TESTIMONY OF THE STATE ATTORNEY GENERAL
TWENTY-FOURTH LEGISLATURE, 2008

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ON THE FOLLOWING MEASURE:
H.B. NO. 2040, S.D. 1, RELATING TO HAWAII'S ECONOMY.

BEFORE THE:
SENATE COMMITTEE ON WAYS AND MEANS

DATE: Friday, March 28, 2008 **TIME:** 9:30 AM
LOCATION: State Capitol, Room 211
Deliver: by e-mail to senatetestimony@capitol.hawaii.gov

TESTIFIER(S): WRITTEN TESTIMONY ONLY
(For more information, contact Bryan C. Yee, Deputy Attorney General, at 586-1180.)

Chair Baker and Members of the Committee:

The Department of the Attorney General recommends that the effective date of this bill be amended as to certain sections, if the bill is passed.

Parts II, III, IV, V, and VI seek to create a new department of planning and sustainability. Section 14 of the bill creates a management team to, among other things, develop appropriate transition plans, develop an organizational structure, prepare a proposed budget, and draft proposed legislation. The Governor would report to the legislature on these efforts before the regular session of 2010. Section 20 of the bill states that, effective July 1, 2010, every reference to the former departments from which the commission on water resource management, the energy resources coordinator, the Hawaii community development authority, the land use commission, the office of environmental quality control, and the office of planning were transferred shall be construed as a reference to the department of planning and sustainability. In short, the bill appears to contemplate the creation of the new department in 2010.

In S.D. 1, however, the effective date was changed to July 1, 2008. This would result in the creation of the new department before the management team has had an opportunity to perform all of the

administrative work necessary for an efficient transition, and possibly before all appropriate statutory references are amended.

If this bill is passed, we recommend that the effective date be amended as follows:

"This Act shall take effect on July 1, 2010, provided that sections 1, 2, 3, and 14 take effect on July 1, 2008."

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LAND USE RESEARCH
FOUNDATION OF HAWAII
700 Bishop Street, Ste. 1928
Honolulu, Hawaii 96813
Phone 521-4717
Fax 536-0132

March 28, 2008

The Honorable Rosalyn H. Baker, Chair and Members
Senate Committee on Ways and Means
Hawaii State Capitol, Room 211
Honolulu, HI 96813

Subject: HB 2040 SD1 Relating to Hawaii's Economy, Part I
(Lease alterations to favor long-term lessees)

Dear Chair Baker and Committee Members:

My name is Dave Arakawa, and I am the Executive Director of the Land Use Research Foundation of Hawaii (LURF), a private, non-profit research and trade association whose members include major Hawaii landowners, developers and a utility company. One of LURF's missions is to advocate for reasonable and rational land use planning, legislation and regulations affecting common problems in Hawaii.

LURF appreciates the opportunity to provide our testimony **in opposition to Part I of HB 2040, SD1 ("this bill").** LURF is opposed to this bill because it violates the Contracts Clause (Article I, Section 10) of the United States Constitution ("U.S. Constitution"). It is unconstitutional because (1) it alters major terms in existing long-term lease contracts and would substantially impair the contractual relationship of such leases; (2) the proposed bill is not designed to promote a significant and legitimate public purpose; and (3) the proposed law is not a reasonable and narrowly-drawn means of promoting a significant and legitimate public purpose. Moreover, prior legal opinions issued by the State of Hawaii's Department of the Attorney General ("Attorney General") have repeatedly cautioned that analogous legislation, which altered existing contract rights to the detriment of lessors and to the benefit of lessees, would violate the Contracts Clause of the U.S. Constitution. Finally, the bill has a number of unintended consequences, which would be detrimental to Hawaii's economy.

HB 2040, SD1. The original version of HB 2040 sought to authorize an independent study and analysis of Hawaii's economy, including recommendations for public policy changes that will begin to address the cost of living, affordability, and quality of life issues that Hawaii residents face.

