LATE

McCully Works
40 Kamehameha Ave.
Hilo, Hi. 96720

January 25, 2014

HB1830
Testimony in SUPPORT
Senate Committee on Commerce and Consumer Protection
Chair Rosalyn Baker
Vice Chair Brian Taniguchi

Aloha Chair Baker,

I have been involved in the reform of appraisal and arbitration practices as controlled by HRS466k since 2009. After great effort by lessee's and concerned parties, and with the leadership of both House and Senate members, we have gained some measure of equity in how leasehold arbitrations are conducted. With your passage of Act 227 (2011) and it's incorporation into statute as HRS466k-6 there has been a renewed focus on adhering to the standards established in U.S.P.A.P when appraisers are acting as arbitrators. This benefits all consumers in Hawaii and was a long needed reform. It has only occurred because of the Report of the Award now required by law. *

Unfortunately some lessees have seen an extraordinary increase in arbitrator's fees, in some cases over 100%. Appraisers have stated the reason for this is the additional reporting requirement necessitated by HRS466k-6. From the perspective of the lessee, this is unjustified and only serves to suppress or intimidate lessees from engaging in the arbitration process. The report required by the statutory reform is a type that is similar to those provided in commercial work and is usually produced for less than 1/5 the cost of a single arbitrators proposed fees for a recent arbitration. In addition to the increase some appraiser/arbitrators are requiring confidentiality clauses be added to the parties Submission Agreements (which govern the arbitration).

It is critical to note that ground leases tend to be long-term leases spanning decades. Ownership of the leased lands is concentrated in the hands of a very small, very wealthy, very sophisticated, group. These owners are not financially stressed by the high cost of arbitration, their expert witnesses or legal representation. Lessors posses a high level of sophistication when participating in the arbitration process, which creates a gross imbalance favoring land ownership throughout, rent negotiations and/or arbitration proceedings.

Whereas for Lessees/consumers, the arbitration process presents a serious financial strain and a complex, legalistic maze which usually requires years to navigate. Specific to leasehold tenure (contracts) on commercial, industrial, and resort properties the reality is that absent public access to open and transparent arbitration data land owners can use the high cost and complexity of arbitration, in combination with their monopoly-like

dominance, as a lever to their exclusive advantage. Unlike the US mainland, Lessees and ultimately the consumers in Hawaii, never benefit from public access to transparent market data, real estate cycles or supply/demand dynamics that level the playing field for all parties. This leads to greater costs to consumers and inefficiencies in our local economy. The bill before you would strengthen 466k-6, ensuring accountability and transparency as the Legislature intended.

This reform should provide further protection for the consumers in Hawaii. Please support HB1830 HD2

Mahalo,

«GreetingLine»

*It should be noted that with a single exception the four Reports of Awards that have been reviewed by my attorney do NOT, in their opinion, meet the standards as required by HRS466k-6. The language of the statute requires "Findings of Fact" and the "appraisers rationale". This constitutes the highest standard required for reporting of any arbitration award [Cat Charter, LLC v. Schurtenberger] Eleventh U.S. Circuit Court of Appeals July 13, 2011 Part II, B (page 12-13)

LATE

HB1830
Submitted on: 3/13/2014
Testimony for CPN on Mar 14, 2014 09:00AM in Conference Room 229

Submitted By	Organization	Testifier Position	Present at Hearing
David S. De Luz, Jr.	David S. De Luz, Sr., Enterprises, Inc.	Support	No

Comments: Aloha Chair Baker: I and our organization, STRONLY SUPPORT HB 1823 HD2 we are currently in 1 DLNR and 1 DHHL lease renegotiations. Currently the DLNR lease is in arbitration. The current statue in place has prolonged the time and caused uncertainty and hardship on us, NOT to mention undue expense, BOTH on the part of us and DLNR. HB 1823 will allow for a more streamlined and more equitable process, saving ALL of us both time and money. We would greatly appreciate your serious consideration supporting this bill and thank you for allowing us the opportunity to submit testimony on this EXTEMELY important issue. David S. De Luz, Jr. David S. De Luz, Sr. Enterprises, Inc. 811 Kanoelehua Avenue Hilo, HI 96720 808-895-4284 djr@teamdeluz.com

Please note that testimony submitted less than 24 hours prior to the hearing, improperly identified, or directed to the incorrect office, may not be posted online or distributed to the committee prior to the convening of the public hearing.

Do not reply to this email. This inbox is not monitored. For assistance please email webmaster@capitol.hawaii.gov

LATE

JAMES W. Y. WONG

HONOLULU OFFICE
3737 Manoa Road
Honolulu, Hawaii 96822
Phone: (808) 946-2966
FAX: (808) 943-3140

ANCHORAGE OFFICE
411 West 4th Avenue, Ste 200
Anchorage, Alaska 99501
Phone: (907) 278-3263
FAX: (907) 222-4852

March 12, 2014

VIA FACSCIMILE
586-6071

Honorable Senator Rosalyn H. Baker, Chair
Honorable Senator Brian T. Taniguchi, Vice Chair
Members of the Senate Committee on Commerce and Consumer Protection

RE: TESTIMONY IN SUPPORT OF HB1830 HD2 – RELATING TO REAL ESTATE APPRAISERS. HEARING SCHEDULED FOR FRIDAY, MARCH 14, 2014, AT 9:00 A.M., CONFERENCE ROOM 229

Dear Honorable Chair Rosalyn Baker, Vice Chair Brian Taniguchi, and members of the Senate Committee on Commerce and Consumer Protection:

My name is James W. Y. Wong and I strongly support HB1830 HD2. If this measure is passed, it will require the recordation of arbitration awards and all of the documents that support the arbitration panel's decision will help open the mystery of how rents are set and provide information to consumers so we can all make better, more informed decisions.

Lessors are very familiar with the arbitration process and practically all Lessees in Hawaii have a clause "if rental or fair market value cannot be agreed by both Lessor and Lessee to resolve the issue, an arbitration clause is enforced". Since all appraisers have access to these arbitrations, they have the data more accessible than us as Lessees which puts the Lessees at a disadvantage.

HB1830 HD2 will allow consumers, like me, to obtain arbitration data so we can better understand the market and make informed decisions.

Please pass HB1830 HD2.

Aloha,

James W. Y. Wong

LATE

KAPOLEI MEDICAL PARK

3737 Manoa Road • Honolulu Hawaii 96822
Telephone (808) 946-2966 • FAX: (808) 943-3140

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Please pass HB1830 HD2.

Aloha,

James W. Y. Wong

LATE

WAIAKAMILO SHOPPING CENTER

3737 Manoa Road • Honolulu Hawaii 96822
Telephone (808) 946-2966 • FAX: (808) 943-3140

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Please pass HB1830 HD2.

Aloha,

James W. Y. Wong

LATE

Waialae Plaza

3737 Manoa Road • Honolulu Hawaii 96822
Telephone (808) 946-2966 • FAX: (808) 943-3140

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HB1830 HD2 will allow consumers, like me, to obtain arbitration data so we can better understand the market and make informed decisions.

Please pass HB1830 HD2.

Aloha,

James W. Y. Wong

LATE

LAND USE RESEARCH
FOUNDATION OF HAWAII
1100 Alakea Street, Suite 408
Honolulu, Hawaii 96813
(808) 521-4717
www.lurf.org

March 13, 2014

Rosalyn H. Baker, Chair
Senator Brian T. Taniguchi, Vice Chair
and Members of the Senate Committee on Commerce and Consumer Protection

Opposition to HB 1830, HD2 Relating to Real Estate Appraisers. (Requires real estate appraisers, acting as arbitrators, to record arbitration awards, the record of an award, and any supplementary, dissenting, or explanatory opinions with the Bureau of Conveyances. Specifies that information recorded is a public record. Effective 7/1/2112.)

Friday, March 14, 2014 at 9:00 a.m. in Conference Room 229

The Land Use Research Foundation of Hawaii (LURF) is a private, non-profit research and trade association whose members include major Hawaii landowners, developers and a utility company. LURF's mission 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 appreciates the opportunity to express its **strong OPPOSITION to HB 1830, HD2,** based on, among other things, the following:

- **HB 1830, HD 1, requires confidential information in lease arbitration awards be publicly recorded and declares that such confidential information is a public record. Thus, this measure alters and violates the confidentiality clauses of existing lease contracts, and therefore violates the Contracts Clause of the United States Constitution.** (*See, HRPT Properties Trust v. Lingle*, 715 F.Supp.2d 1115 [D. Hawaii 2010]; also 2012 LRB Report, Findings 2, 3 and 4; and Recommendation , pp. 18-19)

- **There is no factual justification for this measure, as the latest LRB Report concluded that there was "*no indication of a broad-based compelling need for legislation altering existing lease agreements, which would be required to pass constitutional muster.*" and this measure includes numerous factual inaccuracies.** (See, 2003 Legislative Reference Bureau Report No. 5, *"Real Property Leases,"* by Eric Maehara, Research Attorney, and 2012 LRB Report, Finding #5, p. 19).

