

# Holland & Knight

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September 10, 2021

*Via email to [Jonathan.Lait@CityofPaloAlto.org](mailto:Jonathan.Lait@CityofPaloAlto.org)*

Jonathan Lait  
Director, Planning and Development  
City of Palo Alto

Re: Potential exposure to litigation regarding the interpretation of Palo Alto Municipal Code section 18.70.070(b)(2)(E) with respect to nonconforming uses at 3200 Park/340 Portage/Olive Avenue for consideration at the City Council meeting on September 13, 2021.

Dear Mr. Lait:

As you know, we represent The Sobrato Organization ("Sobrato") on land use matters related to the 12.5-acre site referred to as 3200 Park/340 Portage/Olive Avenue (the "Property"). We were both surprised and alarmed to read that the staff report issued by the Planning and Development Services on September 2, 2021:

- advises the City Council ("Council") that it can - without any further analysis or a amortization study - interpret Palo Alto Municipal Code ("PAMC") section 18.70.070(b)(2)(E) to require a "rebalancing of nonconforming uses" so long as the Council allows "the property owner to rebalance the nonconforming use ratios within the building as current tenant leases expire."<sup>1</sup>
- concludes, without any formal decision, reasoned response to Sobrato's rebuttal or acknowledgement of the City Council discussion on June 14, 2021, that "staff's conclusion that the Fry's Electronics use has been discontinued in accordance with the municipal code section referenced above and in contrast to the property owner's arguments provided in Attachment D."<sup>2</sup>

Please be advised that these two interpretations expose the City to the risk of litigation to protect Sobrato's substantial Property value, in excess of \$200 Million, that they acquired in 2011 and have substantially improved since acquisition, and which is subject to existing leases. It is very

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<sup>1</sup> City Council Staff Report for the City Council Meeting on 9/13/2021 ("Staff Report"), at Packet Pg. 61.

<sup>2</sup> Staff Report, at Packet Pg. 64.

important to understand that the owner's Property value simply cannot be reasonably protected or recouped with the staff's interpretations (e.g., that the Fry's lease area has been vacated/discontinued coupled with the proposed highly unusual and atypical "re-balancing" requirement). As discussed in more detail below, the "legal risks" are not solved, as presented in the staff report with no reasoned legal analysis or explanation, by simply enforcing at "the termination date of existing leases, including lease options, in order to reduce impacts to operational tenants, to limit vacancies, and to reduce legal risks."<sup>3</sup>

### **Correction Needed to Property Definition.**

As a preliminary matter, the Property is often referred to as the "Fry's Site," which can cause some confusion about the Property and the applicability of PAMC section 18.70.070(b)(2)(E).<sup>4</sup> Footnote 1 of the staff report states "Although there are additional structures on the same lot as 3200 Park Boulevard/340 Portage Avenue/Olive Avenue, staff understands this language to apply only to the specific building (the Cannery) referenced." Based on our review, and as described in the attached Chronology, there is no basis for this conclusion and the Property has always been identified as the full 12.5 acre site identified as "3200 Park/340 Portage/Olive Avenue."<sup>5</sup>

In addition to the Cannery, the Property contains several ancillary buildings that contain legally nonconforming uses, including 3250 Park – 11,762 sf (R&D), 3201 Ash – 4,707 sf (R&D), and 270 Lambert – 1,650 sf (Comcast server / switch room).

### **There Has Been No Discontinuance or Abandonment of Former Fry's Space.**

According to the Staff Report, per PAMC section 18.70.040(b), staff has now apparently concluded that the retail use at the site has been discontinued or abandoned for the past year. In making this conclusion, staff has not followed the City's standard practices, which require staff to issue a formal interpretation pursuant to PAMC section 18.01.025, and which would allow Sobrato to appeal the determination. Notably, the Staff Report also does not ask the City Council to make a decision about this conclusion. Instead, the Staff Report asks the City Council to just accept staff's informal determination, which confuses the legal process. As expressed in Sobrato's May 13, 2021 letter, Sobrato disagrees with the preliminary findings in the City's April 22, 2021 letter, which indicated that "*it appears that PAMC section 18.70.040, subsection (b), may now be relevant.*"<sup>6</sup> This statement was not a formal determination, and was presented as a preliminary conclusion that required further analysis.