However, upon referral to the Senate, the Committees on Economic Development and Taxation and Commerce, Consumer Protection, and Affordable Housing determined that many of the issues the original bill proposed to study are already the subject of studies

and reports produced by both the State and private sector entities. For this reason, the Senate Committees determined that, while well intended, the original bill may not successfully respond to the affordability and quality of life issues that Hawaii residents face. Thus, those Senate Committees amended this bill to address two specific economic issues – in Part I, the fiscal impact of commercial leases on small businesses; and in parts II to VI, the State's long-term sustainability. Specifically, the Senate Committees deleted the original contents of HB 2040 and replaced it with language from HB 1075, H.D.1, designated as Part I, and SB 2555, S.D. 1, designated as Parts II through VI. The amendments to this measure are as follows:

The alleged purpose of Part I of this SD1 bill is "to stabilize Hawaii's economy by lessening the onerous provisions of existing commercial and industrial leases of certain lands within urban districts by correcting inequities in long term commercial and industrial ground leases without substantial reduction in the economic benefit to the owners or impact on their ownership of land, without impairing their lease contracts, and without the taking of any property rights without the due process of law."

SD1 proposes a new section to chapter 519, Hawaii Revised Statutes, on terms and conditions of leases of commercial and industrial property that is situated in the State; zoned by a county for commercial, industrial, or mixed use; subject to a lease with an initial term of more than twenty-five (25) years and an unexpired term of five (5) years or more; and all or a portion of which is a parcel of real property of fifty thousand (50,000) square feet or more that is owned by a lessor;

In fact, however, SD1 alters certain lease conditions in existing long-term leases of commercial and industrial properties and provides a tax benefit for lessors who sell the leasehold interest and all improvements to lessees. The SD1 version would change certain terms of the original lease agreement between parties, mostly to the detriment of the lessor and to the benefit of the lessee by, among other things:

(1) Altering the existing contract rights of lessors to withhold approvals for the assignment, transfer, or encumbrance of leasehold property;
(2) Altering the existing contract terms which would require lessees to make substantial new improvements to infrastructure or structures, by changing the contract requirement to making reasonable maintenance and repair work to satisfy laws, ordinances and code requirements, etc., and adding a new provision that the lessee shall not be required to make substantial new improvements to infrastructure or structures;
(3) Altering the contract terms which require the reversion of any improvements on the leasehold property at the termination of the lease;
(4) Altering the contract terms which provide for the calculations of periodic step-ups in lease rent;
(5) Reinterpreting the term "fair and reasonable annual rent" to mean that "the rent shall be fair and reasonable to both parties and shall take into account the improvements existing on the renegotiation date;" and
(6) Entitles the lessor to exclude from State income taxes, any gain the lessor realizes from the sale of the leasehold interest.

HB 2040 SD1, Part I is unconstitutional and will result in litigation against the State.

- **Part I violates the Contracts Clause of the Hawaii State Constitution.** The Contracts Clause provides that a law is invalid if it "operates as a substantial impairment of a contractual relationship." Passing a law which mandates several changes in major provisions of existing long-term leases will substantially impair those existing leases by regulating an area that was not previously subject to regulation, thereby interfering with the expectations of the parties, and impairing the agreed upon terms of those leases.
    - In the case of Anthony v. Kualoa Ranch, 69 Haw. 112, 736 P.2d 55 (1987), the Hawaii Supreme Court recognized that an impairment of contractual rights in existing leases is unconstitutional. The Court ruled that a statue requiring a lessor to purchase a lessee's improvements at the expiration of the lease term violated the Contracts Clause. The Court also observed that:

        "This statute, as applied to leases already in effect, purely and simply, is an attempt by the legislature to change contractual remedies and obligations, to the detriment of all lessors and to the benefit of all lessees, without relation to the purposes of the leasehold conversion act; without the limitations as to leaseholds subject thereto contained in the conversion provisions; not in the exercise of the eminent domain power; but simply for the purpose of doing equity, as the legislature saw it. If there is any meaning at all to the contract clause, it prohibits the application of HRS §516-70 to leases existing at the time of the 1975 amendment. Accordingly, that section, as applied to leases existing at the time of the adoption of the 1975 amendment, is declared unconstitutional."

  Based on the Anthony case, a court likely would immediately strike down the bill as unconstitutional. It is also likely that a court would hold the State liable for damages as a result of the Bill.

