Monica Rent Control Bd.*, *supra*, 16 Cal.4th at p. 772.)

The court in *Jersey Cent. Power & Light Co. v. F.E.R.C.* (D.C. Cir. 1987) 810 F.2d 1168 (en banc) came to a similar conclusion. There, an electric utility sustained a \$397 million loss when it ceased building a nuclear power plant due to dramatically altered regulatory and economic conditions. (*Id.* at pp. 1170-1171.) The Federal Energy Regulatory Commission (FERC) allowed the utility to amortize the cost over 15 years, but refused to allow it to include unamortized portions of the cost in its rate base. (*Id.* at

pp. 1171-172.) FERC relied on prior precedent upholding the exclusion of the unamortized portion of a failed investment. (*Id.* at p. 1172.)

The court stated: “[FERC] maintains that because excluding the unamortized portion of a cancelled plant investment from the rate base had previously been upheld as *permissible*, any rate order that rests on such a decision is unimpeachable. But that would turn our focus from the end result to the methodology, and evade the question whether the component decisions together produce just and reasonable consequences. . . . *The fact that a particular ratemaking standard is generally permissible does not per se legitimate the end result of the rate orders it produces.*” (*Jersey Cent. Power & Light Co. v. F.E.R.C.*, *supra*, 810 F.2d at pp. 1179-1180, italics added; see *Duquesne Light Co. v. Barasch*, *supra*, 488 U.S. at p. 317 [conc. opn. of Scalia, J.] [“while ‘prudent investment’ . . . need not be taken into account as such in ratemaking formulas, it may need to be taken into account in assessing the constitutionality of the particular consequences produced by those formulas.”].)

The fact that fractional indexing erodes real NOI over time was at least relevant. A city could rationally decide not to adopt an ordinance that provides for fractional indexing, if it concluded that this approach does not always provide a fair return. Similarly, here, the City, despite having already adopted a fractional indexing ordinance, could rationally decide that fractional indexing does not provide a fair return in a given case. That, however, is not the procedural posture in which we find ourselves. Rather, the Commission considered the matter and determined that fractional indexing did

provide a fair return. The issue before us is whether the evidence conclusively demonstrates that this finding was erroneous.

“[R]ent regulators must generally permit profits to be adjusted over time for inflation so that the real value of that profit does not shrink toward the vanishing point.” (*Galland v. City of Clovis, supra*, 24 Cal.4th at p. 1026.) Thus, we agree with the Owner that: “Because it is a mathematical certainty that the formula results in a continuous erosion of purchasing power, the results must be tested to determine whether confiscation has in fact occurred.” (Fn. omitted.)

But the Owner did not submit any evidence that its real NOI had been reduced to anywhere near zero. Indeed, inasmuch as it purchased the park in May 2006, and it was awarded a rent increase in April 2009, that was not very likely. According to Dr. Fabrikant, the Owner’s real (i.e., inflation-adjusted) rate of return for the year ending May 31, 2007 was 3.81 percent. The rent increase allowed by the Commission provided a real rate of return of roughly 4 percent. Thus, the Owner has not shown that its real rate of return was eroded at all.

The Owner therefore argues that the real NOI of the park has been severely eroded since 1982 (the base year under the Ordinance). This is comparing apples to oranges, in three respects. First, most of the decline occurred before the Owner purchased the park; the Owner does not explain why it should have standing to complain about the impact of the Ordinance on previous owners. Second, as the Owner itself has argued, in determining whether a rate of return is fair, NOI is just a numerator — its meaning varies,

depending on the denominator. Each successive owner of the park would have viewed its rate of return as a ratio of NOI to purchase price. However, while the NOI in 1982 is in the record, the purchase price paid by the 1982 owner is not. Thus, there is no way of knowing that owner's real rate of return. Third, in addition to NOI, the 1982 owner realized appreciation when the park was sold. Again, without the purchase price, there is no way of quantifying that appreciation. And similarly, absent an appraisal of the park as of 2009, there is no way of knowing whether the Owner has already enjoyed unrealized appreciation.

We conclude that, standing alone, the fact that the formula erodes real NOI — and even that eventually it erodes real NOI almost to zero — fails to carry the Owner's burden.

