Fair Political Practices Commission

Memorandum

To: Chair Ravel, Commissioners Casher, Eskovitz, Wasserman, and Wynne

From: Zackery P. Morazzini, General Counsel
William J. Lenkeit, Senior Commission Counsel

Subject: Discussion of Standards for Determining Material Effect of a Decision on Real Property

Date: June 20, 2013

Summary/Goal

There are significant issues presented in the application of the Political Reform Act's (the "Act's") conflict of interest provisions to real property decisions. Those provisions prohibit a public official from making, participating in making, or using his or her official position to influence a governmental decision if the decision will have a reasonably foreseeable *material* financial effect on that person's interest.

Language needs to be developed to provide a meaningful guide that takes account of the purpose of the law, and implements that purpose without expansion beyond its intended scope. We hope to adequately address all potential situations that reasonably appear to create the possibility of a conflict between a public official's private interest and the public to whom he or she is entrusted to serve. At the same time, we hope to avoid capturing inconsequential or absurd events by our approach. The intent is to develop a more workable system that better serves the purposes of the Act, those bound by it, and those it is meant to protect.

Introduction

Three purposes exist for this regulation. The first and most important is for the public official to be able to determine what is, and what is not, permissible under the Act in performing his or her job duties. The second is for the Legal Division to be able to provide useful guidance and advice to assist these public officials, something that has not been consistently done in this area. Finally, the Enforcement Division must have useful standards and guidelines to enforce against violators.

To fully understand what we are trying to accomplish, it is helpful to begin with a review of the past. This includes both a review of the regulatory history, so we can understand where we are and how and why we got there, as well as a look at the advice letters we have issued over the years in addressing the problem. The advice letters help to provide background for the types of decisions that we are asked to address, as well as a framework for our analysis and a picture of the issues confronting public officials.

Because of the inordinate number of advice letters dealing with real property conflicts since the first regulations emerged and the difficulty of searching letters before they became available on Lexis® we mainly limited review to letters over the past 25 years or so.[1] We also chose, for the most part, to limit our review to letters dealing with "real estate appraisals" because we believe that these letters best exemplify the issues we are faced with.

1988 regulatory changes appear to have provided the impetus for an increase in these types of letters, because of the new measurement/valuation rules instituted at that time and, because the previous rules did not clearly present a standard that could be determined, much less measured. That test increased the use of "real estate appraisals" to meet the challenges posed by the materiality standards it created. This led to the most problematic situations we face today in our conflicts analysis of real property cases.

The final section of this memorandum discusses where we go from here, including possible alternative ways of viewing what constitutes a real property decision, modification or elimination of fixed dollar thresholds, and consideration of more appropriate distance measurements, perhaps based on a flexible scale correlated to the magnitude and type of the decision being considered.

The history of the regulation setting the standard of "material financial effect" on real property begins the discussion. The regulation and its subsequent amendments basically occurred in three distinct periods – the beginning of the Act (from 1976-1985); the mid-term period (mid to late1980s); and the end of the century period (late 1990s to 2000).

Thresholds, Circles, and Bright Lines: The Evolution of the Real Property Materiality Test

Phase One
A Question of Balance

When regulations were initially written to implement the provisions of the Act, one of the more problematic areas concerned what was a "material financial effect" on a financial interest (business entity, source of income, or a real property interest). A difficult question was whether or not value thresholds should be established.

Early consideration of this issue found that the "general consensus was that a material financial effect was something difficult of precise dollar or percentage definition." One comment received in a memorandum from the Attorney General's office suggested that any dollar threshold "contains the negative inference" that it is permissible to dip into the public's pocket book "until such a threshold is reached." (See Staff Memorandum dated April 25, 2013, p. 8.)[2]

In 1976, Regulation 18702, the initial conflict of interest regulation addressing materiality was adopted by the Commission. The regulation took a minimalist approach. The first paragraph, which applied to all financial interests, stated:

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[1] Letters are available on Lexis® from around 1990 forward.
[2] http://www.fppc.ca.gov/agendas/04-13/Memo%2018700.pdf

"(a) The financial effect of a governmental decision on a financial interest of a public official is material if, at the time the official makes, participates in making or attempts to use his or her official position to influence the making of a decision, in light of all the circumstances and facts known at the time of the decision, the official knows or has reason to know that the existence of the financial interest might interfere with the official's performance of his or her duties in an impartial manner free from bias."