- **Part I is also unconstitutional because it does not promote a significant and legitimate public purpose and it is not narrowly drawn to promote a legitimate public interest.** We believe that the provisions of H.B. No. 1075 H.D. 1 , if challenged in court, would fail to meet the test to determine whether a statue is constitutional under the Contracts Clause, as set out in the more recent Hawaii Supreme Court case of Applications of Herrick & Irish, 82 Haw. 329, 922 P.2d 942 (1996) and quoted by the Attorney General in its prior opinions relating to proposed laws which alter lease terms to benefit lessees:

  > In deciding whether a state law has violated the federal constitutional prohibition against impairments of contracts, U.S. Const., art I, § 10, cl.1, we must assay the following three criteria: 1) whether the state law operated as a substantial impairment of a contractual relationship; 2) whether the state law was designed to promote a significant and legitimate public purpose; and 3) whether the state law was a reasonable and narrowly-drawn means of promoting the significant and legitimate public purpose.

- **Part I also may create an unconstitutional "taking" of private property, under the 5th Amendment of the State and U.S. Constitutions.** Under the 'takings clause,' the government is prohibited from taking or damaging private property

without paying just compensation to the owner. In Richardson v. City and County of Honolulu, 802 F.Supp. 326 (D.Haw. 1992), aff'd, 124 F.3rd 1150 (9th Cir. 1997), cert. denied, 525 U.S. 871 (1998), both the United States District Court for the District of Hawaii and the Ninth Circuit found that the City ordinance imposing a rent control cap on leasehold residences was unconstitutional and that the lessor was entitled to a just and reasonable rate of return on its investment, based on an individualized consideration and an absence of many meaningful review process.

- **State Attorney General opinions have concluded that similar bills to rewrite the terms of commercial and industrial leases were unconstitutional, and other similar and comparable unconstitutional legislation has repeatedly failed.** Over the past several years, legislation has been introduced with the recurring theme of legislatively altering the terms and conditions of existing leases to the benefit of lessees and to the detriment of lessors:
    - In 2007, S.B. No. 1252 and S.B. No. 1619, unsuccessfully proposed virtually identical alterations of existing lease contract to favor the lessee;
    - In 2006, S.B. No. 2043, was also held in committee. It would have imposed a surcharge tax on the value of improvements to real property subject to reversion in a lease of commercial or industrial property;
    - In 2000, S.B. 873 S.D. 1 H.D. 2 also attempted to alter existing lease contract terms to the detriment of lessors and to the benefit of lessees by proposing to alter existing lease terms to require a lessor to purchase a lessee's improvements at the expiration of the lease term. The Department of Attorney General opined that S.B. 873 S.D. 1 H.D. 2 violated the Contracts Clause (Article I, Section 10) of the U.S. Constitution as follows: "S.B. No. 873, as presently worded, will substantially impair existing leases without furthering any apparent public purpose... [It is] unlikely that S.B. 873 will be found to be a 'reasonable and narrowly-drawn means of promoting... [a] significant and legitimate public purpose." Governor Cayetano relied on the Attorney General's opinion, and vetoed S.B. No. 873, S.D. 1, H.D. 1.
    - In 2001, in response to H.B. No. 1131, H.D. 1, yet another bill which proposed to alter existing lease contracts to favor lessees, the Attorney General again reaffirmed its opinion that the proposed bill violated the Contracts Clause of the U.S. Constitution.

It is bad public policy to use legislation to alter the terms and conditions of contracts to favor one party to a contract, or to attempt to address private disputes. The proposed H.B. 1075 H.D. 1 is yet another attempt to infringe on a lessor's ability to enter into and negotiate a lease. Under the law, a lease is a contract between two parties entered into at their own free will; the terms and conditions of the lease are agreed to in their entirety when the lease is executed; the lessee and lessor may seek amendments or modifications to the lease terms and conditions as long as both parties agree; and if there is a dispute, either party may seek resolution through the courts.

Conclusion. The intent and application of H.B. No. 1075 H.D. 1 are unconstitutional, profoundly anti-business and bad public policy, and therefore the bill should be held.

Thank you for the opportunity to express our opposition to H.B. 1075 H.D. 1.