2. *Rent Is below fair market value.*

Next, the Owner argues that the increased rent that the Commission allowed (\$388.47) is far below the fair market rent (\$600). Justice Wallin found this argument persuasive.

We note, again, that fair market rent is certainly relevant. In other words, if the Commission had agreed with Justice Wallin and had found that the rent allowed under the Ordinance was so far out of whack with fair market rent that it did not provide a fair return, that decision would have been supported by substantial evidence.

We cannot say, however, that the discrepancy with fair market rent absolutely required the Commission to grant a larger increase. The whole point of rent control is to

reduce rents below the fair market rate. “Thus, comparison of the rate of return of rent-controlled mobilehome parks with those of non-rent-controlled parks . . . is of limited utility in establishing the constitutional minimum rate of return.” (*Galland v. City of Clovis, supra*, 24 Cal.4th at pp. 1026-1027.)

3. *The rate of return is below the rate of return on other, less risky investments.*

The Owner’s key argument is that the rate of return on investment that the Commission permitted is far below the rate of return on less risky investments, such as T-bonds and REITs. Again, Justice Wallin found this argument persuasive. By contrast, the Commission expressly refused to consider this evidence. Thus, preliminarily, the Owner contends that the Commission erred by disregarding it.

A “return on value” calculation divides net operating income by current fair market value. (*Fisher v. City of Berkeley* (1984) 37 Cal.3d 644, 680, fn. 33; *Colony Cove Properties, LLC v. City of Carson, supra*, 220 Cal.App.4th at p. 852, fn. 11.)

A “return on investment” calculation divides net operating income by the owner’s purchase price.¹² (See *Colony Cove Properties, LLC v. City of Carson, supra*, 220 Cal.App.4th at p. 852, fn. 11; *Palomar Mobilehome Park Ass’n. v. Mobile Home Rent Review Com., supra*, 16 Cal.App.4th at pp. 487-489.)

¹² The purchase price may be adjusted down for any subsequent depreciation and up for any subsequent capital improvements. In this case, however, the Owner did not report either.

Dr. Baar gave several reasons for disregarding return on investment. We consider these seriatim.

First, Dr. Baar testified that a return on investment approach, like a return on value approach, is circular.

In general, the courts have agreed that defining a fair return in terms of return on value is circular. (*Federal Power Com. v. Hope Natural Gas Co.*, *supra*, 320 U.S. at pp. 601-602; *Fisher v. City of Berkeley*, *supra*, 37 Cal.3d at p. 680, fn. 33; *Cotati Alliance for Better Housing v. City of Cotati* (1983) 148 Cal.App.3d 280, 287.) As the appellate court explained in *Cotati*: “The fatal flaw in the return on value standard is that income property most commonly is valued through capitalization of its income. Thus, the process of making individual rent adjustments on the basis of a return on value standard is meaningless because it is inevitably circular: value is determined by rental income, the amount of which is in turn set according to value. Use of a return on value standard would thoroughly undermine rent control, since the use of uncontrolled income potential to determine value would result in the same rents as those which would be charged in the absence of regulation. Value (and hence rents) would increase in a never-ending spiral. Similarly, . . . if there was a housing shortage which caused rents to be artificially high, use of present control value as the measure will perpetuate artificially inflated rents. Rent

control utilizing this standard is no rent control at all.” (*Cotati Alliance for Better Housing v. City of Cotati, supra*, 148 Cal.App.3d at p. 287.)¹³

The Commission therefore could properly decline to use a return on value approach. Indeed, the Owner does not take issue with this proposition. Rather, it argues that return on *investment* is different from return on *value*. The difference is that, while value fluctuates, investment is fixed at a single point in time. In particular, value fluctuates in response to changes in rent; investment does not. Thus, a return on investment approach does not suffer from the same circularity.

We agree. Due process requires a fair return. As Dr. Fabrikant suggested, the very concept of a “fair return” begs the question — return on what? “[W]hether a particular rate is ‘unjust’ or ‘unreasonable’ will depend to some extent on what is a fair rate of return given the risks under a particular ratesetting system, and *on the amount of capital upon which the investors are entitled to earn that return.*” (*Duquesne Light Co. v. Barasch, supra*, 488 U.S. at p. 310, italics added.)