This primary rule essentially mirrored language found in many of the common law cases addressing conflicts of interest, but incorporated the "knows or has reason to know" standard used in Section 87100. A second provision expanded that determination, providing a certain balance with the initial language by stating:

"(b) In determining the existence of a material [financial] effect upon a financial interest, consideration should be given, but not be limited to, an analysis of the following factors:

"(A) Whether the effect of the decision will be to increase the income-producing potential of the real property by $100 or five percent per month, whichever is less;

"(B) Whether the effect of the decision will be to increase the fair market value of the real property by $1,000 or more or by .5 percent, whichever is greater."[3]

Finally, the regulation provided:

"The specific dollar or percentage amounts set forth above do not constitute either absolute maximum or minimum levels, *but are merely intended to provide guidance* and should be considered along with other relevant factors in determining whether a financial interest may interfere with the official's exercise of his or her duties in rendering a decision." (Emphasis added.)

The regulation appeared to take a one foot in, one foot out approach with respect to the issues of thresholds.

The first substantive change to this regulation occurred in December 1978. The stated purposes for this change was that the first paragraph "tended to confuse the public" because it contained language relating to foreseeability as well as materiality.[4] The second reason was that the "knows or has reason to know" language "sometimes causes people to think that an official may participate in a decision if, in his own mind, he believes that he will not be biased by the existence of the financial interest." (Staff Memo, 10-27-78, p. 1.) Staff pointed out that this was

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[3] Although factors relating to other financial interests included "increase or decrease," for some reason the factors relating to real property only addressed potential increases.

[4] See Staff Memorandum, dated October 27, 1978, p. 1. (Attachment 1.)

not the intent of the regulation and cited the Commission's opinion in *Sankey Opinion* (2 FPPC Ops. 157), which stated that "disqualification is required if a reasonable person would conclude that the existence of a financial interest might interfere with an official's ability to render an impartial decision."

In attempting to correct these perceived problems, staff's suggested revisions included removing the "foreseeability concepts" from the regulation and applying a more "objective standard similar to the one applied in negligence cases and not one which looks to the state of mind of a particular official." (Staff Memo, 10-27-78, p. 1.)

To do this, staff suggested modifying the language contained in subdivision (a) but keeping this general standard as "necessary to give guidance in those instances in which it is difficult to quantify the effects a decision may have," while at the same time leaning more heavily on the quantified standards by removing the language under subdivision (b) that suggests "the thresholds contained therein are merely a guideline…" (Staff Memo, 10-27-78, p. 2.) The memorandum then explains that the "guideline" language was:

> "… included into the regulation at the time of adoption several years ago because the Commission was uncertain as to how effective and equitable the quantitative guidelines would be in resolving questions of materiality. After several years of application, however, I can report that the guidelines generally have been well received and have produced results which have furthered the purpose of the Act. We have reviewed opinions and advice letters issued during the tenure of the regulation and have found very few instances in which other 'factors' pointed to a result different from that indicated by application of the quantitative standards." (Staff Memo, 10-27-78, p. 2.)

After explaining the proposed changes were needed to overcome certain misconceptions about the application of the quantitative standard, the memorandum explains that:

> "The current regulation does not specify when the general standard of (a) or the quantitative standards of (b) should be applied. *The proposed amendment makes clear that where the effects of a decision are easily quantified, the standards in paragraph (b) must be used*." (Staff Memo, 10-27-78, p. 3, emphasis added.)

Finally, to correct an oversight in the original regulation, the words "or decrease" were added in reference to the financial effect of the decision, "to bring the regulation in conformance with its intent and application." (Staff Memo, 10-27-78, p. 3.) The new proposed language changed the introductory language in subdivision (a) to read:

> "(a) In circumstances where it is not feasible to apply paragraph (b) …, the financial effect of a governmental decision on a financial interest of a public official is material if the decision will have a substantial rather than insignificant effect on the business entity, real property or source of income in question."

The introductory language to subdivision (b) proposed leaving the then-current thresholds in place (excepting the "or decrease" language), but now making their application mandatory by including the language "*will have* a material effect on a financial interest …" (Emphasis added.)

For the first time, the Act now imposed a mandatory fixed determination as to what a material financial effect encompassed. On November 7, 1978, the Commission adopted the new language with one important change. It flipped subdivisions (a) and (b) so that the fixed thresholds took the lead and the general conflict of interest standard faded into the background. Less than six months later, new amendments were proposed. The impetus for this change was to "clarify that the specific dollar and percentage amounts mentioned are merely tools to help one determine if the general standard is met." [5]

To accomplish this, staff proposed moving the general standard back to subdivision (a) and providing as new language, part of the specific standard (which would be flipped back to subdivision (b)), that the thresholds contained therein meet the general standard but "the specific standards may not be applicable because they may not be computable … or … not make sense in terms of the policies and purposes of the Act." (Staff Memo, 04-20-79, p. 1.) Staff further explained that:

> "… these changes reinsert flexibility into the choice of which standard to use and therefore meet the concerns previously expressed by the Commission without returning to the 'bias' standard which was part of the regulation before last November."

