City Left Holding the Trash Bag: Waste Hauler Franchise Fees May Be Challenged as Illegal Taxes

On Thursday, August 11, 2022, the California Supreme Court issued an opinion regarding the applicability of the definition of "tax" in Article XIIIC of the California Constitution, as revised in 2010 by Proposition 26, under franchise agreements. In *Zolly v. City of Oakland*, the Court ruled that the definition of "tax" applies to franchise fees charged to waste and recycling haulers, that the haulers' customers have standing to challenge the franchise fees, and that Oakland had not established, as a matter law, that any of the exceptions from the definition of "tax" applied. Thus, the Court held, the complaint filed by haulers' customers sufficiently *alleged* that the franchise fees are actually unlawful taxes. However, the Court left open the door for the City to prove, based on evidence, that the fees charged under the franchise agreements are exempted from the definition of "tax" under Article XIIIC, including on the ground that the fees are imposed for a specific benefit conferred, e.g., haulers' use of the City's streets, in amounts that do not exceed the reasonable costs to the City for conferring the benefit.

The consequence of this ruling is that similar fees charged by many local governments are at risk of being held unlawful under the Court's reasoning, potentially exposing the local government to writ, refund, damages, or other relief. Accordingly, local governments should evaluate the fees they charge to their waste and recycling hauler franchisees in the context of this ruling and seek to insulate themselves from such challenges in any future franchise agreement.

Background

Beginning with Proposition 13 (adopted in 1978), the California electorate has adopted initiatives that limit local governments' authority to raise revenue, including through taxes or fees. In 1996, the California electorate adopted Proposition 218, which added Articles XIIIC and XIIID to the California Constitution. Article XIIIC is directly relevant here (though Article XIIID is implicated too, as discussed below). It provides that local governments may only impose taxes with express voter approval. However, neither Proposition 13 nor Proposition 218 defined what constitutes a "tax."

In 2010, the California electorate adopted Proposition 26. It added a

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definition of tax to Article XIII. The default is that "any levy, charge, or exaction of any kind imposed by a local government" is a tax, unless one of seven enumerated exemptions apply:

1. A charge imposed for a specific benefit conferred or privilege granted directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of conferring the benefit or granting the privilege.
2. A charge imposed for a specific government service or product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of providing the service or product.
3. A charge imposed for the reasonable regulatory costs to a local government for issuing licenses and permits, performing investigations, inspections, and audits, enforcing agricultural marketing orders, and the administrative enforcement and adjudication thereof.
4. A charge imposed for entrance to or use of local government property, or the purchase, rental, or lease of local government property.
5. A fine, penalty, or other monetary charge imposed by the judicial branch of government or a local government, as a result of a violation of law.
6. A charge imposed as a condition of property development.
7. Assessments and property-related fees imposed in accordance with the provisions of Article XIII D.

(Cal. Const., art. XIIIC, § 1(e).)

Proposition 26 also placed the burden on local governments to prove "by a preponderance of the evidence that a levy, charge, or other exaction is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity." (Cal. Const., art. XIIIC, § 1(e).)

Oakland entered into franchise agreements with waste and recycling haulers. The franchise agreements provided that the haulers would set and impose rates for service, but also required the haulers to pay franchise fees to the City, as consideration for the value of the franchise. The *Zolly* plaintiffs—customers of waste and recycling haulers—filed a complaint alleging that the City of Oakland had

violated Article XIIIC, as revised by Proposition 26, by adopting franchise agreements that mandated that the haulers make franchise fee payments to the City. The superior court sustained the City's demurrer. The plaintiffs pursued appellate review.

Analysis

The Supreme Court (like the Court of Appeal before it) ruled that the City's demurrer was erroneously sustained, and that the plaintiffs must be permitted to proceed with their suit.

First, the City argued that the plaintiffs did not have standing because they were not directly obligated to pay the franchise fees. Instead, any economic injury they suffer comes from the potentially increased rates for service passed on to them by the haulers. The Court rejected this argument. It held that "plaintiffs' allegations of economic injury caused by the challenged fees are sufficient to confer standing to file this suit." However, the Court did not preclude the City from seeking to establish an evidentiary basis for their standing argument, e.g., that the haulers do not in fact pass the fees on to their customers, and thus the customers are not in fact injured.

Second, the City argued that the franchise fees do not, as a matter of law, constitute taxes, reasoning that they are not "imposed by a local government," a requisite trigger to applicability of Article XIIIC, because the franchise fees were instead the product of contractual negotiations with the hauler and were voluntarily agreed to by the hauler in consideration for the franchise rights conveyed by the franchise agreement. The Supreme Court rejected the City's contention.

