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Municipal Corporations—Zoning—Good Faith Expenditures in Reliance on Building Permits as a Vested Right in North Carolina

Zoning has long been recognized as a constitutionally valid exercise of a state’s police power; however, the exercise of this power has resulted in considerable controversy in cases in which a zoning ordinance is enacted subsequent to the issuance of a building permit upon which the permittee has relied. In *Town of Hillsborough v. Smith*, the defendants, having acquired an option on a lot, obtained a building permit to construct a dry cleaning establishment. After the permit was issued, the defendants exercised their option, signed a fifteen thousand dollar building contract, and ordered a considerable amount of business equipment. Five days later the town enacted a zoning ordinance restricting for residential use an area which included the defendants’ property. The defendants continued to make expenditures until they received a letter revoking their building permit and were shown a copy of the enacted ordinance. Despite the revocation, they later commenced construction on the lot. When the town sought to enjoin further work, the defendants answered that since they had made good faith expenditures in reliance on the building permit, without notice of the pending ordinance, they had acquired a vested right to complete construction.

Although the trial court found in favor of the defendants, the North Carolina Court of Appeals granted a new trial on the grounds of an erroneous jury instruction. The North Carolina Supreme Court, reversing, affirmed the trial court’s verdict. The court reasoned that all expenses incidental to the construction that were incurred prior to the effective date of the zoning ordinance would create a vested right to complete construction if the expenses were substantial in nature and made

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4 Id. at 50, 170 S.E.2d at 906.
6 The trial court judge framed the issue for the jury as being whether “the defendants, in good faith, and without notice of the pending zoning ordinance prohibiting the use of their property for business purposes, incur[red] substantial expenses in reliance upon the building permit issued to them on May 3, 1968[.]” Id. at 30.
in good faith reliance on the building permit. Despite conflict in the testimony, the jury's verdict was held to be conclusive on the issues of the defendant's good faith and lack of notice of the pending ordinance. The court further held that substantial expenditures had been made and therefore a vested right had accrued in favor of the permittee.

The theory of vested rights accruing from reliance on a building permit is closely related to the doctrine of nonconforming use. A nonconforming use has been defined as "[a] structure or land lawfully occupied by a use that does not conform to the regulations of the district in which it is situated." Such a use existing when a zoning ordinance is enacted that prohibits or restricts that particular use in effect becomes a vested right and, as a general rule, may be continued. This vested right theory has not only been applied to a nonconforming use when construction was incomplete before the passage of the restrictive ordinance, but also to building permits when substantial expenditures have been made in good faith reliance on the permit.

Before resolving the issue of whether a permittee's expenditures are substantial, the court must initially ascertain the elusive element of good faith. Although the majority of jurisdictions insist upon good faith where expenditures are made in reliance upon building permits, apparently there is no definite formula for its measure. A New York case concluded that one method of ascertaining good faith was the large amount of money

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9 Id. at 55, 170 S.E.2d at 909 (1969).
10 Id. at 56, 170 S.E.2d at 912-13.
11 8 McQUILLIN § 25.157.
12 P. GREEN, ZONING IN NORTH CAROLINA 127 (1952). Another authority's definition is "a lawful use existing on the effective date of the zoning restriction and continuing since that time in nonconformance to the ordinance." 2 YOKLEY § 16-2.
13 See 8-A McQUILLIN §§ 25.180-.188.
14 Id. § 25.181. The idea of a vested right arising from expenditures in good faith reliance on a building permit is considered a property right of the sort guaranteed in the Constitution. Willis v. Woodruff, 200 S.C. 266, 20 S.E.2d 699 (1942). Another argument permittees use is the doctrine of equitable estoppel, which forbids a municipality to revoke a building permit after the permittee has made substantial expenditures in reliance on the permit. See, e.g., Township of Pittsfield v. Malcolm, 255 Iowa 761, 124 N.W.2d 166 (1965) (dog kennel had been built under a permit at a cost of forty-five thousand dollars; a delay of ten months before injunction was sought created equitable estoppel). There are many states, however, that do not allow equitable estoppel to apply to a municipality. E.g., City of Gastonia v. Parrish, 271 N.C. 527, 157 S.E.2d 154 (1967). For a more detailed discussion of the applications of equitable estoppel to building permit denials, see 9 McQUILLIN §§ 26.213, 27.56; 1 YOKLEY § 10-8; Note, Revoked Building Permits and Equitable Estoppel in Florida, 15 U. FLA. L. Rev. 418 (1962).
spent by the permittee in reliance on the legality of his permit. Another
New York decision held that surveys and paper work over an eight
month period was sufficient indication of a property owner’s good
faith, even though construction was not commenced until one month
before a zoning ordinance was amended to prohibit the intended use.
On the other hand, where a permittee possessed only an option on a tract
of land, knowledge of open neighborhood hostility and delay in con-
struction resulted in an adjudication of bad faith. Lapse of time between
the date of the permit and the date the ordinance becomes effective is
frequently relevant on the issue of good faith.