- **This bill is premature, the Legislature should fund, and await the completion of the Legislative Reference Bureau ("LRB") Report required by SCR 90, SD1 (2012).** (See SCR 90, SD1 (2012) and the *2013 LRB Report required by SCR 90, SD1 (2012)*, Executive Summary, p. vii and Recommendation, p. 20)

- **HB 1830, HD2, should also be referred to the Department of the Attorney General for a legal opinion regarding whether it violates the U.S. Constitution; and should also be referred to the Senate Committees on Judiciary and Labor (JDL) and Ways and Means (WAM).** This bill should be reviewed by the Attorney General, the Senate JDL and WAM, due to the legal issues regarding alteration of existing lease contracts, and the impact on the State lease programs administered by the Department of Land and Natural Resources and other state departments and the State budget.

- **The bill violates the spirit and intent of the USPAP Ethics rule relating to confidentiality.**

HB 1830, HD2. This measure applies to existing private lease contracts with confidentiality clauses. Many existing leases in Hawaii provide for confidentiality of the terms relating to leases, lease rents and arbitration awards to determine lease rents. This bill alters the terms of the confidentiality clauses in many existing commercial and industrial leases, and violates the contracts clause of the U.S. Constitution, as follows:

- **Violates the terms of existing private leases with confidentiality clauses**, by requiring real estate appraisers, acting as arbitrators, to record arbitration awards, the record of an award, and any supplementary, dissenting, or explanatory opinions with the bureau of conveyances (for those existing private leases with confidentiality clauses), within ninety days of the notification of the determination of the award to the parties;

- **Nullifies the confidentiality clauses of existing lease contracts and the obligations of the lessors and lessees,** by providing that: *"No agreement between the parties or the appraisers acting as arbitrators shall preclude or deny the requirement to record an award, the record of an award, or any supplementary, dissenting, or explanatory opinions as required by this section."*

- **Unfairly forces real estate appraisers to choose between being a defendant in possible lawsuits to preserve the confidentiality clauses in existing lease contracts, or the revocation or suspension of their licenses or certifications,** by providing that violation of the recording requirements in this measure constitutes a violation for purposes of licensing or certification as a real estate appraiser.

- Further **violates the terms of existing private leases with confidentiality clauses,** by specifying that the information recorded (related to any private leases with confidentiality clauses) is a public record.

- The proposed effective date of this measure is July 1, 2112.

LURF **OPPOSES HB 1830, HD2,** based upon the following:

- **This measure alters and violates the confidentiality clauses of existing lease contracts, and therefore violates the Contracts Clause of the United States Constitution.** The Legislature should not inject itself into existing private leases, by changing the confidentiality clauses of leases, which are very important contract terms which were mutually agreed to by the parties.

  With respect to prior Hawaii legislation that altered the terms of existing contracts, the U.S. District Court, District of Hawaii ("Court") recently ruled that Act 189 (SLH 2009) ("Act 189") violated the Contracts Clause of the U.S. Constitution. Although Act 189 involved a different law, the Court ruled that the law impaired the contractual relationship between the parties; and that Act 189 did not *"reasonably or justifiably further the legitimate purpose of stabilizing Hawaii's economy."* (See, *HRPT Properties Trust v. Lingle*, 715 F.Supp.2d 1115 [D. Hawaii 2010]) While inapplicable to this bill, the Court also held that Act 189 unfairly targeting one lessor, HRPT, and thus also violated the Equal Protection Clause of the U.S. Constitution.

  LURF believes that a court would find this measure unconstitutional, based on, among other things, the following:

  - **Violates terms of existing lease contracts.** Under the law, confidentiality provisions in leases, especially relating to lease renegotiations, are important mutually bargained-for terms of lease contracts. HB 1830, HD1, would violate such existing contract terms, by requiring publicizing such information. A court would likely rule that this measure, clearly "impairs the contractual relationship and expectations of lessors"; and

  - **There is "no factual basis to reasonably or justifiably further the legitimate purpose of stabilizing Hawaii's economy."** The latest State study regarding commercial and industrial lease rents – the 2003 Legislative reference Bureau Report No. 5, *"Real Property Leases,"* by Eric Maehara, Research Attorney (*"2003 LRB Report on Legislation Regarding Real Property Leases"*) does not support the allegations in this measure, in fact, just the opposite.

    Furthermore, in 2012, the Legislature passed SCR 90, SD1 (2012) *"Requesting the Legislative Reference Bureau to Update Their 2003 Report Analyzing the Major Problems Faced by Commercial Lessees by Incorporating an Economic Analysis to Determine if There is a Nexus Between the Existence of High Lease Rents in Hawaii and the Stagnation of Hawaii's Economy."* In 2013, the Legislative Reference Bureau ("LRB") prepared the *LRB Report required by SCR 90, SD1 ("2013 LRB Report required by SCR 90, SD1")* and in that report, the LRB recommended that the Senate and the House fund such an economic analysis during the 2013 session.

> This measure totally ignores the findings of the *2003 LRB Report on Legislation Regarding Real Property Leases* and the also ignores the recommendations of the *2013 LRB Report required by SCR 90, SD1.*

LURF believes that a court would find that there are no facts and economic analysis to justify passage of HB 1830, HD1, based on the total lack of credible factual basis or economic analysis to support this measure, and given the Legislature's own SCR 90, SD1 (2012) and the *2013 LRB Report required by SCR 90, SD1*, which urges an economic analysis relating to the exact issue that is the basis of this measure.

- **There is no factual justification for this bill.** The bill includes numerous undocumented assertions and factual inaccuracies which are inconsistent with the latest *2003 LRB Report on Legislation Regarding Real Property Leases*, which concluded that *"...there was no indication of a broad-based compelling need for legislation altering existing lease agreements, which would be required to pass constitutional muster."*

  The *2003 LRB Report on Legislation Regarding Real Property Leases* did not find any problems with the lease arbitration and appraisal process, and concluded that industrial and commercial lease rents in Hawaii are a result of the supply and demand: *"Instead, the Bureau found that the primary problem facing lessees was the lack of available fee simple commercial and industrial property on the market."* (*See, 2003 LRB Report on Legislation Regarding Real Property Leases*, and 2013 LRB Report, Finding #5, p. 19)

- **HB 1830, HD2 is premature, the Legislature should fund, and await the completion of the LRB Report required by SCR 90, SD1 (2012) *"Requesting the Legislative Reference Bureau to Update Their 2003 Report Analyzing the Major Problems Faced by Commercial Lessees by Incorporating an Economic Analysis to Determine if There is a Nexus Between the Existence of High Lease Rents in Hawaii and the Stagnation of Hawaii's Economy."***

  In 2012, both the Senate and the House passed the attached SCR 90, SD1 (2012), which requested that the LRB update their 2003 Report analyzing the major problems faced by commercial lessees by incorporating an economic analysis to determine if there is a nexus between the Existence of High Lease rents in Hawaii and the stagnation of Hawaii's economy. SCR 90, SD1 (2012), also required LRB to submit a final report of the economic analysis, including any proposed legislation, to the Legislature no later than twenty days prior to the convening of the Regular Session of 2013.

  The *2013 LRB Report required by SCR 90, SD1*, which was submitted to the Legislature for the 2013 session, stated that it could not complete such an economic analysis, but recommended that the *"Chairs of the appropriate subject matter committees in the House and Senate consult with UHERO to draft legislation that ensures a workable approach, including a sufficient timetable and funding."*

  Instead of passing this measure, the Legislature should provide for funding for an economic analysis to determine whether there is actually a strong a nexus between lease rents and the stagnation of Hawaii's economy, which could establish a legal basis to change the terms of existing lease contracts.

- **This measure violates the spirit and intent of the USPAP Ethics rule relating to confidentiality.** Act 227, Session Laws of Hawaii 2011, requires appraisers in arbitration proceedings to certify compliance with the most current Uniform Standards of Professional Appraisal Practice ("USPAP"). USPAP includes and Ethics Rule which requires an appraiser to protect the confidential nature of the appraiser-client relationship.

  Major ethical conflicts will arise whenever lease contracts which are subject to an appraisal and arbitration proceedings include confidentiality clauses. While there may be local exceptions to this USPAP Ethics Rule – this measure violates the spirit and intent of the USPAP Ethics Rule. We do not believe that the legislature should claim a local exception, and pass a bill that violates the spirit and intent of the USPAP Ethics Rules relating to confidentiality.