The following language was proposed at the May 1979 meeting:

> "(a) The financial effect of a governmental decision on a financial interest of a public official is material if the decision will have a substantial rather than an insignificant effect on the business entity, real property or source of income.
>
> "(b) In applying the general standard set forth in subsection (a), the following effects of a governmental decision are substantial unless application of the subsection would not be feasible or would be unreasonable considering the nature of the decision being made and the financial interest being affected:"

In plain English, the proposal now said an effect was material if it was big and not small and, to determine if it was big, you can use these thresholds unless they do not work.

The dollar thresholds remained unchanged. The Commission requested alterations of the language and apparently directed staff to incorporate these changes and bring the regulation back for adoption.[6] The Commission wanted to strike the words "rather than insignificant," and staff suggested replacing "substantial" with "significant" because the word "establishes a standard which has a greater qualitative element than does the word 'substantial.'" The proposed language

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[5] Staff Memorandum, dated April 20, 1979, p 1. (See Attachment 2).
[6] Staff Memorandum, dated May 24, 1979. (See Attachment 3).

in subdivision (b) was improved, and language was added to make it clear that the thresholds were not mandatory. Finally, the thresholds were slightly modified. Subdivision (b) now read:

> "In determining whether it is reasonably foreseeable that the effects of a governmental decision will be significant within the meaning of the general standard set forth in paragraph (a), *consideration should be given to the following factors*:" (Emphasis added.)

For real property decisions, the factors were an increase or decrease to either:

"(A) The income producing potential of the property by the lesser of

(1) One thousand dollars ($1,000) per month; or

(2) Five percent per month if it is fifty dollars ($50) or more per month; or

"(B) The fair market value of the property by the lesser of

(1) Ten thousand dollars ($10,000); or

(2) One half of one-percent if it is one thousand dollars ($1,000) or more."

This language was adopted by the Commission, becoming effective on August 8, 1979. This language remained substantially in effect for the next nine or so years. At the end of this first period we operated under a materiality standard that said: (1) material means substantial (something we could most likely have determined by opening a dictionary); and (2) to determine that, here are some numbers that you may or may not be able to figure out.

Phase II
The Circle Game: Adoption of the "Donut Rule"

In 1985 the Commission began to look at "revising, restructuring and updating," all of the regulations "defining a 'material financial effect.'"[7] The process went back to the drawing board as Commission staff gathered public input in the process.[8] The revisions being considered for the real property standards were generated, at least in part, because the regulated public was having trouble interpreting, and staff was having problems applying, the percentages used in the then-applicable regulations.[9] The general consensus was that the percentages were too difficult to apply and served no useful purpose.

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[7] See Staff Memorandum, dated July 14, 1988, (Attachment 4).

[8] In 1987, realizing that the "revisions are not expected to occur in the immediate future," the Commission proceeded with deleting the superseded portions of Regulation 18702.

[9] Telephone conversation with Robert E. Leidigh March 21, 2013, former FPPC Commissioner and Legal Division staff attorney who drafted the proposed changes.

The proposed amendment to Regulation 18702.1(a)(3) provided situations where real property was considered "directly involved" in the governmental decision. It explicitly included certain redevelopment decisions where official's property was located in the redevelopment area.

The proposal then created a separate regulation to determine real property materiality, and Regulation 18702.3 was born. The general structure of the new regulation was to divide the rules into two parts. The first rule applied "whenever the official's economic interest is directly involved in the decision." (Staff Memo, 07-14-88, p. 2.) The second rule applied when the interest was "indirectly involved" in decisions. In the first instance, "those circumstances dictate disqualification unless it can be shown that there is *no financial effect* on the official's economic interest which *reasonably could result* from the decision." (*Id*, pp. 2-3.) The second "indirectly involved" portion, was developed to apply to property not actually a part of the decision, but affected by it, e.g., when the property was across the street from property being rezoned. (*Id*, p.3.)

The proposed new regulation was intended to replace the real property materiality standards of Regulation 18702. According to staff's memorandum, "[t]he proposed regulation has been the subject of the greatest amount of discussions between the staff and the League of California Cities' representatives. The resulting product has been carefully worked out to try to provide the maximum amount of guidance in determining when an official may or may not participate in decisions which affect the official's real property." (Staff Memo, 07-14-88, p. 5.)