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<sup>3</sup> Staff Report, at Packet Pg. 64.

<sup>4</sup> Fry's Electronics occupied approximately 80,000 square feet of the multi-use Cannery building from 1989 to 2019.

<sup>5</sup> The November 13, 1995 Regular City Council Meeting Minutes ("November 13th Minutes") demonstrate that the amendment was to encompass the "property located at 3200 Park Boulevard, 340 Portage Avenue, and the adjacent former railroad right-of-way with Park Boulevard and Olive Avenue frontage" - the entire site. November 13th Minutes, at 77-237.

<sup>6</sup> Staff Report, at Packet Pg. 76 (emphasis added).

This was similarly presented as a preliminary finding at the June 14, 2021 City Council meeting and no formal decision was reached at that time. We also note that the Staff Report states that the interpretation "reflects the Council's initial perspective."<sup>7</sup> It does not reflect anywhere the Council's final perspective or discussion, which was a proposed motion that would "extend by 1 year from now the period of non-occupancy of retail without a violation of the terms of the balance of the commercial use agreement for the greater Fry's site area."<sup>8</sup> The Council voted to end the item and reopen it in August in order to provide staff with time to review the implications of the proposed motion and to confer with Sobrato.<sup>9</sup>

No formal determination letter has been issued on this conclusion, providing no avenue for Sobrato to appeal and exhaust its administrative remedies, and no reasoned response has been provided to Sobrato's detailed objection letter before or since the June 14th City Council meeting. Instead, City staff has decided to seek indirect direction from the City Council that relates directly to the interpretation of PAMC section 18.70.070(b)(2)(E).<sup>10</sup> This process is unsupported and legally inadequate, given the potential impact on the owner's Property value - particularly in the context of the interpretation of the existing legal non-conforming use provision presented in the Staff Report. At minimum, the City must first provide a reasoned, supported final determination and must provide Sobrato an opportunity to respond and appeal.

**City Must Consider The Unusual Implications of Multiple Legal Non-conforming Uses in a Single Building.**

It must also be noted that the Cannery building is a single building with several allowed legally nonconforming uses, which is unusual and the only such building in the City of which we are aware. Typically, nonconforming uses are in single use buildings that are easier to analyze how they are occupied over time. Based on a recent review of all nonconforming use provisions in both San Mateo and Santa Clara Counties, that has been previously shared with the City Attorney's office and is attached hereto for reference with live hyperlinks, there is no similar provision in any city or county code - and not a single one addresses the issue of multiple legally non-conforming uses in a single building and certainly none requires anything close to an on-going "rebalancing" of uses within a building. It should not be simply assumed that the internal space of any building, particularly the Cannery building, can be easily or economically changed to another use - that is just not the case.

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<sup>7</sup> Staff Report, at Packet Pg. 62.

<sup>8</sup> [City Council Meeting - June 14, 2021](#), YouTube (3:22:57).

<sup>9</sup> *Id.*

<sup>10</sup> Staff Report, at Packet Pg. 62.

**"Re-Balancing" Does Not Represent a Plain Meaning Interpretation.**

As stated in the Staff Report, the Property is subject to a site-specific exception to the restrictions requiring termination of non-conforming uses within a set period of time that was adopted in 2006, and has been subject to one formal interpretation that you issued in 2016, which is discussed below.

The site-specific exception provides:

*The nonconforming uses of the property at 3200 Park Boulevard/340 Portage Avenue/Olive Avenue for retail, research and development, warehouse, and storage uses are permitted in approximately the same ratio of uses existing as of October 16, 2006, subject to the following limitations: (1) retail uses shall not exceed 60,000 square feet, and (2) truck deliveries and other noisy outdoor activities shall be limited to the hours of 8:00 a.m. to 9:00 p.m. weekdays and 9:00 a.m. to 9:00 p.m. weekends.<sup>11</sup>*

In 2016, you approved an interpretation of the mix of uses at the site that allowed for a sizable increase in R&D area over the 2006 ratio without any discussion of the need for "re-balancing". Significantly, "some latitude [was] exercised in 2016 for that change."<sup>12</sup>