Conclusion. For all of the reasons set forth above, LURF believes that the intent and application of HB 1830, HD2, is not factually justified, is premature, violates the confidentiality terms of existing lease contracts, would result in an unconstitutional violation of the Contracts Clause of the U.S. Constitution and should therefore **be held in this Committee.**

Thank you for the opportunity to express our **strong opposition to HB 1830, HD2.**

THE SENATE
TWENTY-SIXTH LEGISLATURE, 2012
STATE OF HAWAII

S.C.R. NO. 90 S.D. 1

SENATE CONCURRENT RESOLUTION

REQUESTING THE LEGISLATIVE REFERENCE BUREAU TO UPDATE THEIR 2003 REPORT ANALYZING THE MAJOR PROBLEMS FACED BY COMMERCIAL LESSEES BY INCORPORATING AN ECONOMIC ANALYSIS TO DETERMINE IF THERE IS A NEXUS BETWEEN THE EXISTENCE OF HIGH LEASE RENTS IN HAWAII AND THE STAGNATION OF HAWAII'S ECONOMY.

WHEREAS, commercial properties in the State remain in the hands of a few large landowners who maintain a system of leasehold tenure and continue to establish long-term leases; and

WHEREAS, in 2003 the Legislature requested the Legislative Reference Bureau to study the major problems facing commercial lessees; and

WHEREAS, the Legislative Reference Bureau's report contained feedback from lessees and lessors, and also reviewed information from real estate analysts, real property tax data, an economic report prepared by SMS, and information from the Department of Business, Economic Development, and Tourism; and

WHEREAS, one of the concluding observations noted in the report was that the feedback for the report indicated there was a lack of available fee simple commercial property on the market; and

WHEREAS, the report also observed that the primary problem lessees in the State face tended to stem from supply and demand; and

WHEREAS, there has been an increase in the outlying areas on Oahu of fee simple, zoned properties since the 2003 report, thus allowing for a comparative analysis of market behaviors through changing economic conditions; and

WHEREAS, ground rents have been previously identified as a major expense to business and have continued to increase at rates that may inhibit robust economic growth; and

WHEREAS, the State's need for economic revitalization would be furthered by a healthy leasehold system in which the risks assumed by the respective parties of the lease, the benefits created by the development, and activities established on the leasehold property are equitably reflected in the setting of the ground rents under the terms of the lease; and

WHEREAS, potential legislation that mandates the alteration of existing lease agreements must meet certain criteria, including whether the legislation was designed to promote a significant and legitimate public purpose; and

WHEREAS, the Legislature finds that sustained economic growth of the State's economy is a significant and legitimate public purpose; and

WHEREAS, a thorough economic analysis should be conducted to determine if there is a nexus between the existence of high lease rents in Hawaii and the stagnation of Hawaii's economy; and

WHEREAS, almost ten years have passed since an economic analysis was undertaken and incorporated into a report on the problems faced by commercial lessees; now, therefore,

BE IT RESOLVED by the Senate of the Twenty-sixth Legislature of the State of Hawaii, Regular Session of 2012, the House of Representatives concurring, that the Legislative Reference Bureau is requested to update their 2003 report analyzing the major problems faced by commercial lessees by incorporating an economic analysis to determine if there is a nexus between the existence of high lease rents in Hawaii and the stagnation of Hawaii's economy; and

BE IT FURTHER RESOLVED that the Research and Economic Analysis Division of the Department of Business, Economic Development, and Tourism and the Economic Research Organization at the University of Hawaii at Manoa are requested to conduct the economic analysis; and

BE IT FURTHER RESOLVED that the Research and Economic Analysis Division of the Department of Business, Economic Development, and Tourism and the Economic Research Organization at the University of Hawaii at Manoa are requested to transmit a draft report of the economic analysis, including any proposed legislation, to the Legislative Reference Bureau no later than November 1, 2012; and

BE IT FURTHER RESOLVED that the Legislative Reference Bureau is requested to submit a final report of the economic analysis, including any proposed legislation, to the Legislature no later than twenty days prior to the convening of the Regular Session of 2013; and

BE IT FURTHER RESOLVED that certified copies of this Concurrent Resolution be transmitted to the Director of the Legislative Reference Bureau, Director of Business, Economic Development, and Tourism, and Economic Research Organization at the University of Hawaii at Manoa.

Charlotte A. Carter-Yamauchi
Acting Director

Research (808) 587-0666
Revisor (808) 587-0670
Fax : (808) 587-0681

DEPT. COMM. NO. 62

LEGISLATIVE REFERENCE BUREAU
State of Hawaii
State Capitol, Room 446
415 S. Beretania Street
Honolulu, Hawaii 96813

January 11, 2013

MEMORANDUM

TO: Honorable Calvin K.Y. Say
Speaker of the House of Representatives

Honorable Donna Mercado Kim
President of the Senate

FROM: Charlotte Carter-Yamauchi CAY
Acting Director

SUBJECT: Commercial Leases: The Case For An Economic Analysis

Enclosed please find the LRB report entitled Commercial Leases: The Case For An Economic Analysis, which was prepared in response to Senate Concurrent Resolution No. 90, S.D. 1 (2012). The pdf version can be accessed at:

http://lrbhawaii.info/reports/legrpts/lrb/2013/scr90_sd1_12.pdf

Pursuant to section 93-16, Hawaii Revised Statues, we will be transmitting a copy of this report to the Legislative Reference Bureau Library.

Also, please note that we will make the report available to the public on January 14th on the Bureau's website. In addition, a limited number of hard copies of the report will be available for distribution from the Bureau's Library.

I hope this information will be of assistance to you and your staff. Please feel free to contact our office 587-0666 if you have any questions.

Enc.

COMMERCIAL LEASES: THE CASE FOR AN ECONOMIC ANALYSIS

JOHN MORSEY
Research Attorney

Report No. 1, 2013

Legislative Reference Bureau
State Capitol
Honolulu, Hawaii 96813

http://www.hawaii.gov/lrb

This report has been cataloged as follows:

Morsey, John
Commercial leases: the case for an economic analysis. Honolulu, HI: Legislative Reference Bureau, January 2013.

1. Commercial leases – Economic aspects – Hawaii.
KFH421.5. L35 A25 13-1

FOREWORD

This report was prepared in response to Senate Concurrent Resolution No. 90, S.D. 1, "Requesting the Legislative Reference Bureau to Update Their 2003 Report Analyzing the Major Problems Faced by Commercial Lessees by Incorporating an Economic Analysis to Determine if There is a Nexus Between the Existence of High Lease Rents in Hawaii and the Stagnation of Hawaii's Economy." The resolution requested the Research and Economic Analysis Division of the Department of Business, Economic Development, and Tourism and the Economic Research Organization at the University of Hawaii at Manoa to conduct the economic analysis and transmit a draft report to the Bureau.

The Bureau extends its appreciation to the staff of the Research and Economic Analysis Division and the Economic Research Organization for their cooperation and timely responses to the Bureau's inquiries.

Charlotte Carter-Yamauchi
Acting Director

January 2013

TABLE OF CONTENTS

Appendices

EXECUTIVE SUMMARY

It is estimated that Japanese investments in Hawaii real estate totaled approximately $15,000,000 during the period from 1985 to 1990, a time known as the "Japanese bubble." This influx of foreign capital led to artificially high land values, which were then used as comparables in rent renegotiations for commercial and industrial leasehold properties. Moreover, the presence of a "not less than" clause in many long-term ground leases resulted in lease rents remaining higher than they would have if the renegotiated rents had been based upon lower land values following the bursting of the Japanese bubble.

Several times since the early 1990s, the Hawaii Legislature has attempted to alleviate the perceived economic burden on lessees of commercial and industrial properties. Much of the legislative focus has been on the "not less than" clause contained in many of the leases. Proposed relief has ranged from legislation authorizing a one-time rent renegotiation overriding any "not less than" clause to bills that would effectively eliminate the clause altogether. However, as these legislative proposals would have the effect of altering various terms of existing lease agreements, the Attorney General has repeatedly concluded that such bills would violate the Contracts Clause of the United States Constitution.

The Attorney General has relied upon the test set forth by the Supreme Court of Hawaii to be applied in determining whether a state law is constitutional under the Contracts Clause. The Court outlined the three-step constitutional analysis as follows:

1. Whether the state law operated as a substantial impairment of a contractual relationship;

2. Whether the state law was designed to promote 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.

In considering bills introduced during the Regular Sessions of 2000, 2001, and 2002, respectively, the Attorney General concluded that a court could find that the measures ran afoul of the Contracts Clause because they did not appear to promote a significant and legitimate public purpose, nor did they appear to be a reasonable and narrowly drawn means of promoting the significant and legitimate public purpose, thereby failing the final two criteria of the constitutional analysis.