The resulting language established a three-tiered test based on the radius from the official's property to the nearest portion of the property that was the subject of the governmental decision. It required the drawing of concentric circles at 300 feet and 2,500 feet centered from the nearest point of the property to the official's property to create these tiers. This concentric circles test later became known as the "donut rule." The regulation required disqualification by the official if the official's property was located within a 300-foot radius of any part of the property that was covered by the decision. Disqualification was also required if the official's property received "new or substantially improved services."

While the memorandum states the disqualification was required, the language of the regulation provided "unless the decision will have no financial effect." No financial effect was interpreted to mean "not any effect at all, none, not even a penny." This became known as the one penny rule. The material financial effect for property located within 300 feet of the subject property was now set at one cent, and property located in that zone was treated the same as "directly involved" property.

Next, the circle drawn at 2,500 feet would serve as the outer limit for the middle zone. Financial effects on property between 300 feet and 2,500 feet would be considered material if over a certain chosen fixed-dollar threshold. A range was presented for the Commission to choose.[10] Staff recommended the threshold be set at $10,000 based upon conversations with those knowledgeable in the field that this was the lowest number that an appraiser could normally

[10] The proposed language offered between $2,000 and $15,000. The Commission chose staff's recommended $10,000 threshold.

measure.[11] Finally, the subdivision (b) provided a third tier for property located beyond 2,500 feet. For those properties, the financial effect was not considered material unless:

> "(1) There are specific circumstances regarding the decision, its effect, and the nature of the real property in which the official has an interest, which make it reasonably foreseeable that the fair market value or the rental value of the real property in which the official has an interest will be affected by the amounts set forth in subdivisions (a)(3)(A) or (a)(3)(B);[12]"

Finally, proposed subdivision (d) of the regulation offered factors "which should be considered" in determining possible financial effects on the official's property. These factors, "include, but are not limited to:

> "(1) The proximity of the property which is the subject of the decision and the magnitude of the proposed project of change in use in relationship to the property in which the official has an interest;
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> "(2) Whether it is reasonably foreseeable that the decision will affect the development potential or income producing potential of the property;
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> "(3) In addition …, in the case of residential property, whether it is reasonably foreseeable that the decision will result in a change to the character of the neighborhood including, but not limited to, effects on traffic, view, privacy, intensity of use, noise levels, air emissions, or similar traits of the neighborhood."

The final Statement of Reasons does not discuss how these factors were determined. It did indicate general support for adoption of the entire regulatory package, with the League, the San Jose City Attorney, and the Sunnyvale City Council, among those supporting the changes.[13] It then quoted case law involving the Act: "It is not just actual improprieties which the law seeks to forestall but also the appearance of possible improprieties."[14]

The Commission adopted the proposed language, setting the threshold at $10,000 for property located within the middle zone. It also made one seemingly small change – changing "should" to "shall" in subdivision (d) referring to the factors to be considered in determining a financial effect. As discussed below, this change would become significant in the advice letters that followed concerning the use of real estate appraisals.

The "donut rule" became the standard of application in real property decisions. Generally speaking, if the property was in the donut hole, one could not participate in the decision. If the

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[11] Leidigh telephone conversation of March 21, 2013.

[12] The tests in (a)(3)(A) and (a)(3)(B) were the fair market value and effect on rental value tests applicable to property in the 300-2,500 range. (See Attachment 5).

[13] A copy of the final adopted regulation along with the Statement of Reasons is included as Attachment 6.

[14] *Witt v. Morrow* (1977) 70 Cal.App.3d, 817, 823, a conflict of interest case involving a councilmember voting on land development on a shopping center being purchased by his employer, which was frequently cited in numerous advice letters addressing what is reasonably foreseeable?

property was outside the donut, you could. It was only when property was "on the cake" portion of the donut itself that an analysis of the financial effects was needed.

The initial goal was to provide more detailed and specific standards to apply in determining materiality. For those properties laying either inside or outside the donut, those determinations were clear. But for those properties sitting on the cake of the donut, and there appeared to be more than a few of them, no one could really tell how the test was to be applied.

Phase III
Dueling Appraisers – The Rise of the "One Penny Rule"

By the late 1990s, the Commission began considering implementing a major overhaul of the conflict of interest regulations in order to find some way to make them simpler and easier to understand and apply. The project, which took part in two phases, involved intense review, discussion, and reorganization of those regulations. The resulting product was the eight-step process. The project resulted in greater clarification of many of the factors applied in a conflict of interest determination.

