

COMMERCIAL LEASES: THE CASE FOR AN ECONOMIC ANALYSIS

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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.

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TABLE OF CONTENTS

	<i>Page</i>
FOREWORD	iii
EXECUTIVE SUMMARY	vi
1. INTRODUCTION	1
Scope of Report.....	1
Methodology	2
Organization.....	3
2. BACKGROUND AND LEGISLATION PRIOR TO 2003	4
Business Leasehold Task Force	4
Related Legislation Prior to 2003	6
Relevant Case Law	7
Attorney General's Opinion Letters	10
3. THE BUREAU'S 2003 REPORT	12
SMS Economic Impact Report	13
Bureau's Observations and Recommendations	13
Low Response Rate.....	15
4. LEGISLATION SINCE 2003	16
Bills Introduced.....	16
Act 189.....	17
5. FINDINGS AND RECOMMENDATIONS.....	18
Findings.....	18
Recommendations.....	19

Appendices

A. Senate Concurrent Resolution 90, S.D. 1 (2012).....	21
B. Senate Concurrent Resolution 89, S.D. 1 (2003).....	24
C. Senate Standing Committee Report No. 3384 (2012)	26
D. Department of Business, Economic Development, and Tourism's Response to the Bureau's Inquiry.....	29
E. University of Hawaii Economic Research Organization's Response to the Bureau's Inquiry	30
F. University of Hawaii Economic Research Organization Draft Research Plan for a Study of Commercial Leasehold and its Impact on Hawaii's Economy.....	31

	<i>Page</i>
G. Attorney General's Opinion Letter Regarding Senate Bill No. 873, S.D. 1, H.D. 2 (2000)	34
H. Attorney General's Opinion Letter Regarding House Bill No. 1131, H.D. 1 (2001)	39
I. Attorney General's Opinion Letter Regarding House Bill No. 2245, H.D. 1, S.D. 1 (2002)	45

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.

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Chapter 1

INTRODUCTION

Scope of Report

During the Regular Session of 2012, the Legislature adopted Senate Concurrent Resolution No. 90, S.D. 1 (hereafter "Resolution"), entitled "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."¹ The Resolution requests 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) to conduct the economic analysis and "to transmit a draft report of the economic analysis, including any proposed legislation, to the Legislative Reference Bureau no later than November 1, 2012."² The Resolution further requests the Legislative Reference Bureau "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."³ It should be noted that no funds were appropriated for the purposes of the Resolution, and as such, no additional financial resources were made available for the project.

The primary direction of the Bureau's 2003 report was "to study the major problems still facing commercial and other land lessees"⁴ Accordingly, that report examined 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. The Legislature intended the scope of this report to be more narrow, however, as Senate Concurrent Resolution No. 90, S.D. 1, is solely concerned with the major problems faced by commercial lessees. The opening *Whereas* clauses of the Resolution make reference to the perceived problem that commercial properties in the State remain in the hands of a few large landowners and cite the 2003 report's observation that there is a lack of available fee simple commercial property on the market.

The Resolution further narrows the scope of this report in the ninth *Whereas* clause, which states that potential legislation that would alter existing lease agreements must meet certain criteria, including being designed to promote a significant and legitimate public purpose. The eleventh *Whereas* clause goes on to state that "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." As noted by the Senate Committee on Commerce and Consumer Protection, the Bureau's 2003 report referenced constitutional concerns that need to be

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1. See Appendix A for Senate Concurrent Resolution No. 90, S.D. 1 (2012).
 2. *Id.* at first and second *BE IT FURTHER RESOLVED* clauses.
 3. *Id.* at third *BE IT FURTHER RESOLVED* clause.
 4. See Appendix B for Senate Concurrent Resolution No. 89, S.D. 1 (2003).

addressed before lease agreements can be amended.⁵ The Committee further stated that if a nexus is established between high lease rents and the stagnation of Hawaii's economy, "this could provide a basis for the Legislature to consider future legislation that may affect commercial leaseholds, while also promoting a significant and legitimate public purpose such as the State's sustained economic growth."⁶

Methodology

In planning for the preparation of the final report of the economic analysis, the Bureau contacted DBEDT's Research and Economic Analysis Division and UHERO to inquire whether the agencies were capable of and intended to conduct the economic analysis and transmit a draft of the analysis to the Bureau. In its response to the Bureau's inquiry, the Research and Economic Analysis Division stated that it was unable to conduct the economic analysis for three reasons:

- It does not have expertise in real estate and legal issues;
- It lacks the necessary resources, both budget and personnel; and
- No funds were appropriated by the Legislature for the conduct of the economic analysis. Because data needed for the economic analysis are not publicly available, surveys would be required to obtain data for the analysis, which would cost tens of thousands of dollars.⁷

Similarly, UHERO's response to the Bureau's inquiry indicated that it did not have the data nor the faculty resources to appropriately conduct the economic analysis.⁸ It stated that the amount of data necessary to perform the economic analysis is significant and not readily available to the public. Again, the absence of an appropriation for the economic analysis appears to be paramount, as UHERO notes that the lack of funding renders the agency unable to hire the necessary economic consultants, graduate students, and undergraduate students that generally compose any research team assembled for its projects. The response indicated that if funding were available, UHERO "would be happy to contribute to an analysis either jointly with DBEDT or separately."

UHERO also provided the Bureau with a draft research plan for a study of commercial leaseholds and their impact on Hawaii's economy.⁹ Guided by a professor in the Department of Economics and the Global Public Health and Population Studies Program at the University of Hawaii at Manoa and a professor of law at the William S. Richardson School of Law, the tasks contemplated by the draft research plan include, among other things:

5. See Appendix C for Sen. Stand. Com. Rep. No. 3384 (2012).
6. *Id.*
7. See Appendix D.
8. See Appendix E.
9. See Appendix F.

INTRODUCTION

- Summarizing selected published studies analyzing the economics of commercial leasehold markets in Hawaii and the United States;
- Documenting changes in commercial lease rents and the price of commercial real estate in Hawaii over time;
- Analyzing the effect of renegotiated long-term commercial lease rents on competition and performance in selected industries that rely on leased commercial real estate;
- Determining whether there is a nexus between changes in commercial lease rents and the performance of Hawaii's economy during the previous two decades; and
- Developing policy proposals to improve the performance of rental markets for commercial leaseholds in Hawaii.

A draft report would be submitted to the Bureau in November 2013 in preparation for the Regular Session of 2014. The draft research plan estimates that the project would cost just under \$200,000, with a majority of the funds devoted to faculty, graduate and undergraduate student assistants, and miscellaneous support staff expenses. It should be noted that the draft research plan was not intended to be a formal University proposal.

As DBEDT's Research and Economic Analysis Division and UHERO have each stated that they are currently unable to conduct the economic analysis requested by the Resolution, the Bureau is unable 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 Hawaii's economy. The Bureau has neither the personnel nor the expertise to undertake a comprehensive empirical fact gathering analysis, nor is it equipped 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.

Organization

This opening chapter discusses the direction and task set forth by Senate Concurrent Resolution No. 90, S.D. 1, the responses received from DBEDT's Research and Economic Analysis Division and UHERO, and the scope of the study. Chapter 2 provides background information regarding legislative attempts to address the problems faced by commercial lessees prior to the Bureau's 2003 report, including analysis of three opinion letters drafted by the Attorney General. Chapter 3 presents a brief overview of the Bureau's 2003 report, entitled "Real Property Leases," including its findings and recommendations. Chapter 4 provides an overview of related legislative action since the Bureau's 2003 report. Chapter 5 contains the Bureau's findings and recommendations.