Subsequently, the Legislature adopted Senate Concurrent Resolution No. 89, S.D. 1, during the Regular Session of 2003, which requested the Bureau to study the major problems still facing commercial and other land lessees. In undertaking the study, the Bureau prepared and disseminated questionnaires to persons and organizations representing a broad spectrum of viewpoints, ranging from landowners or lessors who did not believe that a problem existed, to lessees who were urging a one-time rent renegotiation overriding any "not less than" clause in an

existing lease. Taking into consideration the responses to the questionnaires and the data collected, the Bureau observed, among other things, that one of the main problems cited by lessees was the presence of a "not less than" clause. However, the Bureau found that there was no indication, at the time of the report, of a broad-based compelling need for legislation altering existing lease agreements, which would be required to pass constitutional muster. Rather, the Bureau concluded that the primary problem facing lessees was the lack of available fee simple commercial and industrial property on the market. The Bureau also noted that the response rate for the questionnaires disseminated by the Bureau was very low, thereby making it unclear how much weight should be given to the responses received by the Bureau.

During the Regular Session of 2012, the Legislature adopted Senate Concurrent Resolution No. 90, S.D. 1, which requested the Bureau to update its 2003 report by incorporating an economic analysis to determine if there is a nexus between the existence of high lease rents in Hawaii and the stagnation of the State's economy. The resolution requested the Research and Economic Analysis Division of the Department of Business, Economic Development, and Tourism and the Economic Research Organization at the University of Hawaii at Manoa to conduct the economic analysis and transmit a draft report to the Bureau. However, as no funds were appropriated for the preparation of the requested economic analysis, both the Research and Economic Analysis Division and the Economic Research Organization were unable to provide the economic analysis due to lack of budgetary and personnel resources.

The Bureau has neither the personnel nor the expertise to undertake a definitive economic study. Therefore, this report will provide a review of previous efforts to address issues with high lease rents, the constitutional issues involved, and the possible impact of an economic analysis. Taking into consideration previous legislative action, relevant case law, and opinion letters drafted by the Attorney General, the Bureau concludes that if it is the Legislature's intent to alter existing lease agreements by overriding any "not less than" clause, the economic analysis contemplated by Senate Concurrent Resolution No. 90, S.D. 1, could potentially provide data to effectively address the constitutional concerns raised by the Attorney General. If it were to be determined that a nexus exists between the existence of high lease rents in Hawaii and the stagnation of the State's economy, a court could conceivably find that legislation overriding any "not less than" clause passes constitutional muster by virtue of advancing broad societal interests. Moreover, if the Legislature intends to pursue obtaining an economic analysis, it is advisable that a sufficient timetable and funding be provided for this purpose.

Chapter 5

FINDINGS AND RECOMMENDATIONS

Findings

The Bureau finds as follows:

1. Since the early 1990s, the Hawaii Legislatures have attempted to alleviate the perceived economic burden on lessees of commercial and industrial properties. During the Regular Session of 1993, the Legislature adopted House Concurrent Resolution No. 312, H.D. 2, S.D. 1, requesting the convening of a task force to study the major problems facing commercial land lessees. Although the Legislature did not act upon any of the Business Leasehold Task Force's recommendations, subsequent Legislatures have made repeated attempts to address this issue.

2. Much of the legislative focus has been on the "not less than" clause contained in many of the leases. Many attempts have been made to enact legislation that would have the effect of altering various terms of existing lease agreements, ranging from a one-time rent renegotiation overriding any "not less than" clause to bills that would effectively eliminate the clause altogether. The Attorney General has repeatedly concluded that such bills would violate the Contracts Clause of the United States Constitution.

3. The Supreme Court of Hawaii has held that, despite the language of the Contracts Clause, state's may validly enact statutes that impinge upon existing contractual rights. However, if a statute substantially impairs contractual rights, it must change the contractual and property rights on reasonable conditions and be of a character appropriate to its public purpose. Accordingly, the Court has outlined the three-step constitutional analysis as follows:

   a. Whether the state law operated as a substantial impairment of a contractual relationship;

   b. Whether the state law was designed to promote significant and legitimate public purpose; and

   c. Whether the state law was a reasonable and narrowly-drawn means of promoting the significant and legitimate public purpose.

4. During the Regular Session of 2009, the Legislature attempted to alleviate the burden on lessees by enacting Act 189, which required any appraiser involved in a rent determination under certain leases to consider factors not required by the lease. The United States District Court, District of Hawaii, held that Act 189

violated the third step of the Contracts Clause analysis because it did not reasonably or justifiably further a legitimate public purpose.

5. In its 2003 report, the Bureau concluded that, although it was clear that certain lessees were experiencing significant difficulties under their leases, there was no indication of a broad-based compelling need for legislation altering existing lease agreements. Instead, the Bureau found that the primary problem facing lessees was the lack of available fee simple commercial and industrial property on the market.

6. It is unclear how much weight should be given to the questionnaire responses included in the Bureau's 2003 report, due to the low response rate. Although a total of fourteen questionnaires were sent to lessors and fifty-six to lessees, the Bureau received only five responses from lessors and thirteen responses from lessees. Additionally, all but one of the responders were located on the island of Oahu. It is uncertain whether the responses could reasonably be generalized for lessors and lessees throughout the State.

7. Both the Research and Economic Analysis Division of the Department of Business, Economic Development, and Tourism (DBEDT) and the Economic Research Organization at the University of Hawaii at Manoa (UHERO) declined to provide the requested economic analysis due to lack of budgetary and personnel resources.

8. However, UHERO indicated that, given sufficient time and funding, it would be willing to undertake an economic analysis to be submitted to the 2014 Legislature and submitted a draft research plan with an estimated cost of just under $200,000.

Recommendations

If the Legislature's intent is to alter existing lease agreements by overriding any "not less than" clause, it is advisable to address the constitutional concerns raised by the Attorney General. While the State may validly enact statutes that impinge upon existing contractual rights in the legitimate exercise of its police powers, certain conditions must be met in order to avoid running afoul of the Contracts Clause of the United States Constitution.

As has been noted by the Attorney General, legislation that would override any "not less than" clause could be found by a court to substantially impair contractual relationships. Therefore, it would be necessary for the State to demonstrate that such legislation is a reasonable and narrowly-drawn means of promoting a significant and legitimate public purpose. The stated purpose of the economic analysis that was contemplated by Senate Concurrent Resolution No. 90, S.D. 1, was to determine if there is a nexus between the existence of high lease rents in Hawaii and the stagnation of Hawaii's economy. If such a nexus were found to exist, a court could conceivably find that legislation overriding any "not less than" clause passes constitutional muster by virtue of advancing broad societal interests, namely Hawaii's economy.

However, if the Legislature intends to pursue obtaining an economic analysis similar to that contemplated by the Resolution, it seems clear that funding needs to be provided for this purpose. According to both the DBEDT's Research and Economic Analysis Division and UHERO, the amount of data necessary to perform the economic analysis is significant and not readily available to the public. Without sufficient funding, the agencies lack the resources, both budgetary and personnel, to undertake such a comprehensive empirical fact gathering analysis. Accordingly, if the Legislature wishes to pursue this issue, the Bureau recommends that Chairs of the appropriate subject matter committees in the House and Senate consult with UHERO to draft legislation that ensures a workable approach, including a sufficient timetable and funding, for UHERO to complete an economic analysis to determine whether a nexus exists between high lease rents in Hawaii and the stagnation of the State's economy.

REAL PROPERTY LEASES

ERIC MAEHARA
Research Attorney

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Legislative Reference Bureau
State Capitol
Honolulu, Hawaii 96813
http://www.hawaii.gov/lrb/

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FOREWORD

This report has been prepared in response to Senate Concurrent Resolution No. 89, S.D. 1, adopted during the Regular Session of 2003, which requested the Legislative Reference Bureau study major problems facing commercial and other land lessees.

In conducting this study, the Bureau was directed to contact certain individuals and organizations identified in the Resolution and other stakeholders with a direct interest in the issues set forth in the Resolution. Input was obtained by way of questionnaires soliciting information from identified multi-family, commercial and industrial lessors and lessees, and real estate analysts knowledgeable in the area of leasehold issues. The Bureau also obtained information from studies submitted by stakeholders and data contained in the latest available Quarterly Statistical & Economic Report issued by the Department of Business, Economic Development and Tourism.

The Bureau would like to thank all parties who submitted information in response to our questionnaires and also the real estate analysts who responded to our questions.