As the Owner argues, measuring a fair return in terms of return on investment is not circular. Here, the Owner paid \$9,004,950 for the park. If it is granted a rent increase to bring its income stream up to the “fair return” level, presumably the current

¹³ *Cotati*’s reasoning has itself been criticized. (Hirsch, Legal-Economic Analysis of Rent Controls in a Mobile Home Context: Placement Values and Vacancy Decontrol (1988) 35 UCLA L. Rev. 399, 454-455.)

market value of the park will also increase. However, the Owner’s “investment base” will not; it will still be \$9,004,950. There is no “never-ending spiral.”¹⁴

This is fundamentally a question of law, not a matter for expert opinion. Indeed, as Dr. Baar conceded, his opinions were the product of court decisions, and he would change them if court decisions changed. Thus, his opinion that a return on investment approach would be circular did not constitute substantial evidence. (See *People v. Baker* (2012) 204 Cal.App.4th 1234, 1245-1246 [Fourth Dist., Div. Two].)

Dr. Baar also testified that a return on investment approach is manipulable. A new purchaser would be able to increase rents by paying a high purchase price — “the more you pay, the more you get.” This is not a sound reason, however, to disregard return on investment in every case. In calculating a fair return, a regulator can limit itself to considering only “*prudent investments.*” (*Duquesne Light Co. v. Barasch, supra*, 488 U.S. at p. 309, italics added.) Thus, if there were evidence that a park owner deliberately overpaid to evade rent control, the Commission could disregard return on investment in that particular case.

In *Westwinds Mobile Home Park v. Mobilehome Park Rental Review Bd.* (1994) 30 Cal.App.4th 84, a city argued that a mobilehome park owner was not entitled to a rent

¹⁴ Defendants argue that the City was entitled to disregard return on investment because it was entitled to disregard return on value, and in this case, as the Owner had only recently purchased the park, “the inflation indexed purchase price was essentially the same as the fair market value” The fact that, under these circumstances, the numbers happen to have coincided, however, does not mean that the two underlying concepts are the same.

increase, despite its low rate of return on investment, because it overpaid for the park. The court responded: “[T]here is no *evidence* showing this park was not worth \$1.7 million in 1989. To the contrary, since there is no suggestion this was a ‘collusive sale,’ but was instead an arm's-length transaction between a willing buyer and seller, the price would appear to be proper.” (*Id.* at p. 93, fn. omitted.)

The court also rejected the argument that the park owner had paid too much in light of the rent-controlled income stream: “[T]his . . . is a ‘Catch-22’ argument. It posits that a prudent investor will purchase only rent-controlled property for a price which provides him a fair rate of return at the then-current (i.e., frozen) rental rates. Having done so, however, the fair market value is frozen ad infinitum because no one should pay more than the frozen rental rate permits; and existing rental rates are likewise frozen, since the investor is already realizing a ‘fair rate of return.’” (*Id.* at pp. 93-94.)

Here, as in *Westwinds*, there is no evidence that the Owner overpaid. Because there is no suggestion that there was a collusive sale, the purchase price presumptively reflects fair market value at the time. While Karno admitted knowing that the park was subject to rent control when the Owner bought it, he also knew that the Ordinance contained a “safety valve” allowing a park owner to receive rent in excess of the MNOI formula, when necessary to assure a just and reasonable return. Thus, while the Commission could ignore or discount a park owner’s purchase price in an appropriate case, this was not such a case.

Finally, Dr. Baar testified that a return on investment approach discriminates unfairly between long-term owners and recent purchasers. This assumes that the price of real property rises over time. It is unclear whether Dr. Baar had in mind price rises due to inflation or price rises due to general conditions in the real estate market. To the extent that a price rise is due to inflation, the discrimination can be eliminated simply by calculating rents based on the inflation-adjusted price. To the extent that a price rise is due to general market conditions, Dr. Baar's analysis ignores appreciation. Assume an owner buys property for \$2 million and is allowed to charge \$200,000 a year in rent. Over time, the property appreciates to \$8 million, but the owner is still allowed to charge only \$200,000 in rent. The owner then sells the property to a new owner, who is allowed to charge \$800,000 a year in rent. This is not irrational, because the first owner has received not only the rent, but also \$6 million.

