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Federal Court Considers Ban on "Formula" Businesses

This article examines a pair of cases challenging a zoning ordinance restricting "formula" retail stores and restaurants in Islamorada, Florida, an incorporated village comprised of four islands in the Florida Keys. The U.S. Court of Appeals for the 11th Circuit (the "Court" or the "11th Circuit"; the 11th Circuit covers Florida, Georgia and Alabama) invalidated the portions of the ordinance that restrict development of chain retail stores as an unconstitutional violation of the Dormant Commerce Clause, and remanded the ban on chain restaurants to the lower court for further proceedings under an elevated standard of review.

A. Dormant Commerce Clause. The Dormant Commerce Clause is a legal doctrine inferred from the Commerce Clause contained in Article I, Section 8 of the U.S. Constitution. The Commerce Clause grants to Congress the express power to regulate interstate commerce. Over the years, courts have interpreted this grant of power as evidence of the intent of the drafters of the U.S. Constitution to prevent local legislation that unfairly burdens or discriminates against interstate commerce, such as regulatory measures designed to benefit in-state businesses by burdening out-of-state competitors.

Courts apply two standards of review to determine whether a regulation violates the Dormant Commerce Clause. If a regulation is discriminatory on its face or has the effect of favoring in-state interests, a higher level of scrutiny is applied. Such a regulation will be struck down unless it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives. If a regulation has only indirect effects on interstate commerce, then a lower level of scrutiny is applied. Such a regulation will be upheld if the local interest is legitimate and if the burden on interstate commerce does not exceed the local benefits.

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The 'Greening' of Development (Part 1)

"Green" Legislation. Regardless of where in the country you are located, the sustainable development or "green" movement has either already arrived or is coming soon, and developers, landlords, property managers/operators and tenants alike must all be prepared to keep up with the fast pace of "green" legislation.

According to the U.S. Green Building Council ("USGBC"), buildings account for 72% of the nation's electricity consumption, 39% of the nation's energy use, and 38% of all carbon dioxide (CO_2) emissions. As the threat of global warming is quickly becoming a universally accepted, albeit unwelcome, reality, and more focus is placed on the accelerating scarcity of natural resources (such as water), both local and state governments are enacting legislation aimed at increasing energy efficiency, reducing greenhouse gas emissions, and decreasing other harmful environmental impacts.

California is one of the national leaders in green legislation. The number of cities in California adopting mandatory green building standards more than doubled in the last 18 months – a clear indication that the "green" building phenomenon is quickly becoming less cutting-edge and more mainstream. To date, 28 cities in California have enacted mandatory green building ordinances for certain classes of buildings, and the number is growing steadily. While many of the existing green building standards only regulate construction of governmental buildings, others already affect a larger cross-section of structures, and many of the ordinances currently being enacted will apply to all new construction, as well as major retrofits, as newer and stricter laws are phased in over the next few years. Green building ordinances often include mandatory building standards, as well as financial and other incentives if certain compliance goals are met. For example, the new Green Building Plan passed in the City of Los

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Angeles requires that all new non-residential projects at or above 50,000 square feet of floor area, high-rise residential (above six stories) projects at or above 50,000 square feet, or low-rise residential (six stories or less) of 50 or more dwelling units within buildings of at least 50,000 square feet, meet the intent of the Leader in Energy and Environmental Design® ("LEED®") standard Certified level, and also offers possible financial incentives as well as expedited processing through all city planning/permitting departments if certain LEED® designations are met.