Ken H. Takayama
Acting Director

December 2003

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Chapter 1

INTRODUCTION

Scope of Study

During the Regular Session of 2003, the Legislature adopted Senate Concurrent Resolution No. 89, S.D. 1 (hereafter "Resolution"), entitled "Requesting a Study on Real Property Leases." (See Appendix A.) The primary direction of the Resolution was "...that the Legislative Reference Bureau is requested to study the major problems still facing commercial and other land lessees...." Further, it requested that the Bureau:

- Consult with certain organizations and individuals "with a direct interest in the issues to ensure that all stakeholders are allowed to express their thoughts and concerns;"
- "Consult with the Attorney General for legal issues, opinions, and advice relating to any constitutional issues related to the study; and"
- "Submit a report of its findings and recommendation, including any proposed legislation, to the Legislature no later than twenty days before the convening of the Regular Session of 2004."

The opening *Whereas* clauses of the Resolution make reference to the perceived problem caused by the "artificially high land values" resulting from intense Japanese investment in Hawaii real estate during the period covering 1985 to 1990, estimated to be as high as $15,000,000,000. This massive influx of foreign capital inflated land values locally, which were then used as comparables in rent renegotiations for commercial and industrial leasehold properties, resulting in "highly inflated long-term ground leases" throughout the State. The Resolution states that this has led to lessees in many cases downsizing their businesses, reducing employee work hours and benefits, and reducing capital improvements. In many cases, lease rents were unsustainable by the improved properties' economic uses intended under the terms of the leases. Some lessees unable to pay these inflated lease rents were faced with forfeiture of valuable improvements, mortgage foreclosures, and bankruptcy.

In many cases, due to the fact that leases contained a clause that the renegotiated lease rent could not be less than the lease rent of the previous period (the "not less than" clause), the resulting lease rent remained higher than it would have been if the renegotiated lease rent had been based on the lower land values which deflated following the bursting of the "Japanese bubble." The Resolution further found that these inflated lease rents were imposing burdens on many lessees, resulting in adverse impacts upon the Hawaii economy.

The sixth *Whereas* clause of the Resolution made reference to a similar House Concurrent Resolution No. 312, adopted during the Regular Session of 1993, which created a task force to examine this same problem. That earlier task force found some renegotiated commercial lease rent increases in excess of 200%, causing hardships to and the closures of

many local businesses. Ten years later, the Legislature finds that the problems of lessees remain unresolved.

Methodology

The Bureau has neither the personnel nor expertise to undertake a comprehensive empirical fact gathering analysis, nor is it equipped to undertake a definitive economic study. Additionally, the language of the Resolution is very broad and general. To ensure completion in a timely manner, this study is relatively general and policy oriented and limited in scope.

In undertaking this study, the Bureau was directed to consult with certain specified organizations and any individual or agency or organization with a direct interest in the issues to collect their thoughts and concerns. The primary method of consulting with these persons and organizations was through the preparation and dissemination of a questionnaire. However, upon reviewing some of the public testimony presented at the committee hearings on this Resolution, it became apparent that this request for comments was to be sent out to persons and organizations which represented a broad spectrum of opinions on this issue. The interested parties or stakeholders with whom the Bureau was requested to consult ranged from landowners or lessors who did not believe a problem existed, or believed that any problem had been resolved by the passage of time, to lessees who were urging the imposition of rent caps, a one-time rent renegotiation overriding any "not less than" clause in a existing lease, or commercial leasehold reform permitting the forced purchase of the fee interest under their leasehold properties.

Due to the broad different perspectives on the issues, separate questionnaires were prepared and sent out to persons or organizations identified as lessors and persons and organizations identified as lessees (see Appendices B and C). The primary purpose of the questionnaires was to determine the direct effect the Japanese bubble from 1985 to 1990 had on rent renegotiations. A total of fourteen lessor questionnaires were sent out and fifty-six lessee questionnaires were sent out. Appendix D contains a list of all the recipients of the questionnaires. Although the responses were deemed to be confidential, the response rate was low: five questionnaires were received back from lessors and thirteen questionnaires were received back from lessees.

After reviewing a newspaper article on the scarcity of industrial warehouse space,[1] Bureau staff solicited comments on the contents of the Resolution from real estate analysts with the firms of CB Richard Ellis Hawaii, Colliers Monroe Friedlander Inc., and Grubb & Ellis/CBI Inc. to add a different perspective. Finally, staff had various conversations with representatives of both lessors and lessees, real estate appraisal firms, and financial institutions.

Organization

This opening chapter provides the direction and task set forth by Senate Concurrent Resolution No. 89, S.D. 1, the scope of the study, and the methodology utilized in this study. Chapter 2 provides background information regarding past efforts to address the problems faced

by single-family and multi-family lessees and past attempts to address the problems faced by commercial lessees by past Legislatures and the Council of the City and County of Honolulu. Chapter 3 sets forth an analysis of the responses made to the disseminated questionnaires by lessors and lessees of multi-family leasehold developments and conclusions. Chapter 4 sets forth an analysis of the responses made to the questionnaires by lessors and lessees of commercial and industrial developments and conclusions. Chapter 5 contains the Bureau's recommendations.

ENDNOTES

1. Isle warehouse space is getting scarce, *Honolulu Star-Bulletin*, August 21, 2003.

Chapter 2

BACKGROUND AND PAST LEGISLATION

Single-Family Leasehold Reform

In 1967, in response to ideological forces fighting an oligopolistic land tenure system in Hawaii and spurred on by more practical reasons of increasing lease rents on renegotiations, the State Legislature enacted Act 307, Session Laws of Hawaii 1967, codified as Chapter 516, Hawaii Revised Statutes. Chapter 516, as amended over the years, allows lessees of long-term leasehold interests in single-family residential development tracts the right to purchase the fee interest of their residential lots through a condemnation process involving the fee simple landowner and what is now the Housing and Community Development Corporation of Hawaii. The latter party would condemn the fee interest, paying the fee owner fair compensation for the fee interest and, in turn, sell the acquired fee interest to the leasehold homeowner.

Following extended litigation, in 1984 United States Supreme Court ruled in *Hawaii Housing Authority v. Midkiff*,[1] that Act 307 did not violate the United States Constitution. Shortly thereafter, in *Hawaii Housing Authority v. Lyman*,[2] the Supreme Court of Hawaii in like manner found that Act 307 did not violate the state Constitution. As a result over the last 25 years, the number of leasehold single-family residences fell from a high of approximately 28,000 to 4,600.[3]

Multi-Family Leasehold Reform

Following the successful effort in virtually eliminating the single-family leasehold system in Hawaii, many owners of multi-family residential leasehold units facing lease rent renegotiations, including cooperative housing corporations (i.e., "coops"), condominiums and planned development housing, aspired to be able to purchase the fee interests under their multi-family units. Over the years, numerous bills were introduced to extend the right to purchase the fee interest by multi-family unit leasehold owner, culminating in 1991 with two bills introduced in the Legislature proposing mandatory leasehold conversion for multi-family units, or in the alternative, giving the lessor the option of leasehold conversion or lease rent control.[4]

Senate Bill No. 948, reciting many of the findings of Act 307, called for the mandatory condemnation of multi-family units upon the application of 50% of the units in a development. The then Housing Finance and Development Corporation, following a public hearing to assure that a public purpose was being effectuated, would have the parties negotiate an agreed upon value for the fee interest. Absent agreement, the Housing Finance and Development Corporation would determine the value of the fee interest, based upon the final positions of the parties, and would then condemn the fee interest of the development and resell the fee interest to unit owners. Where this bill departed from Act 307 was in the payment to the fee owner upon condemnation. The fee owner would receive only 50% of the fee value for every unit; however, the fee owner would retain a continued interest in the unit. Upon the subsequent sale of the unit by its owner,

the fee owner would receive 13% of the actual sale price or tax assessed value of the whole unit, whichever was higher. Senate Bill No. 948 was referred to the Committee on Housing and Hawaiian Programs and was not reported out for Second Reading in the Senate.

Senate Bill No. 1255 which was also introduced in 1991, recited many of the same findings that were contained in Act 307; however this bill gave the fee owner the option between leasehold conversion or lease rent control. Senate Bill No. 1255 required a threshold of at least twenty-five (or more than 50%, whichever is less) of owner-occupants of a development to apply for conversion. This time, following a public hearing to determine whether a sale would effectuate a public purpose and establishing the value of the fee interest by mutual agreement of the parties or determination by the Housing Finance and Development Corporation, the fee owner had the option to sell the fee interest at the value determined or keep the fee interest, but any increases in rent would be limited to increases in the consumer price index. In the event the fee owner agreed to sell the fee interest, the price the fee owner received was 100% of the agreed upon or determined fee value for each unit, plus an additional share in any appreciation in the value of the fee interest if the unit was sold within twenty years of the conversion. Initially, the lessor would be entitled to all the appreciation, if any, if the unit was sold immediately upon the conversion. The lessor's share of the appreciation would be reduced by 20% for every two years after the conversion until the ninth year. Thereafter, the lessor's share in the appreciation would remain at 10% until the end of the twentieth year.