Chapter 2

BACKGROUND AND LEGISLATION PRIOR TO 2003

During the period from 1985 to 1990, a time that would come to be known as the "Japanese bubble," it is estimated that Japanese investments in Hawaii real estate totaled approximately \$15,000,000.¹ This influx in foreign capital inflated local land values to levels that were unsustainable by the properties' economic uses.² The artificially high land values were then used as comparables in rent renegotiations for commercial and industrial leasehold properties.³

Further complicating the situation was the fact that many of the long-term ground leases contained a clause that prohibited new lease rents that are less than the previous rent.⁴ In many cases, the "not less than" clause in the leases resulted in lease rents remaining higher than they would have if the renegotiated lease rents had been based on lower land values following the bursting of the Japanese bubble. The Legislature has found that the increased lease rentals imposed hardships on lessees engaged in a wide range of commercial activities.⁵ This has forced a number of lessees to undertake cost-cutting measures, including downsizing their businesses, reducing employee work hours and benefits, postponing improvements, and reducing capital investments.⁶ Some lessees have been faced with the forfeiture of valuable improvements, mortgage foreclosure, or bankruptcy due to the inability to pay their ground rents.⁷

Business Leasehold Task Force

During the Regular Session of 1993, the Legislature adopted House Concurrent Resolution No. 312, H.D. 2, S.D. 1, entitled "Convening a Task Force to Study the Major Problems Facing Commercial Land Lessees." The Legislature found that speculative purchases by foreign investors contributed to businesses experiencing dramatic increases in lease rents upon renegotiation.⁸ The Legislature further found that, despite declining property values, land owners perpetuated the overvaluation of their properties by basing lease rent renegotiation upon "fair market value."⁹ Accordingly, the Legislature requested that a task force be established and convened to study, among other things:

- Whether rents being renegotiated at the time were economically feasible for commercial, industrial, and hotel lessees;

1. Senate Concurrent Resolution No. 89, S.D. 1 (2003), first *Whereas* clause.

2. *Id.*

3. Maehara, Eric, *Real Property Leases*. Honolulu, HI: Legislative Reference Bureau, page 1, December 2003.

4. Senate Concurrent Resolution No. 89, S.D. 1 (2003), second *Whereas* clause

5. House Stand. Com. Rep. No. 1672 (2003).

6. Senate Concurrent Resolution No. 89, S.D. 1 (2003), third *Whereas* clause.

7. *Id.* at fourth *Whereas* clause.

8. House Concurrent Resolution No. 312, H.D. 2, S.D. 1 (1993), second *Whereas* clause.

9. *Id.* at third *Whereas* clause.

- How hotel and small commercial businesses were affected by high lease rents;
- Whether there was a need to introduce legislation limiting or placing a cap on the amount by which lease rents could be increased upon renegotiation; and
- Whether there was a need to introduce legislation requiring that market valuation of income-producing property be appraised more as a function of economic productivity than of potential, speculative value.

The membership of the Business Leasehold Task Force was extremely diverse and represented the views of a wide range of parties, including small businesses, large landowners, commercial developers, and appraisers, amongst others.¹⁰ Because it was apparent that the diversity of viewpoint would not lend itself to reaching consensus on the issues requested by the Legislature, the format decided upon by the task force for its report to the Legislature was a collection of each member's unedited position statement with respect to each issue, followed by the task force's conclusions and recommendations.¹¹

The Business Leasehold Task Force concluded that there was no single, simple solution to the problems surrounding the lease of commercial and industrial properties.¹² The task force did, however, recommend the following actions to ease some of the problems facing commercial lessees while remaining fair to the lessors:

- Laws should be enacted to ensure that arbitrators for lease rent renegotiation arbitrations are selected through a double blind process;
- 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;
- 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;
- The Legislature should urge counties to review their tax assessment procedures for conformity with the Uniform Standards of Professional Appraisal Practice; and

10. *House Concurrent Resolution Convening a Task Force to Study the Major Problems Facing Commercial Land Lessees*. Report to the 1994 Legislature, H.C.R. No. 312, H.D. 2, S.D. 1. Business Leasehold Task Force, page 1, 1994.

11. *Id.* at page 4.

12. *Id.* at page 117.

- 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 renegotiation.¹³

The Legislature did not act upon any of the Business Leasehold Task Force's specific recommendations.¹⁴

Related Legislation Prior to 2003

During the Regular Session of 2000, the Legislature adopted Senate Bill No. 873, S.D. 1, H.D. 2, which provided that for lease renegotiations that are based on fair market value as determined by a real property appraisal, if the fair market value is less than the current rental amount, the lower renegotiated rent shall prevail over any existing contractual provision that prohibits the lowering of lease rent upon renegotiation. However, then-Governor Benjamin Cayetano vetoed the bill, relying in large part on an Attorney General's opinion letter that expressed the view that the bill violated the Section 10 of Article I of the United States Constitution (Contracts Clause).¹⁵ The Governor's Statement of Objections to Senate Bill No. 873, S.D. 1, H.D. 2, noted that the bill would likely not pass constitutional muster because the legislative findings in support of the measure did not justify the resulting impairment of contracts.¹⁶

The House of Representatives then introduced and heard a substantially similar bill, House Bill No 1131, H.D. 1, during the Regular Session of 2001. Despite more extensive legislative findings in section 1 of the bill, the Attorney General again expressed the opinion that the contents of the bill violated the Contracts Clause of the United States Constitution.¹⁷ Ultimately, the bill was not reported out of the Senate Committee on Commerce, Consumer Protection and Housing.

The following year, during the Regular Session of 2002, House Bill No. 2245 was introduced. In its final form, House Bill No. 2245, H.D. 1, S.D. 1, provided for a one-time adjustment for leases renegotiated after January 1, 1990, to reflect fair market rental value, which would prevail over any existing contract provision to the contrary. Despite even more extensive legislative findings than House Bill No 1131, H.D. 1, the Attorney General opined that House Bill No. 2245, H.D. 1, S.D. 1, also resulted in an unconstitutional impairment of contractual obligations and relationships.¹⁸ The bill was not reported out of its Conference Committee.

13. *Id.* at pages 117-119.

14. Maehara, *Real Property Leases*, page 8.

15. See Appendix G for opinion letter from Attorney General to Representative Ron Menor regarding Senate Bill No. 873, S.D. 1, H.D. 2 (2000) (April 20, 2000).

16. Governor Cayetano's Statement of Objections to Senate Bill No. 873, S.D. 1, H.D. 2 (2000) (June 19, 2000).

17. See Appendix H for opinion letter from Attorney General to Senator Ron Menor regarding House Bill No. 1131, H.D. 1 (2001) (March 22, 2001).

18. See Appendix I for opinion letter from Attorney General to Senator Ron Menor regarding House Bill No. 2245, H.D. 1, S.D. 1 (2002) (April 11, 2002).

Relevant Case Law

In determining that Senate Bill No. 873, S.D. 1, H.D. 2, House Bill No. 1131, H.D. 1, and House Bill No. 2245, H.D. 1, S.D. 1, each violated the Contracts Clause of the United States Constitution, the Attorney General relied heavily on two cases brought before the Supreme Court of Hawaii. In the first case, *Anthony v. Kualoa Ranch, Inc.*, the Court held that the application of a statute requiring landlords, at tenants' option, to pay for leasehold improvements to a residential lease that was already in effect on the date that the statute was enacted was an unconstitutional impairment of contractual rights.¹⁹

The lease at issue in *Kualoa Ranch* was entered into in 1953 and contained an express agreement allowing lessees to remove, at their own expense, the building or buildings that were placed on the premises.²⁰ After the expiration of the lease in 1983, Appellee lessees filed suit for specific performance of an alleged agreement to enter into a new lease.²¹ As an alternative, lessees prayed for an order directing Appellant lessors to purchase from them the residential improvements existing on the premises, pursuant to section 516-70, HRS.²² Section 516-70, HRS, as amended in 1975, provided that if a lessee declines to remove onsite improvements and if the lessor refuses to extend the term of an existing lease or to issue a new lease, the lessor shall be required to compensate the lessee for the fair market value of the onsite improvements.²³

The trial court, among other things, rejected lessees' claims for specific performance, but ordered lessors to pay lessees the fair market value of the leasehold improvements as of the date of the expiration of the lease.²⁴ The lessors appealed the ruling to the Supreme Court of Hawaii, contending, in part, that section 516-70, HRS, violated Section 10 of Article I of the Constitution of the United States, which provides that "[n]o State shall...pass any...Law impairing the Obligation of Contracts[.]"²⁵

In examining related cases decided by the Supreme Court of the United States, the Court in *Kualoa Ranch* found that "it is clear that despite the apparent absolute language of the contracts clause, there are cases where, in the legitimate exercise of a state's police powers, statutes which impinge upon existing contractual rights can be validly enacted without contravening the constitutional prohibition."²⁶ However, the Court also noted that 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."²⁷

The Court found that section 516-70, HRS, "very substantially impaired" lessors' contractual rights by obliging them, involuntarily and at the sole option of the lessees, to pay for the residential improvements in order to get the leased premises back, even though the lease had

19. *Anthony v. Kualoa Ranch, Inc.*, 69 Haw. 112, 736 P.2d 55 (1987).

20. *Id.* at 114, 736 P.2d 57.

21. *Id.*

22. *Id.*

23. *Id.* at 115-116, 736 P.2d 58.