This new, unnecessarily rigid "plain meaning" reading of the 2006 amendment does not comport with that latitude or the intent of the City Council reflected in the Minutes of the October 16, 2006 City Council Meeting ("October 16th Minutes"). The words "at roughly the same ratio of uses that presently exist as of this date, October 16, 2006" were added, as documented in the Minutes, as an amendment to the pending motion in response to Council Member Beecham's recommendation that "the amortization language reflect that any use other than retail would not diminish the current retail provided."<sup>13</sup> The October 16th Minutes do not include any reference to "rebalancing" the existing uses, but simply state an intent not to reduce the square footage of retail provided. Sobrato, as described in its May 13, 2021 letter, has supported a reasonable interpretation that would not require an ongoing, unpredictable "re-balancing" of uses over time; and one that would allow the area of each legally non-conforming use to be approximately the same as they were - in total square footage - as of 2006 and interpreted as substantially conforming in 2016 for the current leases.

Staff presents the recommended interpretation as a "plain meaning" reading of the code. As the City Council members noted in 2006, and acknowledged at the June 14th hearing, the language of the code includes an error that renders a plain meaning interpretation ultimately infeasible because there is no way to resolve that inherent discrepancy in the code.<sup>14</sup> At the time of adoption, the

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<sup>11</sup> PAMC § 18.70.070(b)(2)(E).

<sup>12</sup> June 14, 2021 Special City Council Meeting, Summary Minutes, at 11.

<sup>13</sup> October 16th Minutes, at 101-66.

<sup>14</sup> See statements by Mr. Lait that "there was in 2006, at the moment the motion was endorsed, an inherent conflict in what was existing in the field and what the motion stated," and Mr. Yang that PAMC section 18.70.070(b)(2)(E) contains "directly conflicting language" and that "there isn't a good way to go about resolving that conflict." [City Council Meeting - June 14, 2021](#), YouTube (2:45:18, 2:46:28).

Fry's lease was 84,000 sf and the plain language of the code limits retail to a maximum of 60,000 sf. The October 16th Minutes indicate that Vice Mayor Kishimoto recognized that there was a discrepancy between the total square footage occupied by Fry's at that time, which was 80,000 sf of retail and warehouse space, and the fact that "the ordinance indicated retail space should not exceed 60,000 square feet."<sup>15</sup> The October 16th Minutes do not demonstrate that it was the intent of that Council that retail uses not exceed 60,000 sf or to require some type of ongoing "re-balancing". If anything, the October 16th Minutes reveal only that the discrepancy was not resolved before the motion passed.

At the June 14, 2021 Special City Council Meeting, Council members looked to the site's legislative history to resolve the discrepancy based on the intent of prior Councils. Review of the legislative history simply does not support the recommended interpretation. Rather, as detailed in the attached chronology, it demonstrates that past City Councils have intended to work with property owners of the site to retain economic value, while the City plans for development of the area and makes it clear this proposed "re-balancing" is novel. Importantly, the 1995 and 2006 City Councils emphasized the imperative to provide property owners with the requisite time to recoup their investment and a mix of incentives to encourage the shifting of the site's uses overtime to the uses included in the City's planning goals.<sup>16</sup>

Instead of following the direction of the Council to meet and confer, the Staff Report simply advances an interpretation that again circumvents the standard practices that the City has applied to the site since 1995, which have allowed for the Property owner to avoid undue hardship as the City plans for development of the area. The Staff Report states - without any explanation as to how and despite clear and regular communication from the Property owner to the contrary - that "[t]his code interpretation provides immediate clarity to the property owner and staff regarding the allowed mix of nonconforming uses in the building," and that "Staff anticipates that the property owner would utilize the information to inform any future proposals for this property or to otherwise determine if the building is currently in conformance with the code."<sup>17</sup> However, the Staff report entirely ignores the significant, very real risk this interpretation causes, and precisely the type of confusion staff states that it seeks to avoid.