Senate Bill No. 1255. S.D. 2, crossed over to the House of Representatives where its contents were substituted for those of a similar House Bill No. 1982, H.D. 1 (which had earlier passed out of the House). The bill was passed by the House on Third Reading as Senate Bill No. 1255, S.D. 2, H.D. 1.[5] The Senate and House conferees could not come to agreement on a final version of the bill in conference during that Regular Session.

However, in 1991, the Honolulu City Council adopted Ordinance 91-95, which granted multi-family residential leaseholders the right to purchase the fee simple interest to their units in a condemnation procedure similar to Chapter 516, Hawaii Revised Statutes. The new ordinance, codified at Chapter 38, Revised Ordinances of Honolulu (hereafter "ROH"), provided that at least twenty-five of all the condominium owners (defined as owner-occupants) or at least owners of 50% of the condominium units within the development, whichever was less, could trigger the condemnation process by the city Department of Housing and Community Development. Following the inevitable court challenge, the United States Ninth Circuit Court of Appeals in *Richardson v. City and County of Honolulu*[6] held the ordinance did not violate the United States Constitution.

In 2002, in *Coon v. City and County of Honolulu*,[7] the Hawaii Supreme Court upheld the validity of Chapter 38; however, in so doing, the Court held that rules promulgated to implement Chapter 38, relating to determining the minimum number of applicants required to initiate the conversion process violated Chapter 38 by impermissibly lowering the minimum number of applicants required. In order to trigger a condemnation, §38-2.2(a)(1), ROH requires applications from at least twenty-five condominium owners within the development or at least owners of 50% of the condominium *units*, whichever number is less. Rules §2-3, promulgated by the city Department of Housing and Community Development (hereafter the "Department")

authorizes the Department to designate a condominium development eligible for condemnation when it receives applications from twenty-five condominium owners by number, or 50% of the condominium *owners* of a development, whichever is less. Rules §1-2 and §38-2.2 (a)(2), ROH, both define "condominium owners" to mean "owner-occupants," and not all the condominium units in a given development are necessarily owner-occupants. Therefore, while the ordinance required at least twenty-five owner-occupants to trigger a condemnation, the rule simply required 50% of the owner occupants in a condominium development, which could be less than twenty-five in number. This prompted the City Council to attempt to amend Chapter 38 in 2002 by introducing Bill 53, which would bring Chapter 38 in line with the liberal rules for triggering the conversion process, making Chapter 38 as broadly applicable as possible. However, this time the proponents were met by a more organized effort by fee owner lessors seeking to keep the conversion process comparatively narrow by excluding as many multi-family projects as possible from the process established in Chapter 38.

In response to this opposition, Bill 53, after passing Second Reading, was referred back to the Council's Executive Matters Committee where it remains. Instead of moving Bill 53 and continuing public discussion on this matter, the Council passed Resolution 03-69 which established a Leasehold Conversion Task Group. Basically, the mandate of the Task Group was to review Chapter 38 and attempt to identify the issues perceived as unfair by either lessors or lessees and to propose measures to eliminate or mitigate the perceived unfairness. As amended by further resolutions,[8] the Task Group is now composed of six individuals representing the interest of lessors and six individuals representing the interests of lessees and led by a non-member independent facilitator. The Task Group facilitator is to submit a final report to the Executive Matters Committee within six months of the Task Group's first meeting, which was held on October 2, 2003, followed by a public hearing on October 31, 2003.

Commercial Property Leasehold Conversion

Echoing the same concerns that led to the passage of House Concurrent Resolution No. 312 (Regular Session of 1993) and are recited in Senate Concurrent Resolution No. 89 (Regular Session of 2003), on March 31, 1998, Bill 46 was introduced in the Honolulu City Council calling for commercial leasehold conversion. The bill cited the findings of the concentration of the fee title to commercial property being held by a few private landowners. It further cited the artificially high property values caused by wealthy international investors and the use of those high land values by lessors to calculate master ground lease rents. The bill went on to recite that this situation has resulted in inflation, instability and economic disruptions on Oahu with potentially damaging consequences to all members of the community.

Bill 46 would permit any one lessee who owns a commercial project, including hotels and warehouses, to apply with the city Department of Housing and Community Development to commence a condemnation process similar to Chapter 38, relating to multi-family leasehold units. Bill 46 passed First Reading and was referred to the Committee on Policy on April 8, 1998. The bill was not heard in committee and was subsequently filed for no further consideration on March 31, 2000, pursuant to Section 1-2.4, Revised Ordinances of Honolulu, which sets a filing deadline on pending bills.

Business Leasehold Task Force

As stated in Senate Concurrent Resolution No. 89 (Regular Session of 2003), in 1993, the Legislature adopted House Concurrent Resolution No. 312, entitled "Convening a Task Force to Study the Major Problems Facing Commercial Land Lessees." The focus of the task force was to determine:

- How many acres of land in Honolulu in hotel, commercial and industrial uses were leasehold.
- Whether rents being renegotiated for such uses were economically feasible.
- How many hotel and small businesses were affected by high lease rents.
- Small businesses impact on the stability of the Hawaii economy and tax base.
- Where small businesses may relocate to lands with reasonable rents.
- Whether legislation capping lease rents or requiring the income approach to appraising property was required.

Further, the task force was directed to work with the City and County of Honolulu in overhauling its property value assessment methods.

The task force was comprised of forty-one persons representing a wide range of parties, including small businesses, large landowners, commercial developers, and appraisers. Four public hearings were held on Oahu, one on Maui and one in Hilo. Without reaching a concensus on the issues raised by the Resolution or what to include in any final report, the members of the task force decided on a report format that allowed individual statements by each member, addressing the issues raised by the Resolution. The report closed with five recommendations, each of which, while not reflecting a concensus, was supported by a significant majority of the task force members. Those recommendations from the 1993 task force were as follows:

1. Laws should be enacted to ensure that arbitrators for lease rent renegotiation arbitrations are selected through a double blind process, to ensure neutrality.
2. The Legislature should convene a task force consisting of representatives of lessors, commercial and industrial lessees, and financial institutions to explore methods to establish longer periods of known rents.
3. The general excise tax law should be amended to exempt amounts received by fee owners from business and commercial lessees to pay real property taxes owed to the counties.

4. The Legislature should urge counties to review their tax assessment procedures for conformity with the Uniform Standards of Professional Appraisal Practices.

5. The Legislature should enact legislation to designate the American Arbitration Association to administer arbitration panels to determine the fair market rents at the time of commercial and industrial leasehold rent renegotiations.

While none of the specific recommendations was ever acted upon, in 1998 the Legislature enacted Act 180, Session Laws of Hawaii 1998, codified as Section 466K-4, Hawaii Revised Statutes, which required all real estate appraisers who are licensed or certified to practice in this State to comply with the current uniform standards of professional appraisal practices when performing appraisals in connection with a federally or non-federally related real estate transaction. Ironically, in 1999 the Legislature enacted Act 287, codified as Section 466K-4(b), Hawaii Revised Statutes, which specifically exempted real estate appraisers employed by the counties to value real property for ad valorem taxation from the requirement of complying with the uniform standards of profession appraisal procedures. This was completely contrary to recommendation 4 of the task force.

Related Legislation

During its Regular Session of 2000, the Legislature passed Senate Bill No. 873, S.D. 1, H.D. 2, entitled "A Bill for an Act Relating to Real Estate Appraisals." (See Appendix E.) The purpose of the bill was to amend Chapter 519, Hawaii Revised Statutes, which deals with lease rent renegotiations for both commercial and residential leases. In its final form, Senate Bill No. 873 provided that at the time of any rent renegotiation, if the lease rent renegotiated is based on fair market value and is less than the rent currently being paid, that renegotiated rent will prevail over any existing contract provision that bars the lowering of lease rent upon renegotiation.

Governor Benjamin Cayetano vetoed Senate Bill No. 873, S.D. 1, H.D. 2, declaring that it violated the Contracts Clause in Section 10 of Article I of the United States Constitution. The Governor said that the bill, by attempting to statutorily override the "not less than" clause in a lease contract, was an unconstitutional attempt to impair the obligations of a contract. (See Appendix F for Governor Cayetano's veto Proclamation and Statement of Objections to Senate Bill No. 873.)

In an Attorney General's opinion issued on April 20, 2000 (see Appendix G), which the Governor relied upon in vetoing the bill, the Attorney General stated that the prohibition in the Contracts Clause is not absolute, however, there had to be some limits on the power of the State to abridge existing contractual obligations. In its opinion, the Attorney General quoted from the decision of the Hawaii Supreme Court in *Applications of Herrick & Irish*[9] as follows:

> In deciding whether a state law has violated the federal constitutional prohibition against impairment 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.