24. *Id.* at 114, 736 P.2d 57.

25. *Id.* at 117, 736 P.2d 59.

26. *Id.* at 118-119, 736 P.2d 60.

27. *Id.* at 119-120, 736 P.2d 60.

expired.²⁸ The Court reasoned that if the legislature's desire to accomplish equity could justify this substantial and material change in the contractual obligations, then it could also be used to justify changing any other material terms of existing lease agreements.²⁹ The Court stated:

"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."³⁰

Accordingly, the Supreme Court of Hawaii held that section 516-70, HRS, as applied to leases existing at the time of the 1975 amendment, was unconstitutional.³¹

Conversely, in *Applications of Herrick & Irish*, the Supreme Court of Hawaii rejected Appellants' contention that decisions by the Hawaii Board of Certified Shorthand Reporters (Board) resulted in unconstitutional impairment of their contracts.³² The facts in that case stem from the Court's promulgation of the Rules Governing Court Reporting (RGCR), which require a court reporter to be certified in accordance with the RGCR in order for the reporter's transcripts to be used in any court in Hawaii.³³ To be certified under the RGCR, an applicant must pass a proficiency examination that includes a written examination and a speed and accuracy test.³⁴ As originally drafted, if an applicant did not pass the examination, the RGCR allowed the applicant to apply for up to two temporary certificates, provided that the applicant continued to take the examinations.³⁵ On March 7, 1990, the Supreme Court of Hawaii amended the RGCR to allow a temporarily certified shorthand reporter to renew a temporary court reporter certificate indefinitely, provided that the reporter continued to take the examination.³⁶ However, amid criticism and at the recommendation of the Board, the Court repealed the temporary certification provisions on November 10, 1992, giving then-current temporarily certified shorthand reporters until November 1993 to obtain certification.³⁷

At the time that temporary certification was repealed, Appellants Kelly Herrick and Catherine Irish were temporarily certified shorthand reporters.³⁸ Because both Appellants failed to pass the certification examination by the November 1993 deadline, the Board informed them that their temporary certificates lapsed on January 6, 1994.³⁹

28. *Id.* at 119, 736 P.2d 60.

29. *Id.* at 123, 736 P.2d 63.

30. *Id.*

31. *Id.*

32. *Applications of Herrick & Irish*, 82 Haw. 329, 922 P.2d 942 (1996).

33. *Id.* at 332, 922 P.2d at 945.

34. *Id.* at 333, 922 P.2d at 946.

35. *Id.* at 334, 922 P.2d at 947.

36. *Id.*

37. *Id.* at 336, 922 P.2d at 949.

38. *Id.*

39. *Id.*

The Appellants requested from the Board a special exemption from the repeal of temporary certification, or for continued temporary certification, but the Board denied the request in October 1994.⁴⁰ The Appellants appealed the Board's denial with the Supreme Court of Hawaii, arguing in part that their freelance court reporting services constituted a business enterprise that was entitled to constitutional protection against the impairment of contracts.⁴¹ They insisted that "[e]xcept for the repeal of Reporter Rule 11, both applicants would have enjoyed continued contractual rights and income from work on in-state deposition jobs. The repeal of temporary certification has prevented them from working on in-state deposition jobs and caused them to lose significant income."⁴²

In examining the merits of Appellants' case, the Supreme Court of Hawaii set forth the test to be applied in determining whether a statute is constitutional under the Contracts Clause 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 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.⁴³

In examining the first prong of the three-step analysis, the Court found that there was no substantial impairment of a contractual relationship. The record did not show that the Appellants had transcribing contracts at the time that temporary certification was repealed.⁴⁴ Moreover, even if Appellants had an existing contract at the time of repeal, it was not the repeal that would have impaired their contracts, but rather Appellants' failure to pass the certification examination within the grace period after the repeal.⁴⁵ Further, assuming that the Appellants had a contractual relationship impaired, the Court found that the impairment was not "substantial."⁴⁶

Having found that there was no substantial impairment of a contractual relationship, it was not necessary for the Court to examine the final two prongs of the analysis. However, the Court concluded that, even assuming the repeal of temporary certification did substantially impair Appellants' contractual relationships, the remaining two elements of the analysis were not satisfied. The Court found that the purpose of promulgating and amending the RGCR, which is to expedite the orderly administration of justice, should be viewed as serving a significant and legitimate public purpose. Therefore, the amendment of the RGCR by repealing temporary certification served a significant and legitimate public purpose.⁴⁷ Further, the Court found that

40. *Id.*

41. *Id.*

42. *Id.* at 340, 922 P.2d at 953.

43. *Id.*

44. *Id.*

45. *Id.* at 340-341, 922 P.2d at 953-954.

46. *Id.* at 341, 922 P.2d at 954.

47. *Id.* at 341-342, 922 P.2d at 954-955.

the RGCR rule in question was narrowly-drawn to accomplish the public purpose for which it was intended, the orderly and efficient administration of justice.⁴⁸

Attorney General's Opinion Letters

Based in large part on the Supreme Court of Hawaii's holdings in *Kualoa Ranch* and *Applications of Herrick & Irish*, the Attorney General determined that Senate Bill No. 873, S.D. 1, H.D. 2, House Bill No. 1131, H.D. 1, and House Bill No. 2245, H.D. 1, S.D. 1, violated the Contracts Clause of the United States Constitution. Specifically, the Attorney General opined that each of the bills failed to meet the three-part test set forth in *Applications of Herrick & Irish*.

The Attorney General found it clear that existing leases could be impaired by Senate Bill No. 873, S.D. 1, H.D. 2, and House Bill No. 1131, H.D. 1.⁴⁹ With respect to House Bill No. 2245, H.D. 1, S.D. 1, the Attorney General declared that "[i]t is clear that this bill changes contractual obligations."⁵⁰ The severity of the impairment of the leases would depend upon the amount of lost revenue. While this cannot be determined with actual facts surrounding a lease rent renegotiation, the Attorney General stated:

[T]he consequent loss of lease rent income which the lessors may rely upon to pay mortgages, bills, distributions to trust beneficiaries, and other expenses could be substantial. Consequently, the potential harm to lessors and existing contractual rights and expectations under the bill could indeed be a substantial impairment of their contractual relationships with lessees.⁵¹

Having determined that the three bills could substantially impair contractual relationships, the Attorney General addressed whether the bills were designed to promote a significant and legitimate public purpose. The Attorney General stated that, like the legislative action that was at issue in *Kualoa Ranch*, there did not appear to be a broad societal benefit that supported the changes proposed by Senate Bill No. 873, S.D. 1, H.D. 2, and House Bill No. 1131, H.D. 1.⁵² Senate Bill No. 873, S.D. 1, H.D. 2, did not cite any broad societal benefits and the Attorney General concluded that the public purpose discussion in House Bill No. 1131, H.D. 1, "[did] not appear to be sufficiently compelling to withstand constitutional scrutiny."⁵³ The Attorney General also noted that these two bills failed to provide a pass-through of any reduction in lease rent to sublessees. This denial of benefits to sublessees, who were the lessees

48. *Id.* at 342, 922 P.2d at 955.

49. Opinion letter from Attorney General to Representative Ron Menor regarding Senate Bill No. 873, S.D. 1, H.D. 2 (2000) (April 20, 2000), page 2; opinion letter from Attorney General to Senator Ron Menor regarding House Bill No. 1131, H.D. 1 (2001) (March 22, 2001), page 3.

50. Opinion letter from Attorney General to Senator Ron Menor regarding House Bill No. 2245, H.D. 1, S.D. 1 (2002) (April 11, 2002), page 2.

51. Opinion letter from Attorney General to Senator Ron Menor regarding House Bill No. 1131, H.D. 1 (2001) (March 22, 2001), page 3.

52. Opinion letter from Attorney General to Representative Ron Menor regarding Senate Bill No. 873, S.D. 1, H.D. 2 (2000) (April 20, 2000), page 3; opinion letter from Attorney General to Senator Ron Menor regarding House Bill No. 1131, H.D. 1 (2001) (March 22, 2001), page 4.