The California state legislature has also worked diligently over the last few years in enacting "green" initiatives and has already become a trendsetter in the "green" building movement. In 2006, Governor Schwarzenegger signed the California Global Warming Solutions Act of 2006 (known as "Assembly Bill 32" or "AB 32"), which requires the state to reduce greenhouse gas emissions by 25% to 1990 levels by 2020 and 80% below 1990 levels by 2050. The California Air Resources Board ("CARB") is spearheading the implementation of AB 32, and has recently prepared a draft "Scoping Plan", which should be implemented by 2012. The Scoping Plan includes the following proposals (among others): (1) targets to ensure a third of the state's energy mix comes from renewable sources, (2) creating a cap-and-trade mechanism modeled on the European Union emissions trading scheme, possibly including six Western states to avoid having carbon intense industries relocate to neighboring states, (3) strengthening regulations on water use and fuel standards, (4) imposing a fee on citizens to fund the administrative costs of moving to a low carbon economy, (5) expanding recycling schemes, (6) encouraging decreased urban sprawl, (7) improving public transport links, and (8) providing an incentive structure to encourage the adoption of home and community renewable generation technologies, as well as further tax breaks for small clean-tech businesses. The passage of AB 32 has spurred several initiatives to promote renewable energy projects, including small-scale renewable generation projects for residential and commercial buildings. In addition, proposed legislation is currently moving through the California legislature, which, if passed, could require every commercial building constructed on or after January 1, 2030 to be a "net zero energy building", meaning that each building would, among other things, be required to generate onsite all of the power that it needs to operate. Also, as part of the implementation of AB 32, California Senate Bill 375 (SB 375) was adopted in 2008 to link transportation planning and land use with statewide goals to reduce vehicular greenhouse gas emissions from cars and light trucks. (Generally, SB 375 directs CARB to develop a comprehensive greenhouse gas emissions reduction plan to reduce the state's greenhouse gas emissions to 1990 levels by 2020 and to develop and implement greenhouse gas reduction regulations.)

California is a national leader in "green" legislation, requiring a reduction to 1990 levels by 2020 (a 25% reduction from current levels).

This past summer, California also became the first state in the nation to pass a statewide "green" building code (the "Green Building Code"), which was adopted by the California Building Standards Commission on July 17, 2008 and will be codified as California Code of Regulations, Title 24, Part 11. The Green Building Code is expected to lead to improved energy efficiency and reduced water consumption in all new construction throughout the state, while also reducing the carbon footprint of every new structure in California. While the Green Building Code provisions will initially be voluntary, it is set to become mandatory for residential construction in 2010 and for commercial construction in 2011. The mandatory requirements relate to planning and design, energy efficiency and air sealing of the building, water efficiency and conservation, materials conservation and resource efficiency, and indoor environmental quality. The Green Building Code applies to the plans and specifications for, and the construction of, all buildings in the state for which applications for building permits are submitted after the Green Building Code is effective, and the Green Building Code includes standards for single family homes, state buildings, health care facilities and commercial buildings. The Green Building Code includes both mandatory and optional requirements; many of the optional requirements concern residential construction and will become mandatory in the 2010 edition of such code. The Green Building Code includes application checklists that, depending on the type of project, must be filled out and submitted to the appropriate state or local agency. Cities and counties may make appropriate adjustments to the Green Building Code which are necessary due to local climatic, geological or topographical conditions.

The interplay between the local and statewide ordinances is currently unclear and it is likely that additional legislation will be needed in order to determine which of these mounting number of ordinances will control. Regardless, it is clear that cities in California will continue to pass increasingly strict green initiatives and ordinances in order to comply with CARB's proposed measures for implementing AB 32, the Green Building Code, and any additional legislation that will undoubtedly be enacted both at the state and federal levels over the coming years. Developers, landlords, property managers/operators and tenants therefore need to be prepared to respond to the various legislative requirements that will likely become mandatory

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and will eventually apply to all new construction and major renovations, as some such laws already do.

Environmental Performance and Design Standards. While there are a number of different standards by which projects are measured in relation to environmental benchmarks/goals, the LEED® standard, developed and originally unveiled by USGBC in 1999, is by far the most widely recognized and commonly accepted. The Green Building Rating System for New Construction (LEED® NC – version 2.0) was first published in 1999. As of February 2008, the USGBC had 91,000 individual members and 14,624 organizational members, and LEED® projects are in progress in all 50 states and in 41 countries. LEED® certification provides independent, third-party verification that a building project meets certain green building and performance measures. To measure a project's performance, LEED® has developed several rating systems with guidelines for different construction markets. Accordingly, LEED® can be applied to all building types, including new construction, commercial interiors, core and shell, existing buildings, homes, neighborhood developments, schools and retail facilities.