In Stowe v. Burke, the North Carolina Supreme Court explicitly
made good faith a requirement for acquiring a vested right where there
is reliance upon a building permit. The evidence showed that the owner
actually knew of the pending ordinance and the hostility of his neighbors
to the proposed use. An expenditure of over fifty-five thousand dollars
on foundation work ten days before the ordinance took effect could not
create a vested right absent good faith. Thus, although amount of money
expended may be an indication of good faith, it is not the sole criteria
and will be rejected if there are other signs that point to bad faith.

Knowledge of hostility was also present in Warner v. W & O, Inc., in
which neighbors filed a petition for rezoning the day after the optionee
obtained a building permit. Although the permit holder knew of the
pending zoning ordinance, he exercised his option on the property and
had several trees removed before the ordinance became effective. On the
question of good faith, the court stated that the law would not help anyone
expending money for a known illegal purpose, nor “one who waits until
after an ordinance has been enacted forbidding the proposed use and . . .

1927) (plaintiff, in reliance on a permit, bought land, hired an architect, executed
a mortgage and excavated the cellar); accord, Glenel Realty Corp. v. Worthington,
18 Miami Shores Village v. Wm. N. Brockway Post, 156 Fla. 673, 24 So. 2d 33
(1945) (en banc); accord, Graham Corp. v. Board of Zoning Appeals, 140 Conn.
1, 97 A.2d 564 (1953) (knowledge of hostility and hurried expenditures before
ordinance enacted evidence of bad faith).
(permit granted one day before lot annexed to city with prohibitive ordinance).
21 Id. at 533, 122 S.E.2d at 378. The findings of fact allowed the trial judge to
conclude as a matter of law that the defendant had acted in bad faith.
hastens to thwart the legislative act by making expenditures a few hours prior to the effective date of the ordinance . . . .”23

It seems unlikely that the permittee in Smith should win in light of the decisions in Stowe and Warner. The cases serve to highlight that proper resolution of the factual controversy is critical to the issue of good faith. Proof that the defendant had notice of the proposed zoning ordinance upon receiving his permit would have precluded the defense of good faith reliance. Had there been no factual dispute, the trial judge could have determined the issue of good faith as a matter of law.24 Ultimately, the jury decided the question as one of fact with no firm guidelines as to what constituted good faith. The court did state that a conscious race with the city to make expenditures before a prohibitive zoning ordinance is adopted shows a lack of good faith.25 However, the court did not explain how this “race” can be recognized, nor did it specifically discuss the relevancy of time as a factor in determining its existence.

Closely associated with the issue of good faith is the element of notice.26 Some jurisdictions limit a permittee’s opportunity to create a vested right by declaring that no right will ensue if the permittee has actual or constructive knowledge of the pending ordinance.27 In North Carolina, if the permittee makes expenditures when he has actual knowledge of a pending ordinance, such action is apparently a sign of bad faith.28 However, the precise effect of constructive notice is unclear. In Stowe, there was evidence that the permittee received written notice of the hearing to be held on the zoning ordinance. In addition, advertisements appeared in the local newspaper, and the hostility of surrounding property owners did not go unconcealed.29 In Warner, the ordinance was adopted