As detailed in the attached chronology, Sobrato purchased the property in 2011 and has worked in good faith with the City to develop a plan for the Property and has contributed to and actively participated in the North Ventura Coordinated Area Plan process. In contrast to these good faith efforts, the practical implications of the recommended interpretation will only create further confusion because it is not feasible to rebalance the nonconforming use ratios within the building as current tenant leases expire and also re-tenant the site. As demonstrated through negotiations with possible retail tenants to fill the Fry's space, commercial leases require confirmation and clarity on the length of time and amount of square footage that will be available for use throughout the tenancy. Requiring that the ratio of uses be rebalanced when one lease expires will necessarily

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<sup>15</sup> October 16th Minutes, at 101-65.

<sup>16</sup> See November 13th Minutes; Staff Report (CMR 392:06); October 16th Minutes.

<sup>17</sup> Staff Report, at Packet Pg. 66.

impact all other leases as well as the ability for Sobrato to plan for, invest in, market and lease the space and poses a substantial negative impact on the value of the property.

The October 16th Minutes reveal that the Council's priority was to preserve retail. To this point, in response to Council Member Beecham's recommendation that "the amortization language reflect that any use other than retail would not diminish current retail provided," the motion was amended to add "at roughly the same ratio of uses that presently exist as of this date, October 16, 2006."<sup>18</sup> The square footage of retail presently existing on site in 2006 was 98,339, and was permitted by the City in 2016 to be reduced to 84,000 sf. Nowhere in the October 16th Minutes do Council Members discuss a requirement to rebalance the uses if any of the uses were to terminate. In contrast to the intent of the 2006 City Council to preserve retail at its current amount, and somewhat ironically, staff's recommended interpretation to find the Fry's lease area vacated would effectively require termination of a substantial amount of retail due to staff's position that retail has been discontinued or abandoned.

Importantly, this location and non-traditional "buried" nature of the site is not conducive to retail. The Fry's Electronics store was a large format, regional serving use that drew customers to the Property. As described in the attached chronology, Sobrato has expended significant time and effort to market the former Fry's lease area since long before Fry's lease terminated, including significant efforts with Target. If retail leasing, as anticipated and Sobrato has experienced, is not feasible, the "re-balancing" interpretation results in the owner being unable to lease the remainder of the space at the termination of the existing leases, essentially terminating all existing legal non-conforming uses. Sobrato has invested significantly in the City and the Property, and must be given a reasonable period in which to recoup its Property value, which is valued in excess of \$200 million.

### **Limiting the Use of a Structure without Paying Compensation Requires an Amortization Study.**

From ongoing discussions entered into in good faith by Sobrato with Planning and Development Services, we know you are familiar with the concept of amortization as a means to avoid undue economic hardship to a property owner as well as the limits imposed on the regulation of property by the Takings Clause of the Fifth Amendment of the United States Constitution made applicable to the states through the Fourteenth Amendment and Article 1, section 19 of the California Constitution. The Staff Report presents this as optional, but it is not.

It is important that the City Council is fully aware that an interpretation of PAMC section 18.70.070(b)(2)(E) without a duly prepared amortization study exposes the City to significant legal risk, particularly give the substantial value of the Property that relies on the stable R&D area remaining a legal non-conforming use.

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<sup>18</sup> October 16th Minutes, at 101-65.

The primary value of the Property, as has been openly shared with City staff since the Property was acquired in 2011, is primarily in the existing, currently approximately 142,744 sf, of existing R&D use. To reduce this area by any material amount or to create uncertainty in the amount of leasable area by both declaring the former Fry's lease area vacated with no findings or explanation and exacerbating that by developing a wholly new, highly unusual and unpredictable, on-going "re-balancing" of uses would significantly impact the value of the Property. Since the City has been made aware of this value many times over the years, it is inescapable that this interpretation appears aimed precisely to reduce that value, as stated clearly in the Staff Report, by requiring "a reduction in the R&D floor area."<sup>19</sup> The Staff Report also makes very plain that this "rebalancing" would be ongoing and, therefore, entirely unpredictable: "would require the property owner to maintain a mix of nonconforming uses at 340 Portage (former cannery building) in an approximate ratio relative to each other nonconforming land use as it existed in 2006. As nonconforming uses are abandoned or discontinued, such as Fry's Electronics, the floor area associated with the remaining nonconforming uses must be adjusted to align with the 2006 ratio."<sup>20</sup>

With this on-going, unpredictable "re-balancing" Sobrato simply cannot plan for future leasing and this interpretation will result in an immediate negative impact to the value of the Property, and the City has not completed any economic analysis of this impact (e.g. an amortization study) to support its decision. Property value is created and protected only through certainty to allow long term planning.