During the second phase of that process,[15] a major focus of discontent concerned the making of the materiality determination required for properties located between 300-2,500 feet of the property at issue in the decision. If there was agreement on anything during this process, it was that the then-current rule was universally despised.

Led by the city attorney from Santa Rosa and backed up by the Enforcement Division, the argument was that, for the property within the "middle zone," the rule was "impossible to apply." The city attorney stated that "no one, including the city attorney," was able to provide guidance on this with any degree of certainty, and that the city was "required" to hire a real property appraiser before allowing the official to vote.[16] He explained that "hiring an appraiser to conduct the middle zone analysis … is expensive, protracted, and ultimately unreliable."[17]

He then added that he later found out that the Enforcement Division was not prosecuting cases in the middle zone and claimed if city attorneys were advising not to vote unless they obtained an appraisal, and Enforcement was not prosecuting unless they got an appraisal to rebut the appraisal, the test was not workable. (Commission Meeting, 02-04-00.) He argued for a "bright-line test" by just keeping the 300 foot rule as the sole standard because few decisions have any affect beyond 300 feet. Enforcement echoed the need for a bright-line test and described any administrative hearing to enforce the middle zone provision as a battle of "dueling appraisers."

Staff's memorandum stated that the regulations do not require an appraisal and past staff advice letters that had suggested appraisals would be helpful "has led over cautious public officials to perceive that appraisals are a *de facto* requirement if their real property economic interest falls in the middle zone." (Staff Memo, 01-24-00, p. 4, emphasis in memorandum.) In an attempt to change this unintended result, staff noted to the Commission:

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[15] The first phase was the reorganization of the regulations into the eight-step process.
[16] Recording of Commission Meeting, February 4, 2000.
[17] Staff Memorandum, dated January 24, 2000, p. 3. (See Attachment 7.)

> "Clearly, this result was *not* what the Commission intended when it passed Regulation 18705.2(b)(1)(C). The intent was to establish a financial benchmark, to which the public official could look while asking, 'is it reasonably foreseeable that the financial effect of this governmental decision will be above or below this benchmark?" It was never intended that the public official be required to reduce the … [effect] to a dollar certain, or even to estimate it's (sic) ultimate effect in dollars – only to estimate whether the ultimate effect was substantially likely (sic) to be over or under the $10,000 line." (Memo 01-24-00, p. 4), emphasis in memorandum.)

In the end, as former Chairman Getman put it, "the one thing that everybody agrees on is that the current system doesn't work," and suggested staff return with a two tiered system. (Commission Meeting, 2-04-00.) The version of the regulation that was adopted later on that year eliminated the "middle zone" (the donut) and expanded the 300 foot circle to 500 feet. Property within 500 feet was now treated as directly involved and the same presumption of materiality was applied for property within 500 feet of the subject property, property that received new and improved services, and property that was the subject of the decision. This test provided that, under these three circumstances, the financial effect "is presumed to be material. The presumption could be rebutted by proof that it is not reasonably foreseeable that the governmental decision will have any financial effect on the real property" – not one penny (See Regulation 18705.2(a).) This created the seemingly impossible task of rebutting a one penny financial effect on real property while establishing what was intended to be a fixed rule.

For property located outside the 500 foot circle, the financial effect was presumed not to be material. The presumption could, however, be rebutted by proof of special circumstances. Referred to as the "special circumstances test," the regulation went on to state:

> "Examples of specific circumstances that will be considered include, but are not limited to, circumstances where the decision affects:
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> "(A) The development potential or income producing potential of the real property in which the official has an economic interest;
>
> "(B) The use of the real property in which the official has an economic interest;
>
> "(C) The character of the neighborhood including, but not limited to, substantial effects on: traffic, view, privacy, intensity of use, noise levels, air emissions, or similar traits of the neighborhood." (Regulation 18705.2(b)(1)(A-C).)"

These circumstances were similar to, but not exactly the same as the circumstances listed in the 1988 version of the amendments to the real property materiality determination. (See page 8, above.) The primary change was that it eliminated the proximity and magnitude test and added a "use of the real property" test.

The new current rule, which was supposed to be a hard and fast, simple to apply rule, has not turned out that way. Under 500 feet, everything has a financial effect. Over 500 feet, nothing

does. This may be an oversimplification, but not by much.[18] The most important factor in most property decisions was eliminated. Two of the three factors do not even apply in most cases, yet staff has provided advice that they are necessary to determine the question. As will be discussed below, the process under the three phases has led from non use, to misuse, to abuse.