The Court reasoned that the term "impose," as used in Article XIIIC and other relevant authorities, is not limited to compulsory charges. Rather, the term "impose" more broadly includes the establishment of charges that a third party voluntarily pays, such as in exchange for a government benefit, service, or product, or to use government property, or development fees. Further, "whether customers were directly obligated to pay the charge to Oakland is immaterial. It is sufficient that Oakland, pursuant to its legal authority, enacted these franchise fee agreements into law, thereby imposing these fees," which the plaintiffs fairly alleged they ultimately pay through their payment for services to the haulers. The Court added: "If Oakland is suggesting there is uncertainty as to whether any portion of customers' bills is actually attributable to the fees, that is a factual issue bearing on plaintiffs' allegations of financial injury that cannot be resolved on demurrer."

Third, the Court rejected the City's contentions that the fees are categorially exempt from the definition of tax under section 1(e) of Article XIIIC. The City claimed the exemption in subdivision (1)(e)(4)

applied, as a matter of law, which exempts “charge[s] imposed for entrance to or use of local government property, or the purchase, rental, or lease of local government property.” The Court disagreed.

The Court evaluated whether “local government property,” as the term is used in the exemption, refers more narrowly to tangible or physical property, such as city streets and rights-of-way, or more broadly to encompass intangible property, such as a franchise granted to a hauler for the right to use city streets in connection with the collection of waste and recyclables. The Court ruled that it is the former. While in some contexts property may include contract or other intangible rights, for the purposes of this exemption analysis, “local government property” refers to physical property, such as streets, not intangible property, such as franchise agreements.

Next, the Court evaluated whether the challenged fees are exempt as charges “imposed for … use of local government property.” The Court held that they are not exempt as a matter of law, but left open the door for the City to seek to meet its burden to prove that “the payors paid the challenged fees in exchange for a specific use of government property that they would not have enjoyed had they not paid the fee.” Under the Court’s analysis, this is a narrow opening.

The Court reasoned that the exemption of subdivision (1)(e)(4) applies to fees for use of government property that the user would have greater rights to than the general public, e.g., such as a park entrance fee paid by a park visitor, or a fee paid by a utility provider to install equipment within public roadways, such as conduit for the provision of electrical service. As to whether fees were paid in exchange for rights to use public roadways in connection with the collection and hauling of waste and recyclables, the Court held that the City had not, as a matter of law, established that the exemption applied. Rather, it is the City that bears the burden to prove that “the challenged fees were paid as consideration for a special ‘use of local government property.’ ”

The Court left open whether other exemptions might apply, such as the exemption in subdivision 1(e)(1) for fees “ ‘imposed for a specific benefit conferred or privilege granted directly to the payor that is not provided to those not charged,’ but only if the charge ‘does not exceed the reasonable costs to the local government of conferring the benefit or granting the privilege.’ ” The Court explained that since the City’s ordinance approving the franchise agreements stated the “ ‘franchise property interests conveyed here’ “include the right to ‘transact business, provide services, … and to operate a public utility,’ ” the City might be able to prove that the City conveyed a specific benefit not conveyed to those not charged, as provided in this exemption. However, the Court cautioned that the City would also need to prove the fees do not exceed the reasonable costs to the City,

and that whether the electorate intended those costs to be limited to the administrative costs of granting the franchise, or could be broader, would be deferred to another day.

Accordingly, the Court held that the superior court erroneously sustained the City's demurrer, and that the plaintiffs may proceed with their claims that the franchise fees are unlawfully imposed taxes.

Implications

The Supreme Court has opened the door to litigation, including for suits to invalidate fees and/or to seek refunds with respect to franchise agreements for waste and recycling haulers, while preserving for local governments fact-based arguments that the fees are exempt from the definition of tax in Article XIIIC of the California Constitution.

We see several avenues for defending against such claims, including by seeking to demonstrate that (1) the fees are only imposed on the hauler and not actually passed on to the customers; (2) the fees are paid as consideration in exchange for a right to use physical property that is provided to the hauler and not to the public at large; and (3) the fees are "imposed for a specific benefit conferred or privilege granted directly to the payor that is not provided to those not charged," and do not exceed the reasonable costs for conveyance of the special benefit or privilege.

In addition, while *Zolly* only expressly addresses whether the challenged franchise fees constitute taxes within the meaning of section 1(e) Article XIIIC, the Court's reasoning will inform analysis of similar questions, such as whether other fees included within franchise agreements constitute taxes, or whether such fees could also be challenged, under Article XIIID (added by Proposition 218), as "property-related fees" imposed "as an incident of property ownership," and if so, (1) whether the fees are reasonably related to the costs of providing the property related service and proportionally charged to classes of payors, and (2) adopted pursuant to the property-owner protest or voting procedures set forth in section 6 of Article XIIID.

Conclusion

The *Zolly* decision is an important case with broad implications for franchise agreements and associated fees, including as to tax and property-related fee questions. Our attorneys at Burke—including Kevin D. Siegel and Megan A. Burke, who authored this summary—are well versed with these issues and can help limit or avoid liability, including by reviewing existing franchise agreements, helping to craft future franchise agreements, and handling litigation.

Zolly v. City of Oakland (Aug. 11, 2022, No. S262634) __ Cal.5th __, 2022 WL 3270058.