The U.S. Green Building Council (which is a private non-profit organization) has a pilot LEED® Retail certification program, which is currently being refined.

The quality and success of a project's environmental design and construction is evaluated by using the applicable LEED® rating system and awarding points in one of six major environmental categories. The level of LEED® certification depends on the number of points achieved. LEED® currently has four rating levels: (a) basic certification (26-32 points), (b) silver (33-38 points), (c) gold (39-51 points), and (d) platinum (52+ points).

For example, the LEED® Retail certification is currently being refined through a pilot program which was launched in April 2007. On November 19, 2008, USGBC announced the opening of the public comment period for its LEED® Retail rating system, both for New Construction and Commercial Interiors projects. The LEED® Retail certification addresses various types of retail spaces, such as grocery stores, big box retailers, restaurants and banks. There are 70 total possible points available for the Retail LEED® certification, which are allocated among the following categories:

- Sustainable Sites – 16 possible points
- Water Efficiency – 5 possible points
- Energy and Atmosphere – 17 possible points
- Materials and Resources – 13 possible points
- Indoor Environmental Quality – 14 possible points
- Innovation and Design Process – 5 possible points

USGBC will soon roll out its newly approved LEED® guidelines, updated for 2009 ("LEED® 2009"), which are intended to carry the organization through 2013. The significant changes incorporated into LEED® 2009 reconsider certain actions based on scientific research in favor of increasing energy efficiency and reducing carbon emissions in new and existing buildings. Among many other changes, LEED® 2009 will include the introduction of "regionalization", meaning that LEED® certification will allow for the creation of schemes that will give more points for measures most beneficial to local environments (for example, similar water protection measures employed by developers, landlords and property managers/operators will earn more points in Phoenix than in Seattle). USGBC will also introduce new processes for amending its LEED® standards and will somewhat revise the actual certification process by introducing a new agency.

Another rating system is the ENERGY STAR® program jointly developed by the U.S. Environmental Protection Agency and the U.S. Department of Energy in order to help consumers save money and protect the environment through energy efficient products and practices. ENERGY STAR® is an energy-benchmarking tool and a flag for the nation's most energy-efficient properties, which targets simpler strategies than LEED®, and ideally works in concert with LEED® goals. For example, ENERGY STAR® promotes the installation of energy efficient windows, shut down of computers at night, and addition of motion sensors to control lighting, all of which can have a significant effect on a building's performance. In fact, buildings that have earned the ENERGY STAR® label use an average of almost 40% less energy than the average building and emit 35% less carbon, and many of those efficiency practices, such as upgrading light bulbs or office equipment, pay for themselves in energy cost savings, often in three to five years. One of the most significant differences between LEED® and ENERGY STAR® is that with LEED® the burden for certification is largely on architects and engineers at the design stage of a project, while ENERGY STAR® looks exclusively at energy consumption in existing assets, and the responsibility therefore shifts to property managers/operators. It is therefore important for developers, landlords and property managers/operators to become generally familiar with LEED® and other environmental rating standards and to continue to be up to speed on the fast paced changes and developments, as much of the legislation today specifically refers to and/or requires that a developer, landlord or property manager/operator either develop a LEED® certified building or at a minimum adhere to certain LEED® certification standards, which includes the implementation

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B. Formula Retail. In the first case, *Island Silver & Spice, Inc., et al. v. Islamorada, et al.* (11th Cir., No. 07-11418, filed September 8, 2008), the 11th Circuit found that the restrictions on formula retail are an unconstitutional violation of the Dormant Commerce Clause.

In 2002, Islamorada enacted a zoning ordinance which limited "formula retail" establishments to 2,000 square feet or 50 feet of frontage. The ordinance defined "formula retail" as retail sales establishments that are contractually required to maintain standardized features across locations, such as uniforms, services, merchandise, trademark, decor, architecture or layout.

