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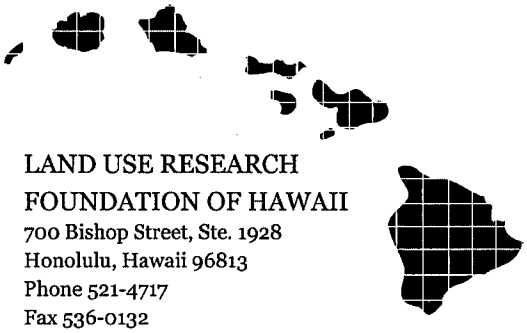

LAND USE RESEARCH
FOUNDATION OF HAWAII
700 Bishop Street, Ste. 1928
Honolulu, Hawaii 96813
Phone 521-4717
Fax 536-0132

Via Capitol Website

March 5, 2009

Senate Committee on Judiciary and Government Operations
Hearing Date: Thursday, March 5, 2009, at 10:15 a.m. in CR 211

Testimony in Opposition to SB 764: Relating to Real Property
(Alteration of provisions in long-term
commercial and industrial ground leases)

Honorable Chair Brian T. Taniguchi, Honorable Vice-Chair Dwight Y. Takamine
and Members of the Judiciary and Government Operations Committee:

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, rational and equitable land use planning, legislation and regulations that encourage well-planned economic growth and development, while safeguarding Hawaii's significant natural and cultural resources and public health and safety.

LURF understands that this measure was proposed by lessees who are having trouble negotiating their leases with one lessor. We and hope that further negotiations, arbitration and mediation can resolve such differences and result in renegotiated leases which can be accepted by both parties. Nonetheless, LURF respectfully **opposes SB 764, SD1,** which:

- changes existing commercial and industrial ground leases by mandating new terms and conditions for the renegotiation of rent with the lessor, and
- changes existing commercial and industrial subleases by giving the master ground lessees the statutory right to automatically pass on any pro rata rent increases to sublessees, if not otherwise specified in the sublease, and denies the subtenants an opportunity to negotiate a fair and reasonable rent with the master lessee.

LURF's objections to SB 764, SD1, can be summarized as follows:

- **"If you put lipstick on a pig, it's still a pig."** SB 764, SD1 is an unconstitutional violation of the Contracts clause of the United States Constitution. You cannot 'fix' an unconstitutional bill by trying to change the 'purpose and intent' section of the bill.

- **"It is not good public policy to pass a state-wide law because of a dispute between one lessor and a few lessees."** How many state-wide lessees are affected? Does a dispute with one lessor warrant a new state-wide law purporting to save Hawaii's economy?
- **"It is unfair and unconstitutional to change the terms of existing contracts to favor one party."** The Attorney General has issued prior opinions finding that such alterations in the terms of existing leases are unconstitutional.
- **"What is good for the goose, should be good for the gander" "You can't have it both ways!"** – Why does the proposed bill provide that negotiations between lessors and lessees must use a new definition of "fair and reasonable annual rent," but at the same time the bill also denies subtenants the opportunity to negotiate a fair and reasonable rent, by mandating that "sublessees shall be charged their pro rata share of the renegotiated lease," of not otherwise specified in the sublease.
- **"No need to legislate, just arbitrate."** Instead of creating a new law that alters existing contracts, the disgruntled lessors should just use the rights and remedies in the contract – arbitration, or inexpensive mediation, which has been offered by the lessor.
- **"Cut the Shibai." "The buck stops here."** Given the legal problems with this bill, we respectfully request that this Judiciary and Government Operations Committee **hold this bill**. The measure is intended to interfere with the ongoing lease negotiations for existing lease contracts with one lessor. The "amended" intent and purpose is a "pretext" (alleged reason, ploy, ruse, red herring, bogus), which states: ".....it is important to support local employers and small businesses in these difficult economic times.....there is a need to alleviate the economic consequences of allowing unfair and unreasonable rent increases for these properties until the local economy improves." As noted above, this bill is meant to affect the lease negotiations with one lessor. If that alleged purpose were true, shouldn't the legislature be trying to help all of the existing business leases in the state? If the alleged purpose is to help lessees "until the local economy improves," where is the sunset date or sunset provisions in the bill?

SB 764, SD1. The changes and key provisions of SB 764, SD1, are described as follows:

- **Amendments by the Committee on Commerce and Consumer Protection (CPN).** The CPN amended this measure to a SD1, by:
  (1) Amending section one to "accurately reflect the purpose and intent of this measure" – in truth, the CPN Committee **"tried to put lipstick on a pig,"** by changing the original unconstitutional purpose and intent to another pretextual purpose and intent which is also unconstitutional;
  (2) Removing the provision relating to the assignment, transfer, or encumbrance of leasehold property;
  (3) Removing the provision limiting the improvements to structures on leasehold property that may be required of lessees; and
  (4) Making technical, nonsubstantive changes for the purpose of clarity and accuracy in the language of this measure.

- **Key provisions of SH 764, SD1: Changes to contract terms of existing leases and existing subleases.** The proposed SB 764, SD1 applies to any

commercial or industrial lease, and would mandate changes favorable to the lessee and detrimental to the lessor and sublessee, with respect to certain terms and conditions of the original lease and sublease agreement between parties, including, among other things:

- Creates new terms and conditions in existing lease contract terms which provide for the calculations of renegotiation of "fair and reasonable annual rent" – - the new law would replace the existing contract terms with a new definitions and legal requirements for determination of lease rent. Requires that all leases existing or entered into on after July 1, 2009, that includes a renegotiation clause that renegotiates rent on a "fair and reasonable annual rent" be construed to mean that a fair and reasonable rent is a requirement and that such a determination take into account the uses, intensity, subsurface and surface characteristics, and neighborhood of the leased site on the renegotiation date; and

- Creates new terms and conditions in existing sublease contract terms, by providing that, unless otherwise specified in the sublease, sublessees shall be charged their pro rata share of the renegotiated lease.

LURF's OBJECTIONS TO SB 764, SD1. We believe that the changes proposed by SB 764, would result in the legislature changing the terms in existing leases and subleases for the clear benefit of lessees and to the detriment of lessors and sublessees. LURF is **opposed to SB 764**, based on the following:

- **"Putting lipstick on a pig."** Any judge or appellate court will review this legislation and ask – "Why did the bill start out with a 'geographic proximity' purpose and intent, then in a SD1, the purpose and intent changes radically to 'economic viability' – while the key lease renegotiation provisions remain identical?"

- **Bill 764 violates the Contracts Clause (Article I, Section 10) of the United States Constitution ("U.S. Constitution").** The proposed bill would change the terms of existing leases, which have already been negotiated and agreed to by the lessor and lessee and would also change the terms and conditions of existing subleases. This bill is a brazen attempt to have the legislature change contractual remedies and obligations, to the detriment of all lessors and subtenants of commercial and industrial properties, and to the benefit of all lessees.

  The Hawaii State Department of the Attorney General (Attorney General) has opined that such legislation, which would change the terms and conditions of existing lease contract terms, is illegal. We believe that if challenged in court, the provisions of this measure, would fail to meet the legal test to determine whether a statute is constitutional under the Contracts Clause, as set forth in the 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 other bills which have attempted to alter existing 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."

This Bill **substantially impairs the contractual relationship** between the lessor and lessee, because it changes the original deal between the lessor and lessee by mandating a new definition for renegotiation of the lease, which is favorable to the lessee and objectionable to the lessor.

The proposed law is **not designed to promote a significant and legitimate public purpose.** First, there is **no significant statewide problem** to be addressed by this measure. The written testimony in support of this measure proves that it is based on **a dispute between one lessor and several lessees.**

Second, there is **no legitimate public purpose**. **The purpose stated in SD1, is a pretext, ploy, ruse and red herring.** It is very important to note that the key provisions in the original SB 764 and the SD1 are identical. However, the "purpose" changes radically - it appears that the CPN Committee attempted to "fix" the purpose and intent language in a SD1, by changing it completely.

- **Old purpose: "Geographic proximity."** The original public purpose of SB 764 was to change lease provisions which were "burdensome" and "so onerous as to force these businesses to relocate to rural areas away from the urban centers...Thus maintaining close geographic ties between small businesses and the communities they serve is a public purpose that requires legislative support."
- **Amended purpose: "Economic viability."** Now, however, to justify the exact same changes in lease renegotiation definitions, the "amended purpose" in SD1 is that "it is in the public interest that its citizens remain employed, that businesses continue to operate and pay wages and taxes, and that financial failures be reduced."

The proposed law is **not a reasonable and narrowly-drawn means of promoting a significant and legitimate public purpose**. The proposed bill is an attempt to resolve a dispute between one lessor and a few lessees in favor of the lessees, based on a state-wide law changing the renegotiation terms of existing leases and also changing and adding new terms of existing subleases, by providing that, unless not allowed under the lease, sublessees shall be automatically charged their pro rata share of the renegotiated lease.

- **Comparable legislation which altered lease terms to the benefit of lessees and to the detriment of lessors has been found to be unconstitutional by the Attorney General.** 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 2008, HB 1075 proposed virtually identical alterations of existing lease contracts to favor the lessee, however, the Senate Economic Development and

Tourism Committee (EDT) held the bill. EDT later placed the contents of HB 1075 into HB 2040, SD2, however that bill was held in Conference Committee.

- In 2007, SB 1252 and SB 1619, proposed virtually identical alterations of existing lease contract to favor the lessee;
- In 2006, SB 2043, 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, SB 873 SD 1, .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 SB 873, SD 1, HD 2 violated the Contracts Clause (Article I, Section 10) of the U.S. Constitution as follows: "SB 873, as presently worded, will substantially impair existing leases without furthering any apparent public purpose... [It is] unlikely that SB 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 SB 873, SD 1, HD 1.
- In 2001, in response to HB 1131, HD 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.
- In 1987, in the Hawaii Supreme Court case of Anthony v. Kualoa Ranch, 69 Haw. 112, 736 P.2d 55 (1987). The Court ruled that a statute requiring a lessor to purchase a lessee's improvements at the expiration of the lease term violated the Contracts Clause. The Court 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."

➢ **It is bad public policy to enact a state-wide law to address a private dispute between one lessor and a group of lessees, and it is also bad policy to change the terms and conditions of existing contracts to favor one party to a contract.** The testimony submitted by proponents proves that SB 764. SD1 is based on complaints of a few lessees against **one lessor**. This situation should not warrant a new state-wide law which changes the terms and conditions of existing leases and subleases of commercial and industrial properties. Prior to approving such legislation, this Committee should investigate the following issues:

- We have been informed by the proponents of this bill, that **the proposed new State law is meant to address the problems of a few lessees with one lessor,** relating to the lease renegotiation clause in their leases;

- Prior to enacting state-wide legislation, it is important to determine **just how many lessees are encountering the alleged problems which have given rise to this state-wide legislation?**
- Prior to enacting state-wide legislation, it is also important to **determine whether the proponents of the bill are small businesses or "master lessees," who hold a master lease and sublease to other businesses?**
- The proposed bill is yet another brazen attempt to favor lessees - it infringes on a lessor's ability to enter into and renegotiate a lease and it creates a new law which would give master lessees the new legal right to automatically pass-on any increase in lease rent to subtenants, unless otherwise specified in the lease.

➢ **"No need to Legislate – just Arbitrate." "It could just take one!"** Instead of pursuing a new state-wide law to change existing lease contracts, the lessees should utilize the Arbitration alternative which is available under their existing lease contracts, or through Mediation offered by the lessor. One major lessee, or a group of similarly situated lessees could share the costs on one arbitration or mediation. If the lessees' definition of "fair and reasonable" annual rent is legally justified and prevails in arbitration or mediation, it would avoid the need for statewide legislation.

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. If there is a dispute regarding the lease terms, usually **either party may seek resolution through arbitration, mediation, or the courts**.

- The proponents of this bill have admitted that the existing leases include an arbitration clause regarding any disputes, which could be used to resolve the existing issue regarding what is a "fair and reasonable" annual rent.
- The lessor who is the purported target of this legislation confirmed that they have resolved other lease renegotiations with most of their lessees, and have offered mediation to other lessees who wish to renegotiate their annual rent;
- The proponents also stated that appraisal experts assisted in drafting the proposed new definition of "fair and reasonable" annual rent, and that their experts were confident that the lessees would prevail in arbitration;
- The proponents cited the costs of mediation or arbitration as a reason they are pursuing statewide legislation, however, **the lessees could all jointly contribute funding toward the first arbitration or mediations, which could set the standard and criteria for all future lease renegotiations**.
- Based on the confidence of the proponents and their experts - it would seem that if the lessees definition of "fair and reasonable" annual rent prevails in the first couple of cases which go to mediation or arbitration, those results would arguably set a precedent for all of the other lease renegotiations - - so no further mediations or arbitrations would be necessary!

CONCLUSION. The intent and application of SB 764, SD1 are unconstitutional, profoundly anti-business and bad public policy, and therefore we respectfully request that **SB 764, SD1 be held in this Committee.**

Thank you for the opportunity to express our **opposition to SB 764, SD1.**