The Attorney General noted that the only public policy stated in Senate Bill No. 873, S.D. 1, H.D. 2, was "The legislature finds that it is in the public interest that the lease rent and sublease rent should be based on the fair market value of the land." Not only was the stated purpose insufficient, but the Attorney General pointed out that in the final version of the bill, any savings that a ground lessee received, as a result of proposed changes in the bill, did not pass through from the lessee-sublessor to a sublessee.

In response, the following year, during the Regular Session of 2001, House Bill No. 1131 (see Appendix H) was introduced. In section 1 of the bill, which took up the first four pages of the bill, the authors of the bill cited all of the historic problems stemming from the concentration of fee ownership of land in a small handful of owners and the leasehold system of property tenure in Hawaii. It further recited the artificial inflation of land values due to international investors and the use of these inflated values in determining ground lease rents. While land values have fallen from the inflated heights, according to the bill, lease rents remain higher than present fair market value can support, due to the "not less than" clause in many lease contracts, thereby negatively impacting the entire State economy.

House Bill No. 1131, H.D. 1, which provided that a lease rent based on fair market value determined by appraisal that is less than the lease rent currently being paid shall prevail over any existing contract provision that bars the lowering of lease rent upon renegotiation, passed out of the House but was not reported out of the Senate Committee on Commerce, Consumer Protection and Housing. (Apparently, the Chairman of the committee relied upon another opinion by the Attorney General, dated March 22, 2001, which basically reiterated its earlier opinion that this bill violated the Contracts Clause by substantially impairing contractual rights and obligations without furthering a significant public purpose by reasonable and narrowly drawn means. See Appendix I.)

Not to be deterred, proponents of commercial leasehold relief returned in 2002 in support of House Bill No. 2245. Basically, the same findings and purpose contained in the previous bill calling for commercial leasehold relief were recited in section 1, this time covering the first eight pages of the bill and also citing the negative impacts on the State's economy caused by the terrorist attack of September 11, 2001. In its final form, House Bill No. 2245, H.D. 1, S.D. 1 (see Appendix J) provided that, notwithstanding existing lease provisions, any lease that had its lease rent renegotiated after January 1, 1990, shall be allowed a one-time adjustment at the option of the lessee to reflect present fair market value. This "one-time correction"[10] was to prevail over any existing contract provision to the contrary. Any one-time reduction in ground lease rent to a lessee/sublessor was to be passed on to any existing sublessee. Further, fair market values were to be derived by the use of uniform standards of professional appraisal practice.

House Bill No. 2245, H.D. 1, S.D. 1 made it to a Conference Committee; however, another Attorney General's opinion, dated April 11, 2002 (see Appendix K), found that this bill also resulted in an unconstitutional impairment of contractual obligations and relationships. The bill was not reported out of Conference Committee.

Again in 2003, proponents of leasehold relief refitted House Bill No. 2245, this time in the form of Senate Bill No. 905 (see Appendix L). In its latest metamorphosis, the bill cited findings covering the first eleven pages of the bill, expanding on previous descriptions of the inherent problems facing lessees and the resultant negative impacts to the State's economy. Senate Bill No. 905 again called for a one-time correction in lease rents to prevail over any existing contract provisions and required the passing down of any reduction in ground lease rent to any sublessee. However, new provisions in the bill: made the one-time correction apply only to leases that were in effect on January 1, 1985, and had a rent renegotiation subsequent to January 1, 1990; did not permit the one-time corrected lease rent to be lower than the lease rent prior to January 1, 1985; and had a "drop dead" clause automatically repealing it on December 31, 2006 or three years after a final court decision upholding its validity, whichever occurs later. An almost identical bill, except for the findings and purpose language in the first section and some minor other differences was also introduced as Senate Bill No. 903.

Both Senate Bill No. 903 and Senate Bill No. 905 were referred to the Senate Committee on Commerce, Consumer Affairs and Housing where they have not been heard and remain carried over to the 2004 Regular Session. Instead, Senate Concurrent Resolution No. 89, S.D. 1, that called for the subject study was reported out of the Committee on Commerce, Consumer Affairs and Housing, adopted in the Senate and later adopted in the House without amendment.

ENDNOTES

1. *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984).

2. *Hawaii Housing Authority v. Lyman*, 68 Haw. 55 (1985).

3. For an analysis of the history of single-family leasehold housing in Hawaii, see Sumner J. La Croix, James Mak and Louis A. Rose, "Single Family Leasehold Housing in Hawaii: An Analysis of its Rise and Fall," Working Paper No. 93-13, July 23, 1993.

4. Senate Bills Nos. 948 and 1255, Regular Session of 1991.

5. House Journal, Regular Session of 1991, page 1278. For purposes of economy, since Senate Bill No. 1255 in all its drafts exceeded 90 pages, it, along with Senate Bill No. 948, was not included in the appendices.

6. *Richardson v. City and County of Honolulu*, 124 P.3d 1150 (1997), cert. den. 525 U.S. 871 (1998).

7. *Coon v. City and County of Honolulu*, 98 Haw. 233 (2002).

8. City Council Resolution 03-244 and 03-278.

9. *Applications of Herrick & Irish*, 82 Haw. 329, 340 (1996).

10. House Bill No. 2245, H.D. 1, S.D. 1, Regular Session of 2002, p. 11, line 5.

Chapter 5

CONCLUDING OBSERVATIONS

Senate Concurrent Resolution No. 89, S.D. 1 (2003), requested that the Bureau to study problems facing lessees. The Bureau sent out questionnaires to various lessees and lessors of multi-family residential leaseholds and commercial leaseholds, and also reviewed information from real estate analysts who agreed to assist the Bureau, real property tax data from the City and County of Honolulu, an economic report prepared by SMS research, and the latest Quarterly Statistical & Economic Report prepared by the Department of Business, Economic Development and Tourism.

1. With respect to multi-family residential leaseholds, as a practical matter, the most active arena at present is the Honolulu City Council, which has established a Task Group that includes many interested parties on both sides of the issue of multi-family leasehold conversion.[1]

2. The primary question being debated by the Task Group members concerns the number of owner-occupants or total multi-family units in a development that should be necessary to trigger the residential leasehold conversion process under the county's ordinance. The lessees want to lower the required threshold, thereby potentially enabling more multi-family projects to convert to fee simple. Conversely the lessors want to require a higher threshold, which would more strictly limit the number of qualifying projects.

3. At the same time, lessee proponents will almost certainly continue in their efforts at the Legislature to enact a law authorizing one-time renegotiation of lease rent, whether or not the lease contains a "not less than" clause that prevents a renegotiated lease rent from being lower than a pre-set level. The intent of the statutorily mandated renegotiation is to offset the perceived effect of the Japanese "bubble" that lessees contend raised real property prices in Hawaii to artificial levels with a corresponding impact on lease rents. This could benefit the lessees of certain multi-family units. Lessors contend, however, that with the passage of time, even these perceived inequities may be removed if real estate values continue to appreciate. As the recent low interest rates have pushed new and resale purchases of single-family and multi-family units to greater heights, the value of the underlying fee simple property may similarly continue to increase.[2] If this holds true, lessors believe that the "not less than" clauses may become irrelevant in future lease rent renegotiations.

4. With respect to commercial and industrial leaseholds, the responses received from lessors, lessees and the real estate analysts consulted, indicate that while the Japanese "bubble" may have negatively impacted the leasehold system in the past, it presently appears to have minimal, if any, continuing effect. While the majority of lessee responses cited the "not less than" clauses as the main problem in their

leases, none claimed the Japanese bubble effect as a major problem in a rent renegotiation, although two lessees claimed it had an effect on the determination of the initial lease rent charged in their leases. However, while some lingering effect of the "bubble" may remain, as evidenced by the two commercial leasehold examples discussed in a previous chapter where commercial lease rents were reduced upon a second renegotiation, even this lingering effect will probably be removed if the real estate market continues to improve.

5. According to the real estate analysts and the SMS economic study, lease rents are probably "right where they should be". In fact, with regard to industrial properties and the present low vacancy rate, lease rents are going up but will have to climb significantly before justifying investment for the development of additions to and renovation of existing inventory.

6. According to the SMS economic impact study, lease rents are not a major component of doing business in Hawaii. This is, however directly contradicted by the responses received from some lessees who reported that their lease rents were in excess of 50% of their costs of doing business. Only a small percentage of questionnaires mailed to lessees were returned. It is possible that lessees who are being substantially impacted by lease rents in the operation of their business were more inclined to respond. However, there can be no doubt that at least some lessees find their present lease rents to be a heavy burden.