There is ample authority that the owner's actual rate of return on investment, particularly when compared to the prevailing rates of return on other comparable investments, is at least *relevant* to whether the owner has been allowed a fair return. Our own Supreme Court has declared that, "when considering whether a price regulation violates due process, a 'court must determine whether the [regulation] may reasonably be expected to maintain financial integrity, attract necessary capital, *and fairly compensate investors for the risks they have assumed*' [Citation.]" (*Kavanau v. Santa Monica Rent Control Bd.*, *supra*, 16 Cal.4th at p. 772, italics added; accord, *In re Permian Basin Area Rate Cases*, *supra*, 390 U.S. at p. 792.)

As already discussed, a regulator is entitled to use a fractionally indexed MNOI formula as a *method* of rate-setting. In other words, in setting rates, it does not have to consider return on investment at all. It does not follow, however, that return on investment need not be considered in determining whether the *resulting rent* is confiscatory and unconstitutional.

We conclude that the Commission abused its discretion by wholly refusing to consider the Owner's evidence regarding rates of return on investment. We turn, then, to whether this error was prejudicial. (Code Civ. Proc., § 1094.5, subd. (b).)

Although the California Supreme Court has held that rates of return on investment are relevant, it has also held that they are not *conclusive*. In *20th Century Ins. Co. v. Garamendi, supra*, 8 Cal.4th 216, it stated: “At least in the general case, such as this, confiscation . . . require[s] ‘deep financial hardship’ . . . , i.e., the inability of the regulated firm to operate successfully — meaning, again, the inability of the regulated firm to operate successfully *during the period of the rate and subject to then-existing market conditions*. [Citation.] Hence, it does *not* arise . . . whenever a rate simply does not ‘produce[] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital.’ Profit of that magnitude is, of course, an interest that the producer may pursue. But it is not a right that it can demand. It is ‘only one of the variables in the constitutional calculus of reasonableness.’ [Citation.]” (*Id.* at pp. 297-298.)

So, the Owner may well ask, what kind of evidence would be sufficient to carry its burden? If it is not enough to prove that the rent allowed (1) is below market value, (2) provides a lower rate of return than other investments with lesser risks, and (3) provides real NOI that decreases constantly and eventually approaches zero, what would be enough?

The California Supreme Court has stated: “[A] producer *may* complain of confiscation only if the rate in question does not allow it to operate successfully. . . . [I]t *cannot* complain if it enables it to operate successfully. [Citation.] In a word, the inability to operate successfully is a necessary — but not a sufficient — condition of confiscation.” (*20th Century Ins. Co. v. Garamendi, supra*, 8 Cal.4th at pp. 295-296.)

“Operate successfully” means more than simply “not go out of business.” The California Supreme Court cited its “operate successfully” requirement to *Federal Power Com. v. Hope Natural Gas Co., supra*, 320 U.S. 591, which stated: “Rates which enable [a] company *to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed* certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called ‘fair value’ rate base.” (*Id.* at p. 605, italics added.)

The California Supreme Court itself has recognized that to “operate successfully,” a company must be able to attract capital and compensate investors for risk. For example, in *Galland v. City of Clovis, supra*, 24 Cal.4th 1003, it stated: “[W]hen considering whether a price regulation violates due process, a “court must determine

whether the [regulation] may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection for the heart of relevant public interests, both existing and foreseeable.” [Citation.] *In other words*, rent regulation must not prevent an efficient enterprise from ““operating successfully”” [Citation.]” (*Id.* at pp. 1021-1022, italics added.)

Moreover, our high court has rejected the idea that an owner challenging price controls must show that it will go out of business. *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805 involved a statute allowing an insurer to seek relief from price controls only if it was ““substantially threatened with insolvency.”” (*Id.* at p. 818.) The court held that this did not “conform to the constitutional standard of a fair and reasonable return. . . . [A] rate may be confiscatory even though it does not threaten the insurer’s solvency.” (*Ibid.*) It added, “[I]n determining a fair rate of return, one must consider ‘the financial integrity of the company whose rates are being regulated [I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. [Citation.] By that standard the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.’” (*Id.* at p. 818, fn. 9.)