When the ordinance was passed, plaintiff Island Silver owned and operated an independent retail store in Islamorada. Six months later, Island Silver entered into a purchase and sale agreement with a buyer seeking to develop a Walgreen's drug store within the same footprint of plaintiff's existing mixed-retail store building. After learning that use as a typical Walgreen's would be prohibited by the Islamorada ordinance, the prospective buyer challenged the formula retail restrictions through the local administrative process. When the buyer did not prevail, it terminated the purchase agreement.

Island Silver then sued Islamorada to invalidate the formula retail restrictions and to recover damages. The District Court granted injunctive and monetary relief in favor of the plaintiff. The District Court also invalidated the formula retail provisions of the zoning ordinance by finding that the provisions violated the Dormant Commerce Clause because they had a discriminatory impact on interstate commerce unsupported by a legitimate state purpose. Islamorada appealed the ruling of the District Court, but the 11th Circuit affirmed the District Court's ruling.

The Court found that while the Islamorada ordinance did not facially discriminate against interstate commerce, the ordinance had the effect of favoring in-state interests. The Court based this determination on stipulations by the parties that the ordinance effectively prevented the establishment of new chain retail stores because premises limited to no more than 2,000 square feet or 50 feet of frontage cannot accommodate the minimum requirements of most nationally and regionally branded retail stores. Since the ordinance would have the practical effect of discriminating against interstate commerce by effectively eliminating any new interstate chain retailers, the Court applied the elevated scrutiny test.

The 11th Circuit affirmed the District Court's holding that Islamorada failed to advance a legitimate local purpose for the ordinance. The ordinance's stated purpose is the preservation of "unique and natural" "small town" community characteristics, encouragement of "small scale uses, water-oriented uses, [and] a nationally significant natural environment", and avoidance of increased "traffic congestion . . . [and] litter, garbage and rubbish offsite".

The Court found that although preserving small town community is a legitimate purpose, Islamorada could not demonstrate "that it has any small town character to preserve", as there are a number of pre-existing formula retail establishments and there is no historic district nor any historic buildings in the vicinity of plaintiff's property. The 11th Circuit also agreed with the District Court's assessment that the ordinance does not effectively serve its stated purpose to preserve Islamorada's small town character, because the ordinance does not restrict formula retail stores smaller than 2,000 square feet or with less than 50 feet of frontage, or large non-chain businesses.

The 11th Circuit also affirmed the finding of the District Court that the ordinance's stated purpose of encouraging small-scale and natural uses is not a legitimate state interest because Islamorada failed to prove that it is "uniquely relaxed or natural", and that there is a "pre-dominance of natural conditions and characteristics over human intrusions". Finally, the 11th Circuit agreed with the District Court's finding that existing regulations could adequately address the ordinance's stated purpose to limit traffic and garbage.

Since the Court determined that the Islamorada ordinance does not provide a legitimate local purpose, the Court did not reach the third prong of the elevated scrutiny test (whether or not Islamorada can show that no adequate, non-discriminatory methods are available). Accordingly, the 11th Circuit struck down the restrictions on chain retail stores as an unconstitutional violation of the Dormant Commerce Clause.

C. Formula Restaurants. In the second case, *Joseph Cachia v. Islamorada* (11th Cir., No. 06-16606, filed September 8, 2008), the 11th Circuit considered the ban on formula restaurants contained within the same Islamorada zoning ordinance. Plaintiff Joseph Cachia entered into a letter of intent to sell his property to a corporation planning to convert the property into a Starbucks coffee shop. When the prospective buyer learned that such use would be prohibited by the Islamorada zoning ordinance, the buyer terminated negotiations.

Cachia sued to, among other things, invalidate the ordinance as a violation of the Dormant Commerce Clause. The District Court found that the prohibition on formula restaurants has only an indirect effect on interstate commerce, because it does not bar all out-of-state restaurants, just those restaurants that operate multiple locations sharing common characteristics such as name, trademark, menu or style. Accordingly, the District Court applied the lower level of scrutiny to the zoning ordinance, and found that the Islamorada ordinance was supported by a legitimate state

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of ENERGY STAR® recommended conservation measures.