Under California law, an ordinance prohibiting an existing use "may be enforced as a constitutionally valid exercise of the state's police power which does not require compensation if a reasonable amortization period for discontinuance of the use is provided." Tahoe Regional Planning Agency v. King ("Tahoe") (1991) 233 Cal.App.3d 1365, 1393. "The principle that 'zoning legislation may validly provide for the eventual termination of nonconforming property uses without compensation if it provides a reasonable amortization period commensurate with the investment involved' is well established." *Id.* at 1395. As the court concluded in City of Los Angeles v. Gage ("Gage"), it is a "logical and reasonable method of approach to place a time limit upon the continuance of existing nonconforming uses, commensurate with the investment involved and based on the nature of the use; and in cases of nonconforming structures, on their character, age, and other relevant factors." (1954) 127 Cal.App.2d 442, 459.

A court will review an amortization provision to determine if it is "unreasonable, arbitrary and discriminatory" as it relates "to its application to the particular property involved." Gage, 127 Cal.App.2d, at 452. "Whether a particular amortization period prescribed by an ordinance mandating the eventual discontinuance of its use is reasonable and commensurate with the investment involved is a factual determination." Tahoe, 233 Cal.App.3d, at 1396 (citing National Advertising Co. v. County of Monterey (1970) 1 Cal.3d 875, 879).

Relevant factors to be considered in determining whether an amortization period is

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<sup>19</sup> Staff Report, at Packet Pgs. 64, 66.

<sup>20</sup> Staff Report, at Packet Pg. 64.

unreasonable as applied to a particular property include amount of investment or original cost, present actual or depreciated value, dates of construction, amortization for tax purposes, salvage value, 'remaining useful life, the length and remaining term of the lease under which it is maintained, and the harm to the public if the structure remains standing beyond the prescribed amortization period.'" *Id.* at 1397.

To avoid a takings claim, the City would need to support not only a new termination date but this "re-balancing" interpretation based on an amortization study that would determine "a reasonable amortization period commensurate with the investment involved." Tahoe, 233 Cal.App.3d at 1395. The need for an amortization study was acknowledged by Mr. Yang at the June 14th hearing.<sup>21</sup> Mr. Yang also recognized that the City cannot rely on the original amortization study that was applied to the Property (which has not been located despite requests to the City for a copy). City staff has acknowledged in the Staff Report that conversion of existing uses within the North Ventura Coordinated Area will require an amortization study.<sup>22</sup> To approve an interpretation of PAMC section 18.70.070(b)(2)(E) without a provision for an amortization study that would provide the City with much needed data upon which to base its decision, is unreasonable and arbitrary and creates substantial legal risk. In the event that the City Council approves the recommended interpretation without amendment, please be advised that Sobrato will exercise its rights under the Takings Clause of the Fifth Amendment of the United States Constitution made applicable to the states through the Fourteenth Amendment and Article 1, section 19 of the California Constitution.

Sincerely yours,

HOLLAND & KNIGHT LLP



Tamsen Plume

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<sup>21</sup> [City Council Meeting - June 14, 2021](#), YouTube (starting at 2:48:16).

<sup>22</sup> "To mandate that office become housing, the City would need to conduct an amortization study and determine the date by which the office use would need to cease. Ceasing office use would not automatically turn the office building into housing; the property owner would need to undertake significant upgrades to the properties in order to convert the existing building to housing or, more likely, demolish the buildings to construct housing. However, this strategy does not provide any funding to support the development of the housing and only provides the required on-site BMR housing as required by the local municipal code." City of Palo Alto, City Council Staff Report, June 14, 2021 Meeting, NVCAP - Review Plan Alternatives, at pdf p. 42.



Enclosures

Attachment A - Chronology

Attachment B - Nonconforming Uses & Structures Chart for Santa Clara County

Attachment C - Nonconforming Uses & Structures Chart for San Mateo County

Cc: Molly Stump, City Attorney, City of Palo Alto  
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