We submit that what is crucial — and what is missing in this case — is evidence of the *actual effect* of rent control on the Owner’s operations. This is the only way to prove that the Owner is unable to “operate successfully” and, as a result, is suffering “deep financial hardship.”

Our view finds support in *Westwinds Mobile Home Park v. Mobilehome Park Rental Review Bd.*, *supra*, 30 Cal.App.4th 84, one of the few cases that have overturned price controls as not providing a fair return. There, the park owner proved that, at the rent allowed, after paying interest on its loan, it actually lost money. (*Id.* at pp. 91-92; see also *Yee v. Mobilehome Park Rental Review Bd.*, *supra*, 17 Cal.App.4th at pp. 1103 & 1103, fn. 3 [no evidence to support finding that parks were breaking even].)¹⁵

Similarly, in *Jersey Cent. Power & Light Co. v. F.E.R.C.*, *supra*, 810 F.2d 1168, a utility alleged “that the company was unable to sell senior securities; that its only source of external capital was [a] Revolving Credit Agreement, which was subject to termination and which placed the outstanding bank loans the company was allowed to maintain below the level necessary for the upcoming year; that the need to pay interest on the company’s debt and dividends on its preferred stock meant that common equity investors not only were earning a zero return, but were also forced to pay these interest costs and dividends and that ‘continued confiscation of earnings from the common equity holder

¹⁵ We are not saying that a rent regulator must take an owner’s interest expenses into account in setting rents. However, once an owner is claiming that the rent that has been set does not provide a fair return, it is significant that the rent level is not sufficient to cover the owner’s actual expenses, including interest.

. . . will prolong the Company’s inability to restore itself to a recognized level of credit worthiness’; that its ‘inability to realize fully its operating and capital costs so as to provide a fair rate of return on its invested capital has pushed its financial capability to the limits’; that ‘[a]dequate and prompt relief is necessary in order to maintain the past high quality of service’; and that the rate increase requested was ‘the minimum necessary to restore the financial integrity of the Company.’ [Citation.]” (*Id.* at p. 1178.) The appellate court held that the utility was entitled to a hearing on these allegations. (*Id.* at p. 1182.)

In this case, the Owner did not introduce any evidence of deep financial hardship. Even though the Commission did err by refusing to consider the fact that the Owner’s rate of return was substantially below the rates of return on other, less risky investments, that fact, even when taken together with all of the other evidence in the case, was insufficient to carry the Owner’s burden. We therefore affirm the trial court’s ruling that the Commission did allow the Owner a fair rate of return.

VI

THE COMMISSION’S FAILURE TO CONSIDER CERTAIN EXHIBITS

The Owner contends that it did not receive a fair hearing because the Commission failed to consider some of the exhibits that Justice Wallin did consider.

A. *Additional Factual and Procedural Background.*

The Owner brought a “package” of exhibits to the hearing before Justice Wallin. Some, though not all, of these exhibits had been attached to the Owner’s briefs.

Justice Wallin ruled that all exhibits not specifically excluded would be deemed admitted. The only exhibits he expressly excluded were exhibits 36-39.

The Commission's final resolution included a list of the exhibits that the Commission had "reviewed and considered." It did *not* list exhibits 35-42 or 44-48. Moreover, the City did not include these exhibits in the administrative record. The trial court granted the Owner's motion to supplement the administrative record by adding these exhibits.

B. *Analysis.*

Preliminarily, the City argues: "The fact that the Resolution did not mention every piece of evidence may have been because it listed only evidence the Commission thought most relevant or it may have been due to a drafting error."

The resolution stated, "Record of Proceedings. In rendering a decision on the Petition, the Commission has reviewed and considered the following record" This indicates that it was listing *all* the evidence that the Commission considered, not just the "principal" evidence or the "most relevant" evidence. Thus, it was sufficient to carry the Owner's burden to show what occurred below. The burden shifted to the City to show that what *apparently* occurred was not what *actually* occurred, whether due to a drafting error or for some other reason. It has not even attempted to do so.

Thus assuming the Commission was allowed to review the evidence (see part IV.A, *ante*), it did err. The trial court, however, ruled that the error was not prejudicial. We agree.

The resolution indicated that the Commission did not consider Exhibits 35-42 or 44-48. Justice Wallin, however, had excluded exhibits 36-39. Therefore, we limit our consideration to exhibits 35, 40-42, and 44-48.