53. *Id.*

most in need of assistance, contradicted any statement of public purpose.⁵⁴ Accordingly, the Attorney General concluded that a court could find that Senate Bill No. 873, S.D. 1, H.D. 2, and House Bill No. 1131, H.D. 1, do not appear to "promote a significant and legitimate public purpose," nor do they appear to be a reasonable and narrowly-drawn means of "promoting the significant and legitimate public purpose," thereby failing the final two criteria for determining whether a law is violative of the contract clause."⁵⁵

Similarly, the Attorney General opined that House Bill No. 2245, H.D. 1, S.D. 1, failed to further a broad societal interest. Section 1 of the bill stated that the Legislature intended to promote economic stability. However, the Attorney General believed it unclear as to why the bill's one-time lease adjustment would promote economic stability, stating that "[i]n spite of the findings in section 1, we cannot conclude that the bill meets its stated purpose of economic stability or furthers a broad societal interest."⁵⁶ Further, the Attorney General contended that even if the bill was designed to promote a significant and legitimate public purpose, the bill did not appear to provide a reasonably and narrowly-drawn means to accomplish the public purpose.⁵⁷ Accordingly, the Attorney General concluded that House Bill No. 2245, H.D. 1, S.D. 1, violated the Contracts Clause "in that it substantially impairs contractual relationships without promoting a significant and legitimate broad societal interest."⁵⁸

54. Opinion letter from Attorney General to Representative Ron Menor regarding Senate Bill No. 873, S.D. 1, H.D. 2 (2000) (April 20, 2000), pages 3-4; opinion letter from Attorney General to Senator Ron Menor regarding House Bill No. 1131, H.D. 1 (2001) (March 22, 2001), pages 5-6.

55. *Id.*, citing *Applications of Herrick & Irish*, 82 Haw. 329, 340, 922 P.2d 942, 953 (1996).

56. Opinion letter from Attorney General to Senator Ron Menor regarding House Bill No. 2245, H.D. 1, S.D. 1 (2002) (April 11, 2002), pages 2-3.

57. *Id.* at page 3.

58. *Id.*

Chapter 3

THE BUREAU'S 2003 REPORT

During the Regular Session of 2003, the Legislature adopted Senate Concurrent Resolution No. 89, S.D. 1, entitled "Requesting a Study on Real Property Leases." The resolution made reference to the adverse impacts that the Japanese bubble and the "not less than" lease clause had upon Hawaii's economy, increasing unemployment and reducing tax revenues.¹ Stating that ten years had passed since the Business Leasehold Task Force was convened, the resolution requested the Bureau to "study the major problems still facing commercial and other land lessees."² The resolution further requested the Bureau, in conducting the study, to consult with:

- Any individual, agency, or organization representative with a direct interest in the issues;³ and
- The Attorney General for legal issues, opinions, and advice relating to any relevant constitutional issues.⁴

In undertaking the study, the Bureau prepared and disseminated a questionnaire to persons and organization that represented a broad spectrum of opinions on this issue.⁵ The interested parties ranged 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.⁶

Due to the varying perspectives on the issues, separate questionnaires were prepared and sent to persons or organizations identified as lessors or as lessees.⁷ The primary purpose of the questionnaires was to determine the direct effect of the Japanese bubble on rent renegotiations.⁸ The Bureau also solicited comments on the issues from a number of real estate analysts.⁹ Finally, Bureau staff had various conversations with representatives of lessors and lessees, real estate appraisal firms, and financial institutions.¹⁰

1. Senate Concurrent Resolution No. 89, S.D. 1 (2003), fifth *Whereas* clause.

2. *Id.* at Be it Resolved clause.

3. *Id.* at first *Be it Further Resolved* clause.

4. *Id.* at second *Be it Further Resolved* clause.

5. Maehara, *Real Property Leases*, page 2.

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.*

SMS Economic Impact Report

In response to the Bureau's questionnaire, one lessor submitted an economic report entitled *Economic Impact Report on Commercial and Industrial Lease Rent Issues*, prepared by SMS and dated October 2003.¹¹ The SMS report utilized data that was generally available to the public to address the claims contained in Senate Concurrent Resolution No. 89.

The SMS report made the following conclusions:

- There was little correlation between industrial lease rents and the overall direction of the economy;¹²
- Hawaii businesses were not failing at a high rate. In fact, the number of bankruptcy filings by businesses was decreasing and business confidence was rising;¹³
- There was no data to support the idea that the increasing lease rents, which had increased slower than inflation, was a major problem for businesses in Hawaii;¹⁴ and
- The claim that lease rents were at unsustainable levels was inaccurate, as evidenced by low vacancy rates.¹⁵

The SMS report also concluded that legislation by the State to change the terms of existing commercial contracts would have a chilling effect on foreign investment.¹⁶ The prospect of a government that is willing to revise existing contracts would make investment in Hawaii appear too risky and thus affect the investment climate stability.¹⁷

Bureau's Observations and Recommendations

Taking into consideration the responses to the questionnaires, data collected, and the SMS report, the Bureau reached the following concluding observations regarding commercial and industrial leaseholds:

- While the Japanese bubble may have impacted the leasehold system in the past, it appeared to have minimal, if any, continuing effect. While a majority of lessees cited the "not less than" clause as the main problem in their leases,

11. *Economic Impact Report on Commercial and Industrial Lease Rent Issues*. SMS, prepared for Kamehameha Schools. October 2003.

12. *Id.* at page 10.

13. *Id.* at page 8.

14. *Id.* at page 12.

15. *Id.* at page 12.

16. *Id.* at page 13.

17. *Id.*

none claimed that the Japanese bubble was a major problem in rent renegotiation;¹⁸

- According to the SMS economic report and the real estate analysts that the Bureau consulted with, lease rents were probably "right where they should be";¹⁹
- There were conflicting reports regarding the burden of lease rents. While lessees reported that their lease rents were in excess of 50% of their costs of doing business, the SMS report concluded that lease rents are not a major component of doing business in Hawaii;²⁰
- According to lessees, the high concentration of leasehold control by a small handful of large landowners caused problems in renegotiating lease rents due to the shortage of comparable fee simple transactions to use to establish fair market values;²¹
- The Department of Business, Economic Development, and Tourism indicated that, overall, business in Hawaii appeared healthy;²² and
- One of the main problems cited by lessees was the presence of a "not less than" clause. Despite numerous attempts to enact legislation that would alter terms of existing lease agreements, most of these attempts failed due to Attorney General opinion letters concluding that the bills violated the Contracts Clause of the United States Constitution. 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.²³

Ultimately, the Bureau concluded that the primary problem facing lessees was the lack of available fee simple commercial and industrial property on the market.²⁴ There was insufficient commercial and industrial zoned land, fee simple and leasehold, in the market place.²⁵ Accordingly, the Bureau's recommendations largely focused on steps the Legislature could consider to make more fee simple property available for commercial or industrial use.²⁶ The Bureau also suggested that the Legislature could direct the Director of Commerce and Consumer Affairs to convene a group of stakeholders to explore methods of appraisal that may be fairer and more equitable to all parties.²⁷ While establishing a more equitable method of determining lease

18. Maehara, *Real Property Leases*, page 22-23.

19. *Id.* at 23.

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.* at 23-24.

24. *Id.*

25. *Id.*

26. *Id.* at 24-26.

27. *Id.* at 26.

rents may not relieve the need for more available commercial and industrial lands or address lessee concerns regarding their present leases, the Bureau posited that it may help future lessees avoid some of the pitfalls being experienced by the then-current lessees.²⁸

Low Response Rate

It should be noted that the response rate for the questionnaires disseminated by the Bureau was very low. A total of fourteen questionnaires were sent to lessors and fifty-six questionnaires were sent to lessees.²⁹ Although the responses to the questionnaires were deemed to be confidential, the Bureau received only five responses from lessors and thirteen responses from lessees.³⁰ With the exception of one lessor with land holdings on three separate islands, the responders were all located on the island of Oahu.³¹

Given the low response rate, it is unclear how much weight can be given to the questionnaire responses that the Bureau received from lessors and lessees. For example, the lessees who responded to the questionnaire claimed that their lease rent costs had risen at a much higher rate than their other costs of doing business.³² The reported lease rent costs ranged between 14% and 66% of their total costs of doing business, with most at or around 50%.³³ However, the SMS economic impact report concluded that lease rents are not a major component in the increasing cost of doing business in Hawaii.³⁴ It is possible that lessees who were being substantially impacted by lease rents in the operation of their business were more inclined to respond to the Bureau's questionnaire.³⁵

The responses to the Bureau's questionnaire show that at least some lessees believed that their lease rents were a heavy burden. However, it is uncertain whether this feeling could be generalized to lessees throughout the State or was specific to those lessees that responded to questionnaire. Similarly, as all but one responder were located only on the island of Oahu, it is unclear whether the questionnaire results may reasonably be generalized for commercial leaseholds throughout the State, or are specific to lessors and lessees on the island of Oahu.