23 Id. at 43, 138 S.E.2d at 787.
25 276 N.C. at 56, 170 S.E.2d at 910.
26 As in Stowe and Warner, the trial judge properly instructed the jury in Smith that expenditures must be made in good faith “without knowledge of the pending ordinance.” Record at 30, 276 N.C. 48, 170 S.E.2d 904 (1969).
27 1 Yokely § 9-7; see, e.g., Sharrow v. City of Dania, 83 So. 2d 274 (Fla. 1955) (permit was subject to revocation despite expenditures in reliance when proposed ordinance had been heard on first reading before adoption by city council); accord, Tuscon v. Arizona Mortuary, 34 Ariz. 495, 272 P. 923 (1928) (no vested right to build when informed before major construction that ordinance affecting land is contemplated). Contra, Yocum v. Power, 398 Pa. 223, 157 A.2d 368 (1960) (unpassed city council ordinance has no governmental authority). See Note, 15 U. Fla. L. Rev. 418, supra note 14.
29 255 N.C. at 533, 122 S.E.2d at 378.
before any construction started, and the permit holder was well aware of neighborhood opposition to the proposed use. In Smith, however, none of these factors was clearly present. The defendant admitted hearing vague talk of a proposed ordinance, but did not believe that it affected him. The town argued that publication of the notice of the hearing imparted constructive knowledge of the pending ordinance; hence, they urged that Smith should not be allowed to account for expenditures made after the date of publication. The court, however, held that all expenditures were valid until the effective date of the ordinance and that a jury verdict of no notice was conclusive. The concept of sufficient notice thus remains confused. The confusion could have been considerably reduced if the court had explicitly stated its views on constructive notice. Arguably, Smith stands for the proposition that newspaper advertisements stating that a public hearing is to be held on a pending zoning ordinance do not impart constructive notice such as will bar a finding of good faith. The court has probably made the better choice here by allowing the jury to hear evidence of constructive notice, without declaring it bad faith as a matter of law.

After resolving the issues of good faith and notice, another problem remains: how does the court determine what constitutes substantial expenditures? Most jurisdictions hold that a building permit alone does not create a vested right but that the landowner must make substantial expenditures or incur substantial obligations in reliance on the building permit. North Carolina followed the majority rule in Warner v. W & O, Inc., 263 N.C. 37, 41, 138 S.E.2d 782, 785 (1964), holding that "the permit created no vested right; it merely authorized permittee to act."

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8 263 N.C. at 41, 138 S.E.2d at 785.
9 276 N.C. at 56, 170 S.E.2d at 910.
10 8 McCULLIN § 25.156; 101 C.J.S. Zoning § 243 (1958); see, e.g., Graham Corp. v. Board of Zoning Appeals, 140 Conn. 1, 97 A.2d 564 (1953); Roselle v. Moonachie, 49 N.J. Super. 35, 139 A.2d 42 (Super. Ct. 1958). Contra, Yocum v. Power, 398 Pa. 223, 157 A.2d 368 (1960) (permit for church issued under existing law could not be revoked because of pending proceedings to prohibit use); Shapiro v. Zoning Board of Adjustment, 377 Pa. 621, 105 A.2d 299 (1954) (issuance of permit allowed right to vest); Hull v. Hunt, 53 Wash. 2d 125, 331 P.2d 856 (1958) (lack of expenditure or change of position did not invalidate permit; right vests on application for permit if thereafter issued). Indeed, one authority suggests that some recent cases show a trend of allowing a right to vest if reliance expenditures are made pending issuance of a building permit. Contra, Spur Distributing Co. v. City of Burlington, 216 N.C. 32, 3 S.E.2d 427 (1939) (permit denied where the ordinance was enacted during consideration of the permit application).
The Town of Hillsborough argued that the test for establishing a substantial expenditure is whether or not actual construction has begun. Rejecting this contention, the court adopted the majority rule as stated by the New Hampshire Supreme Court in *Winn v. Lamoy Realty Corp.*: "the better view . . . is that where an owner, relying in good faith upon a permit and before it has been revoked, has made substantial construction on the property or has incurred substantial liabilities, relating directly thereto . . . the permit may not be cancelled."

In deciding a substantial expenditure question, two factors must be kept in mind—what type of expenditure will be considered, and how much expenditure is substantial. In a case prior to *Smith* in which business equipment was purchased and placed at the site of a proposed service station, the North Carolina Supreme Court admitted this evidence and allowed the jury to determine whether these expenditures were substantial. Apparently, an expenditure of this type was one the court would allow a jury to consider in reaching their verdict. The decision in *Warner* hinged on the absence of the property owner’s good faith, but had language indicating that incidental expenditures as opposed to actual construction, are relevant to the resolution of a vested rights question. The court in *Warner* carefully examined the facts—that an architect’s drawing completed before issuance of the building permit was not contracted for in reliance on it, that a contract to purchase land that was voidable would not create a vested right, and that the removal of several trees before the ordinance took effect was not substantial construction.

Presumably, if the contract had been binding, and the drawings made in reliance, those expenses would have been considered.

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8 McQuillin § 25.157; 9 Id. § 26.219; 1 Yokley § 9-5.