Exhibit 35 was a copy of the Ordinance as originally enacted in 1984. The current version of the ordinance, however, is found elsewhere in the administrative record.

Exhibits 40 and 41 were transcripts of testimony that Dr. Baar had given in a different proceeding. However, they were largely consistent with his testimony in this case. He did add that “most of the park owners who . . . purchased parks in the last 15 to 20 years” had cap rates of 8 or 9 percent, and “the overwhelming majority of the mobilehome parks in the State of California . . . have a rate of return greater than 7%” However, this was merely cumulative of the evidence that the park had a below-market rate of return.

Exhibit 42 included an appraisal (performed by Neet) of market rent on a different mobilehome park in a different city. Its relevance is not apparent to us.

Exhibit 44 was a list of verdicts and settlements won by a mobilehome law firm not involved in this case. Again, we fail to see how this was relevant.

Exhibit 45 related to fires at mobilehome parks. Yet again, it appears to be irrelevant.

Exhibit 46 showed that banks were offering interest rates from 4.07 to 5.35 percent on their longest-term certificates of deposit. This was cumulative of the evidence

that the Owner's rate of return was below the rates on T-bonds (5.03 percent) and REITs (9.88 percent).

Exhibit 47 was an excerpt from an appraisal treatise stating that a cap rate is not identical to a rate of return. However, Dr. Baar testified that cap rates are somewhat different from rates of return. Thus, this, too, was cumulative.

Finally, Exhibit 48 was a document submitted by Dr. Baar in connection with a different proceeding. It stated that in 2003-2007, the average cap rate for large mobilehome parks in California was 6.8 percent. It also stated that in 2006, the average price per unit paid for large mobilehome parks in California was \$50,311.

Dr. Baar testified, however, that in 2005-2007, the relevant cap rates were "in a 6 to 8 percent range." He also testified that in 2006, the average price per unit paid for large mobilehome parks in California was \$50,311, and that the price the Owner paid was "in that range." Thus, yet again, this evidence was cumulative.

In arguing prejudice, the Owner does not describe the omitted exhibits and does not attempt to show how considering them could have changed the outcome. Instead, it argues, basically, that Justice Wallin considered the exhibits and the Commission did not; the outcome before Justice Wallin was different than the outcome before the Commission; and therefore the exhibits must have changed the outcome. However, there were other differences between the two proceedings — most notably, the identity of the decision-maker.

Justice Wallin relied on Dr. Fabrikant’s opinion regarding a fair rate of return, which was derived from the rates of return on alternative investments. By contrast, the Commission was convinced that the rates of return on alternative investments (and also cap rates, which, while not identical to rates of return, served an analogous function in this context) were simply irrelevant. The omitted exhibits, to the extent that they were relevant at all, merely showed what the prevailing rates of return and capitalization were. Even if the Commission had considered them, it would have disregarded them. Thus, the failure to consider them was plainly harmless.

VII

THE COMMISSION’S RELIANCE ON

COMMISSIONER MOLDENHAUER’S “PERSONAL FINDINGS”

The Owner contends that it did not receive a fair hearing because the Commission improperly relied on Commissioner Moldenhauer’s personal findings.

A. Additional Factual and Procedural Background.

In February 2009, the Commission held a hearing to review Justice Wallin’s decision. That hearing was continued to April 2, 2009.

On April 2, 2009, before the hearing, Commissioner Moldenhauer sent a letter to an assistant city attorney in which he set forth “[his] own personal findings” He added, “I would like to plainly share them with you, and if appropriate, the rest of the Commission.”

In the letter, he asserted that the Owner's purchase price had presumably been calculated so that the future revenue stream — which consisted of rent, as restricted under the Ordinance, plus appreciation — constituted a fair return. He stated, among other things, "A fair return on a property includes two components: a) land rent, and b) property appreciation. Both components are reflected in the transfer (purchase) price of any real property. For example, an investor may buy land far from any opportunity to enjoy any land rent, but that investor is still satisfied with his total return because of property appreciation alone. Land rent is not required to achieve a 'fair' return." He concluded that "no other adjustment, other than the adjustments provided for under the ordinance[,] are necessary. The ordinance provides for a fair total return"

On April 22, 2009, the Owner objected to any reliance on Commissioner Moldenhauer's letter, because (1) Commissioner Moldenhauer was not qualified as an expert, and (2) Commissioner Moldenhauer had not testified and the Owner had not had an opportunity to cross-examine him.