Advice Letters: Assisting the Public Official (or not) in Making the Real Property Materiality Determination:

> "Contrariwise, if it was so, it might be; and if it were so, it would be; but as it isn't, it ain't. That's logic."
>
> — Lewis Carroll

> An appraiser's opinion is useful, if it's relevant, and you can rely on it, if it's right. But if it isn't, you can't. That's our advice.
>
> —Staff Advice Letters (see below)

Section 83114 (b) provides for the Commission to also issue advice letters, which are issued by Commission staff and provide a limited immunity. Essentially, they can be used as a complete defense and evidence of good faith in an enforcement proceeding.[19]

The earliest advice letter we found dealing with real property appraisals[20] to determine a material financial effect on real property was the *Toomey* Advice Letter, A-81-137. In this letter, we ignored the basic general rule and went straight to the "consideration" guidelines, advising that two officials who owned apartment buildings could participate in decisions to restricting condominium conversions until the rental vacancy rate reached five-percent, because the city assessor said the decision would have no effect on the value of apartment buildings.

In the only other pre 1988 standards letter we found (*Angelo* Advice Letter, I-87-217), we told an official facing a general plan decision to build nine houses on parcels adjacent to his property, that we could not advise him because we could not determine what the effect would be and it "may be difficult to calculate." We added: "you do not have to hire an appraiser. A city or county tax assessor or a real estate broker probably can provide that type of information."

After the regulatory amendments in 1988 to provide more structured guidance in making the materiality determination, the number of advice letters involving real estate appraisers increased dramatically. The first, the *Phelps* Advice Letter, A-88-429, concerned whether an official, who owned property 285 feet from a house deeded to the city, could participate in a land

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[18] For example, there is no materiality threshold to rebut the presumption of nonmateriality beyond 500 feet, making enforcement of those cases difficult at best.

[19] Only formal advice ("A" letters) grant immunity.

[20] Under the established law, no one can legally prepare a real estate appraisal in a federally related transaction unless he or she is licensed. However, anyone licensed or not, can legally prepare an appraisal if it does not involve a federally related transaction. This includes a person preparing an appraisal for a public official making a determination under our regulations or testifying for that official in an Enforcement action. Our only instruction is that the appraisal must be done by a "qualified real estate professional."

use decision to make the house a museum. We advised the official that he had a conflict of interest *unless* he could establish that the decision would have *no* financial effect on his property. We then stated "[s]hould you or the city obtain a *real estate expert's* opinion that the decisions on the use of the [subject] property *could* have no financial effect on your home, you *would be able* to participate in the decisions regarding those uses. Conversely, determination by a real estate expert that decisions directly affecting the … property *could* have any financial effect on the value of your home would require disqualification." (Emphasis added.[21]) And so began the process of creating (at least the appearance) of the "exception by appraisal rule."

Our next step came with the *Green* Advice Letter, A-90-075. In that letter, we were asked if a planning commissioner who owned a residence "just outside the boundaries of the downtown development plan project area" could participate in certain plan decisions when the decisions "were not interdependent and each could proceed without the other." We advised that "use of an independent appraiser to assess the impact of the development on the fair market value of his residence constitutes a reasonable, good faith effort to make the determination of materiality, *provided that the assessment included consideration of the above factors.*" (*Green*, p. 3, emphasis added.)[22] We added that so long as the official confirmed that these factors were taken into consideration, "he is entitled to rely upon the report's conclusion that the decisions will not … have a material financial effect." (*Ibid.*)

Thus, our journey onto thin ice continued. For the first time, we were telling an appraiser how to do his or her work based upon the mandatory language provided in our regulation. We began making it clear that we would not consider any appraisal unless the appraiser applied the factors listed in our regulation, further advising that the factors in Regulation 18702.3(d) "should be applied by a qualified real property appraiser" to determine whether the pending decisions will have a material financial effect on the official's real property interests." (See *Stone* Advice Letter, No. A-92-133a, *Strauss* Advice Letter, I-92-290. This language, used a number of times in advice letters, led to the mistaken belief that we were requiring appraisals.)

As appraisals continued to come in, it became clear that we did not know how to advise with respect to them, other than to say that they *must* consider the factors listed in our regulations, they must be done by a qualified *professional* able to make the determination, but the official was responsible for making the ultimate call.[23] Appraisals used terms such as "highest and best use analysis," "standard deviations" and "linear regressions," or other elements of appraisal nomenclature with which we are unfamiliar. One stated that the "adjusted r-squared is simply r-squared for *degrees of freedom* according to the formula r^2 (adj.) = 1 – ($1r^2$)(n-1/n-2)." One request asked if it was necessary to get "comparables." It was clear that we wanted no part of getting involved in the appraisal analysis business. We began repeating standard language such as:

> "An appraisal conducted by a disinterested and otherwise qualified real estate professional will be considered a good faith effort to assess the materiality of pending governmental decisions indirectly affecting a public official's property.