Excess construction costs of a newly constructed LEED® certified building are currently estimated at anywhere from 2% to 10%, although some developers, landlords and property managers/operators contend that the costs can be significantly higher, depending on what LEED® certification level is sought to be achieved and/or how many environmental components are incorporated into the project. While green construction undeniably is more costly, the costs of construction and/or compliance are generally at least partially offset by a variety of benefits in the long run, including, among many other things, (i) improvement of indoor air quality for patrons and employees alike in indoor regional malls and buildings, as well as in tenant spaces, which also results in improved workforce health and increased productivity, (ii) public relations value resulting from a company's commitment to minimize the project's environmental impact, (iii) operational cost savings of up to 8% to 9% resulting from greater energy efficiency, as well as additional savings due to reductions in water usage, decreases in stormwater runoff, and cost savings due to other environmental benefits, and (iv) increases in the project's/building's rental and resale value.

These conclusions are based on studies such as the Co-Star Group Study of 1,300 office buildings published in April 2008, which indicated a broader demand by property investors and tenants for buildings that have earned either LEED® certification or the ENERGY STAR® label. The study also found that LEED® buildings command rent premiums of $11.24 per square foot over their non-LEED® peers and have a 3.8% higher occupancy. Similarly, the study found that rental rates in ENERGY STAR® buildings represent a $2.40 per square foot premium over comparable non-ENERGY STAR® buildings and have 3.6% higher occupancy. The study concluded that, for these reasons, ENERGY STAR® buildings are selling for an average of $61 per square foot more than their peers, while LEED® buildings command as much as $171 more per square foot. While more research is needed, the results of this and similar studies are substantiating that green buildings can save significantly on energy costs (typically 25-30%) and command a premium when renting or selling.

{A discussion of 'green' development and leasing and related topics will follow in Part 2 of this article in an upcoming issue of Retail Perspectives – stay tuned.}

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interest (the economic protection of small, locally-owned businesses) and the burden on interstate commerce does not exceed the local benefits. The District Court found that Cachia failed to state a valid claim under the Dormant Commerce Clause because the ban on formula restaurants survives the lower standard of review.

On appeal by Cachia, the 11th Circuit disagreed with the District Court. In particular, the 11th Circuit determined that the ban on formula restaurants has more than an indirect effect on interstate commerce. The 11th Circuit ruled that although the ordinance does not facially discriminate against out-of-state business, the ban on restaurants operating under the same name, trademark, menu or style effectively prohibits interstate restaurants from operating locally. Accordingly, the 11th Circuit held that the elevated scrutiny test should apply and remanded the case back to the District Court for further proceedings under this higher level of review.

D. Relevance to California. While the 11th Circuit's decisions in *Island Silver* and *Cachia* are currently binding only on Florida, Georgia and Alabama, they may have relevance to California, as they involve a similar issue as was addressed in *Wal-Mart Stores Inc. v. City of Turlock*, a California 5th District Court of Appeal case in April 2006 (which was reported on in Retail Perspectives in the fall of 2006) – the power of a municipality to control and organize development in its boundaries as a means of serving the general welfare. In *Wal-Mart*, the court held that a central California town's ban on discount superstores in excess of 100,000 square feet devoting at least 5% of sales floor area to non-taxable items (such as groceries) was a valid exercise of such power because it reasonably implemented a legitimate policy choice of preferring neighborhood shopping centers equally dispersed throughout the city over big-box megastores. The reason these decisions may have relevance to California is that *Wal-Mart* was a state court decision, whereas the 11th Circuit opinions were based on the U.S. Constitution and the Dormant Commerce Clause, which were not at issue in *Wal-Mart*. Wal-Mart had also filed in federal court alleging several constitutional violations, but after the California 5th Circuit's decision, Wal-Mart did not appeal to the California Supreme Court and did not continue with federal case, so it is not clear what might have transpired if Wal-Mart had gone further in federal court, and there is now some authority that could be cited that might support Wal-Mart, or another big box retailer, if such an ordinance were to be challenged again.

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