9 Brief for Appellant at 11, 4 N.C. App. 316, 167 S.E.2d 51 (1969). This is the minority rule. See, e.g., Kiges v. City of St. Paul, 240 Minn. 582, 62 N.W.2d 363 (1953).

100 N.H. 280, 281, 124 A.2d 211, 213 (1956) (emphasis added) (no vested rights acquired where expenses and obligations were very small in relation to the total cost of the proposed building). The rule was followed in North Carolina although it was used more to advocate a good faith requirement than to articulate a position on substantial expenditures. See Stowe v. Burke, 255 N.C. 527, 122 S.E.2d 374 (1961).

8 In re Rose Builder’s Supply Co., 202 N.C. 497, 163 S.E. 462 (1932).

263 N.C. at 41-42, 138 S.E.2d at 785.

40 In *In re Tadlock*, 261 N.C. 120, 134 S.E.2d 177 (1964), the court would not allow the plaintiff to enlarge a trailer park, part of which had been completed before an ordinance prohibiting the use was adopted, because the enlargement was still in the planning stage. This case was decided on the basis of a nonconforming use since a building permit had never been issued. Presumably, the same result
Although the North Carolina Supreme Court has noted with approval the majority rule pertaining to substantial expenditures, Smith is apparently the first case to face squarely the issue of what types of expenditures will be considered in creating a vested property right. The court explicitly stated that they found no difference between expenditures resulting in physical changes to the land itself, and expenditures made for construction materials, equipment, or for contracts for construction or equipment. Although the court in Warner held it unnecessary for a permittee to complete construction before the ordinance took effect, in Smith, the court sets forth more complete guidelines for permit holders attempting to acquire a vested right to complete construction on the basis of substantial expenditures. In considering the amount expended and the nature of the obligations incurred, rather than physical change in the land itself, the jury is allowed to arrive at a more equitable determination of whether substantial expenditures have actually occurred.

By holding that binding contractual obligations made in good faith reliance will be considered as substantial expenditures, the court may have created an additional problem in determining what constitutes a binding obligation. In Warner, the contract to purchase property was not considered a valid expense because it was voidable. Smith may make it necessary for a court to make an initial determination of the enforceability of the contracts involved in order to reach the substantial expenditure question.

The court in Smith detailed the types of expenditures that will be

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4 Smith v. Picture, 45 55, 170 S.E.2d at 909.
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allowed as evidence of substantial expenditure; however, the question of what dollar amount is required to make these expenditures substantial was not fully discussed. Although the issue is normally left to the jury, the court indicated that the mere purchase of property, no matter what the cost, will not suffice.\textsuperscript{46} Thus, the jury is left with almost unlimited latitude in determining the dollar amount of expenditure necessary for the creation of a vested right. Perhaps a better solution than leaving so much discretion with the jury would be to establish a certain minimum percentage of the estimated total cost of building as the necessary requirement for a vested right to complete construction. The main disadvantage in establishing a fixed minimum percentage is readily observed when one considers large-scale enterprises. Such undertakings would be required to expend greater sums in order to satisfy the percentage requirement. If they fall short, the right to complete construction is lost. Meanwhile, less expansive enterprises can easily satisfy the requirement with a proportionately smaller expenditure, thus acquiring a vested right to complete construction. A suggested minimum percentage would, however, provide a useful rule-of-thumb in many instances.

Despite some unanswered questions, the area of vested rights is now much clearer in North Carolina. A permittee now knows that money expended on anything incidental to the proposed use—building contracts, equipment, purchase money—will be allowed as evidence of substantial expenditures, a position that prior cases have only intimated. Whether the court must now determine the enforceability of contracts as part of the test of substantial expenditures is unclear. Exactly how much of the total cost of construction must be expended before the vested right accrues is left to the jury’s discretion and will probably change with each set of facts. In any event, it is safe to predict that future permittees will have an easier task in acquiring a vested right.

\textbf{ELIZABETH LYNNE POU}

\textbf{Securities Regulation—Allowance of Attorneys’ Fees in 14(a) Derivative Suits}

With the recognition of an implied private right of action under section 14(a) of the 1934 Securities Exchange Act,\textsuperscript{1} individual shareholders

\textsuperscript{46} 276 N.C. 55, 170 S.E.2d at 909.

\textsuperscript{1} Securities Exchange Act of 1934 §14(a), 15 U.S.C. §78n(a) (1964) [hereinafter cited as 14(a)], provides: