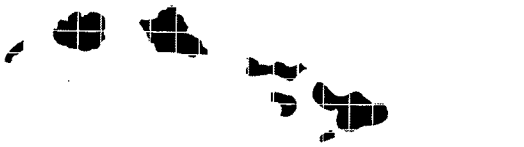

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February 16, 2009

Senate Committee on Commerce and Consumer Protection
Hearing Date: February 17, 2009, at 8:30 AM in CR 229

Testimony in Opposition to SB 770: Relating to Real Property
(Alteration of provisions in long-term
commercial and industrial ground leases)

Honorable Chair Rosalyn H. Baker, Honorable Vice-Chair David Y. Ige
and Commerce and Consumer Protection 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, 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 respectfully opposes **SB 770,** which mandates certain changes in terms and conditions of existing long-term commercial and industrial ground leases; and exempts certain sales of fee interest to lessees from state income tax.

LURF is **opposed** to this bill based on the following:

- **Bill 770 violates the Contracts Clause (Article I, Section 10) of the United States Constitution ("U.S. Constitution").** Bill 770 is unconstitutional based on the following:
    - It alters major terms in existing long-term lease contracts and would substantially impair the contractual relationship of such leases;
    - The bill is not designed to promote a significant and legitimate public purpose;
    - The proposed law is not a reasonable and narrowly-drawn means of promoting a significant and legitimate public purpose; and
    - Prior legal opinions issued by the State of Hawaii's Department of the 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.

- SB 770 is based on **complaints of a few lessees against one lessor. It is bad public policy to enact a state-wide law to address a private dispute between a group of lessees and one lessor, and it is also bad policy to change the terms and conditions of contracts to favor one party to a contract.**
- **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. 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.**

SB 770. The bill is premised on the erroneous premise that inequities exist in the relationship of fee simple owners of commercial and industrial properties (lessors) and the holders of long term leasehold interest in those properties (lessees). The purpose of this bill is to implement changes in the certain terms and conditions governing existing long-term leases of commercial and industrial properties, to the benefit of lessees and to the detriment of lessors; and to provide a tax benefit for lessors who sell the leasehold interest and all improvements to lessees.

The proposed SB 770 applies to any commercial or industrial lease of fifty thousand square feet or more, and would mandate changes favorable to the lessee with respect to certain terms and conditions of the original lease agreement between parties. These changes include, among other things:

- Changes the existing contract rights of lessors to withhold approvals for the assignment, transfer, or encumbrance of leasehold property – - Bill 770 proposes to change the existing lease term to provide that "the approval of the lessor may not be unreasonably withheld;"
- Changes the existing contract terms, responsibilities and obligations of lessees, which requires the lessees to make major and substantial improvements to the leasehold property, or to any infrastructure supporting the leasehold property - - the changes proposed by SB 770 would reduce the existing responsibilities and obligations of the lessee to "only reasonable maintenance and repair work to satisfy federal, state, and county laws, ordinances, and code requirements ensure the public's health, safety and welfare, and the lessee shall not be required to make substantial new improvements to infrastructure or structures," as originally provided in the lease
- Changes the existing contract terms relating to the reversion of any improvements on the leasehold property at the termination of the lease – - the new changes proposed in SB 770 would provide that "the improvements shall be returned subject to reasonable wear and tear that may have resulted from the use of the improvements over the full term of the lease;"
- Changes the existing contract terms which provide for the calculations of periodic step-ups in lease rent – - the new law would replace the existing contract terms with a new requirement for determination of lease rent - that "the increases in lease rent shall be determined, in part, on a determination of the financial feasibility of the rent increase in relation to the current use of the leasehold property;" and

- Adds a state income tax exclusion for certain sales of fee interest to lessee – - "In the event that a lessor determines to sell the leasehold interest and all improvements on the leasehold property to the lessee, the lessor shall be entitled to exclude from gross income, subject to the tax imposed by chapter 235, in the year of the sale, any gain the lessor realizes from the sale."

SB 770 is an unconstitutional impairment of contract under the 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. It is an attempt to have the legislature change contractual remedies and obligations, to the detriment of all lessors and to the benefit of all lessees. The Hawaii State Department of the 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 SB 770, would fail to meet the test to determine whether a statue 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 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."

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 placed the contents of HB 1075 into HB 2040, SD2, however this 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 statue 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 a group of lessees and one lessor, and it is also bad policy to change the terms and conditions of contracts to favor one party to a contract.

- We have been informed by the proponents of this bill, that **the proposed new State law is meant to address the problems of a <u>few lessees</u> with <u>one lessor,</u>** the lease renegotiation clause in its leases, and the lease renegotiations by <u>one lessor</u> with several of its lessees;
- 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 legislation?**
- Prior to enacting state-wide legislation, it is also important to **determine whether the proponents of the bill are small business or "master lessees," who hold a master lease and sublease to other businesses?**
- The proposed SB 770 is yet another attempt to favor lessees and to infringe on a lessor's ability to enter into and negotiate a lease. This situation should not warrant a new state-wide law which changes the terms and conditions of existing contracts.

Instead of pushing a state-wide law, the lessees should utilize the Arbitration alternative under their existing lease contracts or the Mediation offered by the lessor. If the lessees' definition of "fair and reasonable" annual rent prevails, it would avoid the need for <u>statewide legislation</u>. 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 mediation, arbitration, or the courts.

- The proponents of SB 770 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 lease renegotiation with most of their leases, and have offered mediation to other lessees who wish to renegotiate the annual rent;
- The proponents also stated that appraisal experts assisted in drafting the proposed 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 few mediations or arbitrations. 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 SH 770 are unconstitutional, profoundly anti-business and bad public policy, and therefore **SB 770 should be held in this Committee.**

Thank you for the opportunity to express our **opposition to SB 770.**

Based on the above, we respectfully request that SB _____ **be held** in the Senate Committee on _____.

Thank you for the opportunity to express our **opposition** to SB ____.