28. *Id.* at 27.

29. *Id.* at 2.

30. *Id.*

31. *Id.* at 13.

32. *Id.* at 17.

33. *Id.*

34. *Economic Impact Report on Commercial and Industrial Lease Rent Issues*, page 10.

35. Maehara, *Real Property Leases*, page 23.

Chapter 4

LEGISLATION SINCE 2003

Bills Introduced

During the Regular Session of 2003, the House of Representatives reprised the one-time adjustment contained in House Bill No. 2245, H.D. 1, S.D. 1, this time in the form of House Bill No. 648. With legislative findings spanning the first twenty-three pages of the bill, House Bill No. 648 authorized a one-time adjustment of any ground lease that had been renegotiated after January 1, 1990, to reflect fair market rental value as determined by a real property appraisal.¹ Unlike previous legislation, however, House Bill No. 648 provided that the adjusted rent could not be lower than the rental amount negotiated pursuant to the lease prior to January 1, 1985.² Further, the one-time adjustment provision of the bill was to be automatically repealed on December 31, 2006, or three years after a final court decision upholding its validity if challenged, whichever occurred later.³

Upon introduction, House Bill No. 648 passed First Reading and was referred to the House Committees on Consumer Protection and Commerce and Finance. Ultimately, the bill was carried over to the 2004 Regular Session and was re-referred to the House Committee on Consumer Protection and Commerce, which recommended that the measure be held. Two bills that were virtually identical to House Bill No. 648 were also introduced in the Senate during the Regular Session of 2003, in the form of Senate Bill No. 903 and Senate Bill No. 905. Though they were both referred to the Senate Committee on Commerce, Consumer Protection and Housing, neither received a hearing.

Citing the Japanese bubble and the limited availability of fee simple commercial and industrial properties, Senate Bill No. 2642, introduced during the Regular Session of 2004, would have established an advisory task force to review methods of arriving at renegotiated lease rents. The bill required the task force to consider the use of indices, other than fair market value based upon comparable sales prices, to establish lease rents for commercial and industrial properties. The bill was not heard.

The Regular Session of 2005 again saw the introduction of a bill that would offer relief to lessees through a one-time adjustment, this time in the form of Senate Bill No. 28. Unlike previous legislation, Senate Bill No. 28 authorized the one-time adjustment upon a determination by the appropriate circuit court that the renegotiated lease rent was inequitable due to circumstances beyond the control of and unforeseen by the parties of the lease. Also introduced that year, Senate Bill No. 2 prohibited any future lease provision that would prohibit or preclude a renegotiated rent in an amount less than the current rent. Both Senate Bill No. 28 and Senate Bill No. 2 carried over to the 2006 Regular Session, but were never heard.

-
1. House Bill No. 648 (2003), page 27.
 2. *Id.*
 3. *Id.* at 28.

Act 189

The Legislature also attempted to alleviate the economic burden on lessees of commercial and industrial properties by enacting Act 189, Session Laws of Hawaii 2009. Act 189 required that, for commercial and industrial leases that include a provision that renegotiated rental amounts shall be based on a "fair and reasonable" annual rent, the provision be construed to require that the rent be fair and reasonable to both the lessor and the lessee. Act 189 further required that the lease provision take into account all relevant attendant circumstances relating to the lease, including the uses and intensity of the use of the leased property and the surface and subsurface characteristics of the leased property and surrounding neighborhood. Act 189 became law without the Governor's signature.

Given the detailed specifications in Act 189, including square footage owned by a lessor, duration of lease, and lease language, HRPT Properties Trust (HRPT), through its subsidiaries, was the sole landowner covered by the law. Accordingly, HRPT brought suit against then-Governor Lingle on the grounds that, among other things, Act 189 ran afoul of the Contract Clause and the Equal Protection Clause of the United States Constitution.

In *HRPT Properties Trust v. Lingle*,⁴ the United States District Court, District of Hawaii, utilized the three-prong analysis to determine whether Act 189 violated the Contracts Clause of the United States Constitution.⁵ The court found that the first prong, whether the contractual relationship was impaired, was clearly satisfied.⁶ The court also found that the articulated goal of Act 189, which was to stabilize the state economy, was a significant and legitimate public purpose, thus satisfying the second prong.⁷ Upon identifying a legitimate public purpose, the court examined whether Act 189 was "based upon reasonable conditions and is of a character appropriate to the public purpose justifying the legislation's adoption."⁸ The District Court held that Act 189 failed the third prong because it did not "reasonably or justifiably further the legitimate purpose of stabilizing Hawaii's economy" and thus it violated the Contracts Clause of the United States Constitution.⁹

The District Court also held that Act 189 violated the Equal Protections Clause of the United States Constitution by unfairly targeting HRPT.¹⁰ The court found that Act 189 was deliberately tailored to cover only HRPT's leases and noted that no one had advanced any rational reason to justify that, out of all landowners, HRPT alone should be targeted by Act 189.¹¹ The court held that this specific classification was not a rational means of stabilizing Hawaii's economy and, therefore, it violated the Equal Protections Clause.¹²

4. *HRPT Properties Trust v. Lingle*, 715 F.Supp.2d 1115 (D.Hawaii 2010).

5. *Id.* at 1135. See also discussion at notes 43-48 of chapter 2 *supra* and accompanying text.

6. *HRPT Properties Trust*, 715 F.Supp.2d at 1136.

7. *Id.* at 1137.

8. *Id.* (citing *Energy Reserves Group, Inc.*, 459 U.S. at 412, 103 S.Ct. 697).

9. *Id.* at 1140.

10. *Id.*

11. *Id.* at 1142.

12. *Id.*

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

FINDINGS AND RECOMMENDATIONS

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.

Appendix A

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.

1 WHEREAS, commercial properties in the State remain in the
2 hands of a few large landowners who maintain a system of
3 leasehold tenure and continue to establish long-term leases; and
4

5 WHEREAS, in 2003 the Legislature requested the Legislative
6 Reference Bureau to study the major problems facing commercial
7 lessees; and
8

9 WHEREAS, the Legislative Reference Bureau's report
10 contained feedback from lessees and lessors, and also reviewed
11 information from real estate analysts, real property tax data,
12 an economic report prepared by SMS, and information from the
13 Department of Business, Economic Development, and Tourism; and
14

15 WHEREAS, one of the concluding observations noted in the
16 report was that the feedback for the report indicated there was
17 a lack of available fee simple commercial property on the
18 market; and
19

20 WHEREAS, the report also observed that the primary problem
21 lessees in the State face tended to stem from supply and demand;
22 and
23

24 WHEREAS, there has been an increase in the outlying areas
25 on Oahu of fee simple, zoned properties since the 2003 report,
26 thus allowing for a comparative analysis of market behaviors
27 through changing economic conditions; and
28

1 WHEREAS, ground rents have been previously identified as a
2 major expense to business and have continued to increase at
3 rates that may inhibit robust economic growth; and
4

5 WHEREAS, the State's need for economic revitalization would
6 be furthered by a healthy leasehold system in which the risks
7 assumed by the respective parties of the lease, the benefits
8 created by the development, and activities established on the
9 leasehold property are equitably reflected in the setting of the
10 ground rents under the terms of the lease; and
11

12 WHEREAS, potential legislation that mandates the alteration
13 of existing lease agreements must meet certain criteria,
14 including whether the legislation was designed to promote a
15 significant and legitimate public purpose; and
16

17 WHEREAS, the Legislature finds that sustained economic
18 growth of the State's economy is a significant and legitimate
19 public purpose; and
20

21 WHEREAS, a thorough economic analysis should be conducted
22 to determine if there is a nexus between the existence of high
23 lease rents in Hawaii and the stagnation of Hawaii's economy;
24 and
25

26 WHEREAS, almost ten years have passed since an economic
27 analysis was undertaken and incorporated into a report on the
28 problems faced by commercial lessees; now, therefore,
29

30 BE IT RESOLVED by the Senate of the Twenty-sixth
31 Legislature of the State of Hawaii, Regular Session of 2012, the
32 House of Representatives concurring, that the Legislative
33 Reference Bureau is requested to update their 2003 report
34 analyzing the major problems faced by commercial lessees by
35 incorporating an economic analysis to determine if there is a
36 nexus between the existence of high lease rents in Hawaii and
37 the stagnation of Hawaii's economy; and
38

39 BE IT FURTHER RESOLVED that the Research and Economic
40 Analysis Division of the Department of Business, Economic
41 Development, and Tourism and the Economic Research Organization
42 at the University of Hawaii at Manoa are requested to conduct
43 the economic analysis; and
44

1 BE IT FURTHER RESOLVED that the Research and Economic
2 Analysis Division of the Department of Business, Economic
3 Development, and Tourism and the Economic Research Organization
4 at the University of Hawaii at Manoa are requested to transmit a
5 draft report of the economic analysis, including any proposed
6 legislation, to the Legislative Reference Bureau no later than
7 November 1, 2012; and
8

9 BE IT FURTHER RESOLVED that the Legislative Reference
10 Bureau is requested to submit a final report of the economic
11 analysis, including any proposed legislation, to the Legislature
12 no later than twenty days prior to the convening of the Regular
13 Session of 2013; and
14

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

SENATE CONCURRENT RESOLUTION

REQUESTING A STUDY ON REAL PROPERTY LEASES.