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[21] In addition to misapplying the new regulation, the letter misapplied the statute.

[22] At that time: (1) proximity and magnitude, (2) income producing potential and (3) character of the neighborhood.

[23] In some letters, we did make the call, although this seemed almost random.

> However, a decision to participate in the decisionmaking on the basis of an appraisal is permissible under the Act if and only if the official makes the ultimate factual determination that the appraisal is reliable and correct."[24]

The primary reason for the increase in the use of appraisals was the $10,000 threshold. Almost all the letters dealt with property within the 300-2,500 foot range and the $10,000 threshold, although some found that an appraisal could be perhaps the only effective method to rebut the presumption of materiality unless there was "no financial effect."

After the Commission received considerable negative input regarding the perceived need for appraisals to examine the materiality question, it attempted to resolve this problem. The Commission abolished the middle zone test (with its $10,000 measurement) and establish a bright-line rule with an expanded 500 foot zone, within which the presumption of materiality applied unless rebutted by proof that it was not reasonably foreseeable that the decision would have *any financial effect, not even a penny* on the official's real property.

It is not clear whether, at the time of this change, anyone foresaw that appraisals would begin to be used as the only escape key for the one-penny presumption. Staff could only find two letters before the change where appraisals were used related to the 300 foot analysis, both of which we responded to with our non-conclusion conclusion that it was "your call."

One of the major arguments made against the $10,000 threshold was that city attorneys could not afford the time or the money to hire appraisers, who were the only ones who, they believed, could make that determination. They needed a bright line rule so that they did not have to go through that process. So we gave them the 500 feet/one penny rule. The intended result was that an appraiser would no longer be needed to make the call.

Two things have since happened. First, many facing a potential conflict now found the time and the money to hire appraisers when they wanted to get around the one penny rule, and appraisers were making that call, for a time, with very little challenge. Second, staff, not knowing what a one penny effect meant, either proceeded cautiously, advising that every decision concerning a parcel of land had a one penny effect, unless the official could prove otherwise, or advising that an appraisal would provide good faith reliance if the appraiser considered the factors in our regulation, but it was still up to the official to make the determination.[25]

We also were still requiring "our factors" to be considered, even though those factors had been changed and moved into a part of the regulation for consideration as factors rebutting the presumption of non-materiality for property beyond 500 feet. The problem with requiring use of these factors is threefold: (1) we should not be telling an appraiser how to do something we do not know how to do; (2) the factors are not all inclusive, and were specifically never intended to be, yet we were treating them as such and, most importantly; (3) two of the factors almost never apply (income producing potential and use of the property). Most of the questions involve single–family residences, which are not valued based on income producing potential because they

[24] One letter asked if the proper way to do that was to get another appraisal?
[25] Over time this eventually changed. (See summaries attached.) Appraisals have been uncommon lately.

are not income producing property. As for the "use of" test, the use is already established as a single-family residence and it will still be used as a single-family residence after the decision.

So at the same time we were telling an official that he could not vote on a council decision to put covers on bus stops because he lived within 500 feet of a bus stop, we were telling other officials that they could vote on issues such as a development project within 500 feet because an appraiser said, considering our factors, there would be no affect on value.[26] (See *Raggjianti* Advice Letter, A-02-170.) Worse yet, two years ago Enforcement brought an action against an official for voting on a housing development to take place on property immediately next to his. The official brought in an appraiser who testified that there would not even be a one penny financial effect on his property. The Administrative Law Judge accepted this "expert testimony" and threw out the case.

The 500 foot/one penny rule has, in some cases, not been as hard and fast as it was intended and, in other cases, it has been too hard and fast. In any event it does not really do justice to the conflict of interest concept in many circumstances. For these reasons, we recommend that this issue be revisited.

Issues for Consideration

Where to go from here: Part of the problem was addressed with the recent changes to our interpretation of "reasonably foreseeable." That simple change returns us to what the Act says and, instead of immediately thinking about mechanical thresholds, it has us properly considering the standard of what is reasonable as perceived by the ordinary person. As mentioned earlier in a discussion of one of the earliest versions of the regulation, this standard is common in negligence cases.