7. According to real property tax data from the City and County of Honolulu, in certain areas of Oahu, a small handful of large landowners (including in some cases the State and the City), control a high concentration of commercial and industrial leasehold properties. This has caused, according to some of the lessee responses, problems in renegotiating lease rents due to the shortage of comparable fee simple transactions to use to establish fair market values.

8. There is no question that there are lessees who are being heavily impacted by the leasehold tenure system in commercial and industrial properties. However, indications from the Department of Business, Economic Development and Tourism (DBEDT) are that overall, business in Hawaii appears healthy at this time.[3] According to DBEDT, recent private sector construction activity, particularly in single-family and multi-family construction, projected federal spending for improving military facilities, and a rebounding visitor industry following the Iraq hostilities and the SARs epidemic all point to a positive future business environment for Hawaii.

9. One of the main problems that lessee responses cited in their existing leases was the presence of "not less than" clause. Over the last several years, many attempts were made by lessees to enact legislation that would have the effect of altering various terms of existing lease agreements. These attempts received varying degrees of support from legislators. However, most of these attempts have failed in the past as a result of State Attorney General opinions that the bills violated the provision of

the United States Constitution clause prohibiting the impairment of contracts. While it is clear that certain lessees are experiencing significant difficulties under their present leases, there is no indication at this time of a broad based compelling need for the Legislature to pass legislation to mandate the alteration of existing lease agreements.

10. The final (and by no means profound) conclusion to be drawn from the responses to the questionnaires, the responses from the real estate analysts, and the other information received is the lack of available fee simple commercial and industrial property on the market. Whether the situation is attributed to the leasehold system, the land entitlement system, or simple geography, the primary problem lessees face tends to stem from supply and demand. There simply is not enough commercial and industrial zoned land, fee simple and leasehold, in the market place.

Whether or not the Legislature chooses to assist lessees by passing legislation to mandate the alteration of existing lease agreements, the Legislature may want to consider taking steps to make more fee simple property available for commercial or industrial use. None of the items discussed below are "simple", "easy", or "free". At the very least, most will require extensive discussion, investigation, planning, and development prior to implementation.

A. *Potential base realignment and closing (BRAC) for Fort Shafter.* The United States Department of Defense is preparing for another BRAC review of military bases in 2005. Conspicuously, Fort Shafter has not been mentioned as a recipient of the recently well publicized massive federal military base spending that is to flow into Hawaii over the next decade. The Legislature could direct the Department of Business, Economic Development and Tourism to initiate discussions with federal authorities regarding any future plans for Fort Shafter and, particularly with commercial and industrial purposes in mind, the "Shafter Flats" area makai of the Moanalua Freeway.

B. *Designation of a new community development district in urban Honolulu to be overseen by the Hawaii Community Development Authority.* Pursuant to Section 206E-1, Hawaii Revised Statutes, one of the purposes of the Hawaii Community Development Authority is to plan and assist with the redevelopment of "undeveloped, blighted, or economically depressed (areas)...potentially in need of renewal, renovation, or improvement to alleviate such conditions as dilapidation, deterioration, age, and other such factors or conditions which make such areas an economic or social liability."

In answer to the concerns and comments regarding the lack of available new or renovated industrial properties near the urban core, the Legislature could consider directing the Hawaii Community Development Authority; the Department of Business, Economic Development and Tourism, or both to determine whether one or more areas makai of the freeway, between the Aloha Tower complex and the airport would warrant redevelopment under the auspices of the Hawaii

Community Development Authority. The area could be designated a community development district pursuant to section 206E-5(a) and redeveloped in the same manner that the Kakaako community development district has been and is being redeveloped. Any proposed community development plan for this new district should encourage the redevelopment and expansion of commercial and industrial uses in the district, and steps taken to ensure that improvements to infrastructure do not have the unintended consequence of improved infrastructure raising property values to the point that industrial expansion is impeded.

C. *State industrial parks.* The Legislature could consider directing the Department of Land and Natural Resources to review the possibility of making more land available for industrial purposes through its industrial parks program pursuant to part VII of Chapter 171, Hawaii Revised Statutes. Further areas that the Legislature could have the Department consider for the development of industrial parks include the present Oahu Community Correctional Center site (if in fact the Legislature foresees relocating the correctional center), the piers and support areas of the former Army terminal (the Kapalama Military Reservation) generally located near the intersection of Nimitz Highway and Waiakamilo Road, and state lands at Sand Island, Kapolei, and Kalaeloa.

D. *Review the land use and zoning process.* The demand for more commercial and industrial land requires more land to be developed for those uses; that, in turn, requires more speed, flexibility, and certainty in the existing land use and zoning process. A group of representatives of large landowners, environmental interests, urban planners, agricultural interests, land use attorneys, the State Office of Planning, and other state and county planning agencies, should be convened to explore ways to expedite the land use and zoning process.

Presently, to develop land for any urban use in the Ewa or central Oahu agricultural land use district, the land must undergo a State Land Use Commission contested case hearing and action decision to be reclassified from the agricultural district to the urban district. It would probably also need an amendment to the relevant Honolulu development plan for the proper land use designation which, in turn, will require a public hearing and action by the Honolulu Planning Commission and the review and passage of an ordinance by the Honolulu City Council. (The correct land use designation on the development plan should, but need not in all cases, be in place prior to the land use reclassification process.) The application for the development plan amendment would trigger a Chapter 343, Hawaii Revised Statutes, environmental assessment and probably a full environmental impact statement preparation process, which must be completed prior to consideration of the development plan amendment application. The final discretionary step, assuming the land is not in any special district, such as the coastal zone special management area, would be a change in zoning, which again would require a public hearing and action by the Honolulu Planning Commission and the review and passage of an ordinance by the Honolulu City Council. This

all would be followed by what are referred to as ministerial but hardly simple steps, including at minimum, subdivision permits and building permits. These governmental steps are normally preceded by meetings with community groups, neighborhood boards, and a plethora of state and county agencies.

The described process will take a matter of years, not months. It will require a number of experienced consultants, including, at minimum, attorneys, land planners, civil engineers, traffic consultants, environmental consultants and archaeologists. Added to the mix could be environmental or hazard material engineers, acoustical engineers, architects, flora and fauna consultants, economists, and other specialty consultants. The process is very expensive, especially if there are the added costs of land which must be carried during this period.

Further along the process will be added, until then some unknown, conditions of development that will include, at minimum, requirements for improvements to the area's infrastructure, including roads and highways, water distribution and storage system, wastewater collection and treatment system, and electrical utilities. Additional impact fees for basic services, such as police and fire protection, school facilities, and parks, can be anticipated.

Any landowner, even one not bearing land carrying costs, would be very hesitant to undergo this land entitlement process. This is particularly so because the initial steps, while costing money, are discretionary and not guaranteed. The pitfalls of the process have been magnified by recent court decisions overturning earlier obtained land entitlements for failure to follow the exacting steps required by this land entitlement process.

The process and problems involved in making more land available for commercial and industrial use are complex. Simple solutions to problems of this complexity cannot be expected. Simply abolishing the Land Use Commission will not solve these problems. Accordingly, a group of representatives of stakeholders in the land entitlement process should be established to review the entire process with the intent of trying to not only shorten or expedite the process, but also remove some of the uncertainty and risks in the entire land entitlement process. This would benefit not only landowners and developers but, in the final analysis, the end users whether they be homeowners or commercial or industrial businesses.

E. *Review methods of appraisal for renegotiation of lease rents.* The Legislature could direct the Director of Commerce and Consumer Affairs to convene a group of representatives of commercial and industrial lessors and lessees, financial institutions, and real estate appraisers (through the real estate appraiser program under chapter 466K, Hawaii Revised Statutes) to explore methods of appraisal which may be more fair and equitable to all parties. Presently, according to the responses of both lessors and lessees to the questionnaire, the great majority of

renegotiations are based on a set return on the fair market value of the land at its highest and best use without encumbrances, using comparable sale prices of like properties in the area.

A negotiation based on a weighed average of various indices, such as the fair market value of the land, recently renegotiated comparable lease rents, the consumer price index, and a review of the comparable values of the unencumbered land and the lessee improvements, may result in more equitable method of determining lease rents. While this may not relieve the need for more commercial and industrial lands available or address the present needs of some of the lessees with their present leases, it could help future lessees avoid some of the pitfalls being experienced today by some lessees.

ENDNOTES

1. Both parties who returned the completed lessor and lessee questionnaire discussed in this chapter are actively participating in the Task Group discussions.

2. Experts expect pause in Oahu home Sales, Honolulu Star-Bulletin, November 25, 2003.

3. See notes through and accompanying text.