1 WHEREAS, during the "Japanese bubble" period covering 1985
2 to 1990, Japanese investments in Hawaii real estate totaled
3 approximately \$15,000,000,000, sending land prices spiraling
4 upward to levels unsustainable by the properties' economic uses;
5 and
6

7 WHEREAS, these artificially high land values were used as
8 the basis for the calculation of highly inflated long-term
9 ground leases, and many of these leases do not permit new lease
10 rents that are less than the previous rent; and
11

12 WHEREAS, having to pay these inflated lease rents has
13 imposed a burden on some lessees who have been forced to
14 undertake cost-cutting measures such as downsizing their
15 businesses, reducing employee work hours and benefits,
16 postponing improvements, and reducing capital investments; and
17

18 WHEREAS, some lessees who were not able to pay their ground
19 rents have had to walk away from their properties and forfeit
20 valuable improvements, and some face mortgage foreclosures or
21 bankruptcy; and
22

23 WHEREAS, the failure of these businesses adversely impacts
24 upon Hawaii's economy, adding to the rolls of the unemployed and
25 reducing tax revenues; and
26

27 WHEREAS, in 1993, the House of Representatives and the
28 Senate adopted H.C.R. No. 312 which created a task force to
29 examine the problems of lessees; and
30

31 WHEREAS, the task force report stated, "Commercial lease
32 rents have increased in recent years. Contracts negotiated some
33 20 to 30 years ago are coming up for renegotiation and some of
34 the lessees have found themselves facing increases in excess of
35 200%. Some are mom and pop operations and neighborhood shops.

1 Increasingly, however, larger businesses, retail chains and
2 other local commercial operations have been forced to shut their
3 doors as their business becomes unviable. Sadly, many jobs are
4 lost, the goods and services they provided in our neighborhoods
5 and communities are lost, their business to supporting
6 industries are lost, the opportunities for our local businesses
7 and entrepreneurs are lost." The task force also found fault
8 with the practice of settling disputes over value by use of
9 arbitration and recommended change; and

10
11 WHEREAS, now that ten years have passed and many problems
12 for lessees still remain; now, therefore,

13
14 BE IT RESOLVED by the Senate of the Twenty-second
15 Legislature of the State of Hawaii, Regular Session of 2003, the
16 House of Representatives concurring, that the Legislative
17 Reference Bureau is requested to study the major problems still
18 facing commercial and other land lessees; and

19
20 BE IT FURTHER RESOLVED that, in conducting the study, the
21 Legislative Reference Bureau is requested to consult with
22 representatives of the Kamehameha Schools, the Hawaii Bankers
23 Association, the Small Landowners of Oahu and Small Landowners
24 Association of Hawaii, the Land Use Research Foundation of
25 Hawaii, the Hawaii Council of Associations of Apartment Owners,
26 and any individual or agency or organization representative with
27 a direct interest in the issues to ensure that all stakeholders
28 are allowed to express their thoughts and concerns; and

29
30 BE IT FURTHER RESOLVED that the Legislative Reference
31 Bureau also is requested to consult with the Attorney General
32 for legal issues, opinions, and advice relating to any
33 constitutional issues related to the study; and

34
35 BE IT FURTHER RESOLVED that the Legislative Reference
36 Bureau is requested to submit a report of its findings and
37 recommendations, including any proposed legislation, to the
38 Legislature no later than twenty days before the convening of
39 the Regular Session of 2004; and

40
41 BE IT FURTHER RESOLVED that a certified copy of this
42 Concurrent Resolution be transmitted to the Director of the
43 Legislative Reference Bureau.

Appendix C

STAND. COM. REP. NO.

3384

Honolulu, Hawaii

APR 13 2012

RE: S.C.R. No. 90
S.D. 1

Honorable Shan S. Tsutsui
President of the Senate
Twenty-Sixth State Legislature
Regular Session of 2012
State of Hawaii

Sir:

Your Committee on Commerce and Consumer Protection, to which was referred S.C.R. No. 90 entitled:

"SENATE CONCURRENT RESOLUTION REQUESTING THE INSURANCE COMMISSIONER TO CREATE A WORKING GROUP TO STUDY WAYS TO INCREASE COMPETITION IN HAWAII'S HEALTH INSURANCE MARKET,"

begs leave to report as follows:

The purpose and intent of this measure is to request the Insurance Commissioner to form a working group to study ways to increase competition in Hawaii's health insurance market.

Prior to the hearing on this measure, your Committee made available for public review and comment, a proposed S.D. 1 of this measure. The proposed S.D. 1 deleted the contents of the measure and inserted language that requested the Legislative Reference Bureau to update their 2003 report analyzing the major problems still facing commercial and other land lessees.

Your Committee received testimony in support of the proposed S.D. 1 from the Citizens for Fair Evaluation; McCully Works, Inc.; Chika Nakano Repair Shop; Central Park Community Association, Halawa Valley; and twenty-five individuals. Your Committee received testimony in opposition to the proposed S.D. 1 from the Small Landowners Association. Your Committee received comments on the proposed S.D. 1 from the Legislative Reference Bureau.

Your Committee finds that issues surrounding leasehold tenure and its effect on commercial property in the State date back many

years. In 2003, the Legislative Reference Bureau was requested to study the major problems facing commercial lessees in the State. The Legislative Reference Bureau's report noted several general observations about commercial lessees in the State. The report also referenced constitutional concerns that had to be addressed before existing contractual obligations, such as lease agreements, could be amended. Your Committee understands that before the Legislature may pass legislation potentially altering existing lease agreements, certain criteria must be met, including whether the legislation was designed to promote a significant and legitimate public purpose. Your Committee notes that the Legislative Reference Bureau's report incorporated an economic analysis relating to commercial leases, but nearly ten years have passed since the report was submitted.

Your Committee further finds that a current economic analysis would be helpful 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 is established, this could provide a basis for the Legislature to consider future legislation that may affect commercial leaseholds, while also promoting a significant and legitimate public purpose such as the State's sustained economic growth. Your Committee concludes that amendments to the proposed S.D. 1 of this measure are necessary to narrow its scope and clarify that only commercial leases will be analyzed.

Accordingly, your Committee has amended this measure by adopting the proposed S.D. 1 and further amending the measure by:

- (1) Clarifying 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;
- (2) Clarifying 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, rather than the Legislative Reference Bureau through consultation with the Governor's office, Attorney General, and others, are requested to conduct the economic analysis;

- (3) Requesting 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 transmit a draft report of the economic analysis, including any proposed legislation, to the Legislative Reference Bureau no later than November 1, 2012;
- (4) Clarifying 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;
- (5) Amending the title and other findings for accuracy; and
- (6) Making technical, nonsubstantive amendments for the purposes of clarity and consistency.

As affirmed by the record of votes of the members of your Committee on Commerce and Consumer Protection that is attached to this report, your Committee concurs with the intent and purpose of S.C.R. No. 90, as amended herein, and recommends its adoption in the form attached hereto as S.C.R. No. 90, S.D. 1.

Respectfully submitted on
behalf of the members of the
Committee on Commerce and
Consumer Protection,


ROSALYN H. BAKER, Chair

JUN 29 RECD



Appendix D

DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT & TOURISM

NEIL AMBERCROMBIE
GOVERNOR
RICHARD C. LIM
DIRECTOR
MARY ALICE EVANS
DEPUTY DIRECTOR

No. 1 Capitol District Building, 250 South Hotel Street, 5th Floor, Honolulu, Hawaii 96813
Mailing Address: P.O. Box 2359, Honolulu, Hawaii 96804
Web site: www.hawaii.gov/dbedt

Telephone: (808) 586-2355
Fax: (808) 586-2377

June 26, 2012

To: Ms. Charlotte A. Carter-Yamauchi
Acting Director, Legislative Reference Bureau

Through: *for* Richard C. Lim, Director *Mary Alice Evans*

From: Eugene X. Tian, Ph.D. *E.T.*
Economic Research Administrator

Subject: Analysis on Commercial Lease Rents

I am writing to respond to your inquiry regarding the Research and Economic Analysis Division's capability and intention to conduct a study on the commercial lease rent as requested in the Senate Concurrence Resolution No. 90, S.D. 1 of the 2012 legislation.