The first thing we have to do is figure out what we are determining. This sounds pretty basic, yet from the beginning we have not really been able to come up with a workable method to apply the concept of a "reasonably foreseeable material financial effect" to real world real property conflict of interest issues. By comparison, the common law method was pretty easy; a call 'em as you see 'em test on a case by case basis using the path established by cases before you.

Are we looking at perceived conflicts as well as actual conflicts as was addressed in the early regulation, and maintained by Commission Opinions and California case law? Or are we only looking at measurable and quantifiable financial effects, as has also been claimed by some? Are other tangential benefits also to be considered? There are many incidents where there will be no direct measurable effect on the value of a property but there may be some "incidental" affects such as providing more convenient shopping, more restaurants or recreational facilities, or better access to desired areas nearby.

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[26] Most of the time when an appraisal is involved the determination is that the decision "will have no effect on value." An appraiser's conclusion of value does not include pennies, so this is not even addressed. Because we usually dodge the question, this has rarely been pointed out.

Did the Act intend to modify, or clarify, California conflict of interest case law? When the Commission last considered this issue, staff memorandum stated that the $10,000 threshold was not intended as a fixed determination of materiality, but only a useful estimation, and that we were not measuring actual financial effects. The result was a change to the 500 foot/one penny rule.

But one penny is not a financial effect, and we are only kidding ourselves if we think it is. One penny is something given away free at many sales counters, something most will not bend over to pick up off the ground. It will not even buy a gum ball anymore. The only thing a penny is good for it to create illusions, as when you see an item being sold for $39.99 to make you think you are getting it for under $40. But we are not here to create illusions.

Perhaps we should move toward a simple standard that considers if a reasonable person would perceive that the official will see a personal benefit that will conflict with his or her public duties as a result of this decision. While we will perhaps never be able to answer this question with absolute certainty (and we should not be expected to) we should be able to provide better guidelines than what we have now. This effort should be made in keeping with our duty to effectuate the purposes of the Act.

Appraisers: We seem to have a misconception about what an appraiser does. They do not "measure" exact values, so any exact threshold can be problematic. They do not have special instruments, such as a surveyor might use, that only they are trained to use and that measure with a high degree of precision. The appraiser simply provides an opinion of value. This opinion is based upon what the market reflects. The question an appraiser asks is "would a typical buyer pay …?" Under the one penny rule, staff contends a typical buyer would pay one penny to make almost any decision, since a penny has no value and the decision, presumably, does. So anyone can make that determination. But is that really a meaningful determination?

The Act was not intended for real estate appraisals to drive the conflict of interest analysis, or for us to be literally measuring dollar effects. That is not possible. Staff believes we should move toward a standard that asks if a reasonable person would believe the official is conflicted, and develop guidelines that would address the major situations where that would be the case. The whole concept of conflict of interest laws has, for over a hundred years, been based on a reasonable person determination and should continue to be that way. The Act was not intended as a job creation measure for appraisers. "You don't need a weatherman to know which way the wind blows."[27]

What is a Real Property Decision?: We have never really defined what a real property decision is. Currently, anything that happens at a location is a real property decision, including installation of bus stop covers, decisions to upgrade the facilities at city hall, fix pot holes, improve landscaping, or enact a "no dogs on beach" ordinance. But is it really any decision regarding something that happens on real property, or is it something that would at least have some minimal impact on the residents nearby? Therefore, another part of this project should be to look at the question of when something rises to the level of a real property decision under the Act.

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[27] Bob Dyan, *Subterranean Homesick Blues*, from the album *Bringing It All Back Home*, released March 1965.

Magnitude: When it comes to real property decisions, we make no distinction between the peanut and the elephant. While we hold certain truths to be self-evident, one of those is not that all real property decisions are created equal. So why do we treat them that way? It doesn't matter whether the decision involves a basketball arena for the Kings, a Wal-Mart Super Center, a master planned community, or a permit for a parade down Main Street. They are all treated the same. There is probably no way to avoid using certain distance measurements, but they should fit the decision. We should have sizes that fit the magnitude of the decision.

Conclusion: Staff plans to continue to seek public input and have at least one interested persons meeting between now and the time suggested language is presented to the Commission. This memorandum is intended to provide a basis for discussion by the Commission to guide staff's rewriting of the regulations.

Attachments

1. Staff Memorandum dated October 27, 1978
2. Staff Memorandum dated April 20, 1979
3. Staff Memorandum dated May 24, 1979
4. Staff Memorandum dated July 14, 1988
5. Proposed Regulation 18702.3 (1988)
6. Adopted Regulation 18702.3 and Final Statement of Reasons
7. Staff Memorandum, dated January 24, 2000
8. Appraiser Advice Letter Summaries