On April 23, 2009, the Commission issued its decision, which stated, in part, "the Commission hereby adopts Commissioner Moldenhauer's comments as follows" The decision proceeded to set forth much of those comments verbatim.

In the trial court, the Owner argued again that the Commission erred by considering Commissioner Moldenhauer's personal findings, because (1) Commissioner Moldenhauer was not qualified as an expert, and (2) the Owner had not had an opportunity to controvert Commissioner Moldenhauer's opinions.

The trial court ruled: “The record reflects that[] Commissioner Moldenhauer’s ‘comments’ were adopted based upon the evidence. There is no evidence in the record that Commissioner Moldenhauer’s ‘comments’ were used or relied upon as expert opinion evidence by the Commission.”

B. *Analysis.*

The Owner argues yet again that Commissioner Moldenhauer was not qualified as an expert and that it was denied an opportunity “to test, explain or rebut” his conclusions.¹⁶

The Owner relies on *English v. City of Long Beach* (1950) 35 Cal.2d 155, in which a civil service board terminated a police officer based, in part, on evidence taken by individual board members informally, outside the hearing; several board members had talked to the officer’s examining physician, and one board member had consulted his own personal physician. (*Id.* at p. 157.) The court held that the officer was deprived of a fair trial: “Administrative tribunals which are required to make a determination after a hearing cannot act upon their own information, and nothing can be considered as evidence that was not introduced at a hearing of which the parties had notice or at which they were present. [Citations.]” (*Id.* at p. 158.)

As the trial court found, there is no indication that the Commission treated the letter as evidence. Indeed, there is no indication that the other commissioners ever saw

¹⁶ The Owner does not raise any claim under the Brown Act. (Gov. Code, § 54950 et seq.)

the letter. Rather, it appears that city staff received the letter and relied on it in drafting a proposed decision. The other commissioners then voted to adopt the proposed decision.

The views in Commissioner Moldenhauer's letter were not evidence; rather, they were conclusions rationally based on the evidence.¹⁷ Karno, an experienced real estate investor, had testified that the purchaser of a mobilehome park must determine whether to agree to a given purchase price based on the cap rate, which he defined as NOI divided by the purchase price. He admitted that, based on the park's cap rate, the purchase price was fair. He also admitted that, before deciding to purchase the park, he knew it was subject to rent control; he had even read the Ordinance. Finally, Dr. Baar testified that appreciation is one component of a fair rate of return.

The Owner argues that there was no evidence supporting Commissioner Moldenhauer's conclusion that an owner could receive a fair return with no rent at all. This conclusion follows, however, from Dr. Baar's testimony that appreciation is one component of a fair return; thus, provided appreciation is sufficiently high, an owner could conceivably receive a fair rate of return without any rent at all. In any event, in this case, the Commission did not actually reduce rents to zero. Accordingly, the owner cannot show that it was prejudiced by Commissioner Moldenhauer's conclusion on this particular point.

¹⁷ As noted above, the Commission's final decision repeated many of the points that Commissioner Moldenhauer made in his letter. The Owner does not argue, however, that these findings were not supported by substantial evidence.

The Owner also relies on *Whispering Pines Mobile Home Park, Ltd. v. City of Scotts Valley* (1986) 180 Cal.App.3d 152. There, however, a rent control commission rejected the *only* expert testimony before it regarding a fair return and relied instead on its own experience and knowledge. (*Id.* at pp. 158-159.) The court held that “there is no proper evidentiary basis for the Commission’s conclusions on a fair rate of return” (*Id.* at p. 161.) Here, by contrast, Commissioner Moldenhauer’s conclusions, and the adoption of those conclusions in the Commission’s final decision, were supported by the evidence.

VIII

DISPOSITION

The judgment is affirmed. Respondents shall recover costs on appeal against the Owner.

NOT TO BE PUBLISHED IN OFFICIAL REPORTS

RICHLI
Acting P. J.

We concur:

KING
J.

CODRINGTON
J.