At this time, we are unable to conduct such study for three reasons:

1. We do not have expertise in real-estate and legal issues;
2. We lack the necessary resources in our division, both budget and personnel;
3. Data needed for the study are not publically available; therefore, surveys would be needed to obtain data for the analysis which would cost tens of thousands of dollars (which were not appropriated by the legislature).

If you have any question, please contact me at 586-2474 or at xtian@dbedt.hawaii.gov.

JUN 19 REC'D

Appendix E

College of Social Sciences
University of Hawai'i Economic Research Organization



UNIVERSITY
of HAWAII
MĀNOA

June 14, 2012

Charlotte A. Carter-Yamauchi
Acting Director Legislative Reference Bureau
State of Hawaii
State Capitol, Room 446
415 S. Beretania Street
Honolulu, Hawaii 96813

Dear Mrs. Carter-Yamauchi,

Thank you for your inquiry into UHERO's research capacity regarding Economic Analysis of Commercial Lease Rents. I understand that the Senate adopted CR No. 90, S.D. 1 requesting that DBEDT and UHERO conduct an economic analysis with a deadline of November 1, 2012.

While this subject is worthy of additional study, and I would be happy to devote UHERO resources to some analysis as they become available, UHERO does not currently have either the data or the faculty resources to appropriately study this issue. The data necessary to correctly study the commercial lease hold issue in Hawaii is significant and to the best of my knowledge not readily available publicly. And, because no funds were allocated for this study, UHERO would be unable to hire economic consultants, graduate and undergraduate students that generally make up 50% of any research team assembled for UHERO projects. Should funding become available to cover data costs and the cost of hiring staff, UHERO would be happy to contribute to an analysis either jointly with DBEDT or separately. However, even with funding to support the desired economic analysis, UHERO would need much more time than the four and a half months between now and the November 1 deadline mentioned in your letter. Depending on the scope of the analysis, I would expect to spend more like eight to twelve months on such a study.

Feel free to contact me with any questions.

Sincerely,

A handwritten signature in black ink, appearing to read 'Carl Bonham', with a long, sweeping underline.

Carl Bonham
Executive Director, UHERO
(808) 956-7605

Appendix F

4 December 2012

UHERO Draft Research Plan For a Study of Commercial Leasehold and its Impact on Hawaii's Economy

Project Background

This project proposal is a response to a request by the 2012 Hawaii State Legislature for the University of Hawaii Economic Research Organization (UHERO) to conduct an economic analysis of commercial leasehold in Hawaii. The text of the resolution follows.

SCR 90, SD1

HIGH LEASE RENT AND STAGNATION OF HAWAII'S ECONOMY.

Requests 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.

Requests 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 to transmit a draft report of the economic analysis, including any proposed legislation, to the Bureau no later than November 1, 2012.

Requests the Bureau 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.

(SSCR 3384, HSCR 1801-12)

Outline of the Project

UHERO proposes to conduct a study that updates the Legislative Reference Bureau's 2003 Report, *Real Property Leases* (prepared by Eric Machara). The UHERO study will undertake the following tasks:

- Summarize selected published studies analyzing the economics of commercial leasehold markets in Hawaii and the United States.
- Document changes in commercial lease rents in Hawaii over time using available data.
- Document changes in the price of commercial real estate in Hawaii over time using available data.
- Analyze the structure of commercial leasehold contracts to determine how rent renegotiation clauses in commercial leasehold contracts transmit changes in commercial land prices to changes in lease rents for commercial land.

- Analyze how changes in renegotiated long-term commercial lease rents have affected competition and performance in selected Hawaii industries that rely intensively on leased commercial real estate.
- Evaluate whether the supply of commercial real estate for selected industries in Hawaii is responsive to the price of commercial real estate in Hawaii.
- Compare Hawaii markets for leases of commercial real estate with other U.S. and foreign markets.
- Consider possible linkages between changes in commercial lease rents and the performance of Hawaii's economy over the last two decades.
- Develop a set of policy proposals to improve the performance of rental markets for leasehold commercial real estate in Hawaii.

Project Personnel

Sumner La Croix, the principal investigator for the project, is Professor in the Department of Economics and the Global Public Health and Population Studies Program at the University of Hawai'i-Mānoa and is a research fellow with the University of Hawaii Economic Research Organization. La Croix is a member of the editorial board of the *Journal of Economic History* and is an associate editor of *Asian Economic Journal*. He is one of several co-authors of *Government and the American Economy: A New History* (University of Chicago Press 2007), and the author of numerous professional articles on the economic history and economic development of the Asia-Pacific region. He has published (with Louis Rose and James Mak) two articles on the history of residential leasehold in Hawaii in *Urban Studies* and *Research in Law and Economics*. He is currently engaged in revising both articles for inclusion in his new book on the economic history of Hawaii. La Croix's c.v. is attached to this proposal.

David Callies, Benjamin A. Kudo professor of law at the William S. Richardson School of Law, will be assisting with the project. He teaches land use, state and local government and real property at the law school. Among his seventeen books are *Bargaining for Development: A Handbook on Development Agreements, Annexation Agreements, Land Development Conditions and Vested Rights* (with Curtin and Tappendorf) (ELI, 2003); *Property and the Public Interest* (with Hylton, Mandelker and Franzese) (Lexis Law Publishing, 3d ed., 2007); *Preserving Paradise: Why Regulation Won't Work* (Univ. of Hawaii Press, 1994); *Regulating Paradise: Land Use Controls In Hawaii* (Univ. of Hawaii Press, 1984), and (with Robert Freilich and Tom Roberts), *Cases and Materials on Land Use* (Thomson-West, 5th ed., 2008).

Project Time Frame

The project will commence on 1 June 2013. During the **Summer of 2013**, Professor La Croix will work with two graduate assistants to conduct interviews with lessors and lessees of commercial property in Hawaii, lawyers, economists, urban planners, and government officials to understand their perspectives on the commercial leasehold market and to conduct a questionnaire; to compile, clean, and assess data sets with information on prices and contract terms for commercial leases in Hawaii over the last two decades;

to review major federal and state court rulings on relevant commercial leasehold cases; to review and assess the professional literature(s) on this topic; and to compile various proposals for legislative reform in Hawaii and reforms implemented in other U.S. states.

During the **Fall of 2013**, Professor Sumner La Croix will work with the project's graduate research assistant to conduct econometric analysis of the available commercial leasehold data for Hawaii; prepare a draft of the report for comment by consultants and UHERO staff; and prepare a draft report to submit to the Legislative Reference Bureau by 12 November 2013. La Croix will be available to testify to committees of the Hawaii State Legislature about the final Report's findings and policy recommendations and will make a presentation that is open to the public regarding the final Report's findings and policy recommendations.

Budget

We expect the research described above to cost just under \$200,000, with the majority of the funds devoted to compensate economics and law faculty for summer research overload, a buyout of faculty time during the Fall of 2013, graduate and undergraduate student assistants, and miscellaneous UHERO support staff expenses. Other expenses include the cost of acquiring data on commercial leasehold in Hawaii from local commercial real estate companies.

Please direct any questions about the project to Professor Sumner La Croix, the project principal investigator (lacroix@hawaii.edu) or Professor Carl Bonham, the UHERO Executive Director (Bonham@hawaii.edu)

Appendix G

BENJAMIN J. CAYetano
GOVERNOR



EARL L. ANZAI
ATTORNEY GENERAL

THOMAS R. KELLER
FIRST DEPUTY ATTORNEY GENERAL

STATE OF HAWAII
DEPARTMENT OF THE ATTORNEY GENERAL
425 QUEEN STREET
HONOLULU, HAWAII 96813
(808) 586-1500

April 20, 2000

The Honorable Ron Menor
Representative
House of Representatives
State Capitol, Room 320
415 S. Beretania Street
Honolulu, Hawaii 96813

Re: S.B. No. 873, S.D. 1, H.D. 2

Dear Representative Menor:

We are responding to your request for a follow-up memorandum regarding the constitutionality of S.B. No. 873, S.D. 1, H.D. 2 ("S.B. No. 873"), which was further amended by the Committee on Finance of the House of Representatives in pertinent part as follows:

- 1) Deleted requirement that any reduction in a sublessor's rent shall result in a corresponding reduction in rent between the sublessor and the sublessee;
- 2) Deleted the state income and general excise tax credits for lessors to cover loss lease rental income due to the new renegotiation provisions in S.B. No. 873; and
- 3) Added a requirement that disputes arising during rent renegotiation regarding the fair market value of the leased land be resolved by appraisal under section 10-13.6(b), Hawaii Revised Statutes ("HRS") or section 171-18.5 (b), HRS, rather than by arbitration under chapter 658, HRS.

Based on the changes to S.B. No. 873, we are of the opinion that S.B. No. 873 violates Section 10, Article I of the United States Constitution ("Contracts Clause"). Additionally, the proposed amendment to present section 519-1(b), HRS, which adds a new rent dispute resolution mechanism utilizing appraisals as provided in sections 10-13.6(b) and 171-18.5(b), HRS, is in direct conflict with the requirement in present section 519-2(b), HRS, that rent reopening

Source: Maehara, Eric, Real Property Leases. Honolulu, HI: Legislative Reference Bureau, December 2003, Appendix G.

The Honorable Ron Menor
April 20, 2000
Page 2

disputes be resolved by binding arbitration by the Housing Finance and Development Corporation ("HFDC").

As noted in our legal memorandum of April 6, 2000, the United States Supreme Court has said with regard to Contract Clause claims that "the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula." United States Trust Co. v. New Jersey, 431 U.S. 1, 21, 97 S.Ct. 1505, 1517, 52 L.Ed.2d 92, 109 (1977). However, the United States Supreme Court stated in Allied Structural Steel Co. v. Apannaus, 438 U.S. 234, 242, 98 S.Ct. 2716, 2721, 57 L.Ed.2d 727, 734 (1978), that "[i]f the Contracts Clause is to retain any meaning at all, . . . it must be understood to impose some limits upon the power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power." [Emphasis in original].

Thus, in analyzing Contracts Clause claims, the United States Supreme Court in United States Trust Co. v. New Jersey, 431 U.S. at 22, 97 S.Ct. at 1517-1518, 52 L.Ed.2d at 109-110, noted as follows:

Yet private contracts are not subject to unlimited modification under the police power. The Court in Blaisdell recognized the laws intended to regulate existing contractual relationships must serve a legitimate purpose. [Citation omitted.] A State could not "adopt as its policy the repudiation of debts or the destruction of contracts or the denial of means to enforce them." [Citation omitted.] Legislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption.

The Hawaii Supreme Court in Applications of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 953 (1996) stated the test to be used in determining whether a statute is constitutional under the Contracts Clause 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.

As was discussed in our prior memorandum, it is clear that existing leases could be impaired by the provisions of S.B. No. 873, and that the consequent loss of lease rent income which the lessors may rely upon to pay mortgages, bills, and other expenses could be substantial. Unlike the prior House version of S.B. No. 873, however, the present draft deleted the provision

The Honorable Ron Menor
April 20, 2000
Page 3

for state net income and general excise tax credits to reimburse lessors for any lease rent revenue lost due to a reduction in lease rent that may result from S.B. No. 873. Consequently, the potential harm to lessors and existing contractual rights and expectations under the present bill could indeed be a substantial impairment of their contractual relationships with lessees. Therefore, the only questions remaining are whether the bill "changes the contractual and property rights on reasonable conditions and is of a character appropriate to its public purpose." (Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 120, 736 P.2d 55, 60 (1987)).

In this regard, the only public policy noted in S.B. No. 873 is stated as follows:

"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."

Viewing this public policy against the potentially substantial loss of rental income and the ensuing impairment of existing leases that would occur should S.B. No. 873 be enacted, it would appear that the change in law proposed to be effected by S.B. No. 873 would not be reasonable and would not be "of a character appropriate to its public purpose." Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 120, 736 P.2d 55, 60 (1987).

In this regard, S.B. No. 873 is similar to the statute at issue in Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 736 P.2d 55 (1987), wherein a provision in section 516-70, HRS, which required lessors to purchase a lessee's leasehold improvements at the expiration of the lease term was struck down as unconstitutionally impairing the obligation of existing leases in violation of the Contracts Clause. In Kualoa Ranch, the Supreme Court noted that the public purpose sought to be advanced by section 516-70 was to accomplish equity. In rejecting this justification for the statute in question, the Supreme Court in Kualoa Ranch, 69 Haw. at 124, 736 P.2d at 63, noted as follows:

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.

Like the legislative action that was at issue in Kualoa Ranch, the legislature has not cited any broad societal benefits that support the changes proposed by S.B. No. 873. In fact, the public

purpose behind the prior versions of S.B. No. 873 has been lost by the deletion of the requirement that rent reductions that may result under the bill be passed onto the sublessees by sublessors. By deleting this pass-through requirement, S.B. No. 873 now denies the benefits of S.B. No. 873 to those lessees most in need of rent relief.

Consequently, it appears that a court could find that the changes proposed in S.B. No. 873, "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" without advancing any broad societal interest. Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 124, 736 P.2d 55, 63 (1987). S.B. No. 873, as presently worded, does not appear "... to promote a significant and legitimate public purpose," and does not appear to be "... a reasonable and narrowly-drawn means of promoting the significant and legitimate public purpose," thereby failing the final two criteria for determining whether a law is violative of the Contracts Clause. Applications of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 953 (1996).

Additionally, it should be noted that S.B. No. 873 creates a conflict between the provisions of sections 519-1 and 519-2, HRS, in that S.B. No. 873 now proposes to amend section 519-1 to provide that "[a]ny disagreement over fair market value that cannot be resolved by negotiation shall be settled by the procedure of appraisal set forth in sections 10-13.6(b) and 171-18.5(b) and not by arbitration under chapter 658." Present section 519-2(b) requires binding arbitration by the HFDC "[i]n the event the parties to a lease are unable to achieve an agreement under any reopening provision." This latter provision is in direct conflict with the "appraisal" dispute resolution process provided for in S.B. No. 873.

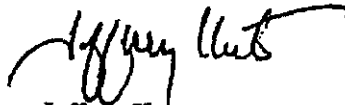
Also, section 10-13.6(b) and section 171-18.5(b), HRS, provide that "[f]air market value shall be determined on a per acre basis" Very few residential lots are one acre in size, with most residential lots being under 10,000 square feet in size. Under normal appraisal practice, the use of one acre lot size to determine fair market value is more appropriate for valuing large parcels and may not result in an appropriate or accurate valuation of smaller lots, which are typically appraised using comparable sales of lots of similar size. Thus, in addition to creating a conflict with the arbitration requirement of section 519-2(b), S.B. No. 873 may also result in erroneous and inaccurate land valuations.

In conclusion, S.B. No. 873 as presently worded, will substantially impair existing leases without furthering any apparent public purpose. The elimination of the net income and general excise tax credits to compensate lessors for any rental income losses that may result from the changes effected by S.B. No. 873, and the deletion of the requirement that any reduction in lease rent be passed on to sublessees by sublessors, make it unlikely that S.B. No. 873 will be found to be a "reasonable and narrowly-drawn means of promoting . . . [a] significant and legitimate public purpose." Applications of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 953 (1996).

The Honorable Ron Menor
April 20, 2000
Page 5

Consequently, it appears that S.B. No. 873, as presently worded, would be found to violate the Contracts Clause.

Very truly yours,



Jeffery Kalo
Deputy Attorney General

Approved:



Earl I. Anzai
Attorney General

JK:jn
c:\jmenor\hd2

Appendix H

BENJAMIN J. CAYETANO
GOVERNOR



EARL I. ANZAI
ATTORNEY GENERAL

THOMAS R. KELLER
FIRST DEPUTY ATTORNEY GENERAL

STATE OF HAWAII
DEPARTMENT OF THE ATTORNEY GENERAL
425 QUEEN STREET
HONOLULU, HAWAII 96813
(808) 586-1500

March 22, 2001

The Honorable Ron Menor
Senator, Eighteenth District
The Twenty-First Legislature
Hawaii State Capitol, Room 219
415 South Beretania Street
Honolulu, Hawaii 96813

Re: H.B. No. 1131, H.D. 1

Dear Senator Menor:

We are writing in response to your request dated March 22, 2001, for review and comment on whether H.B. No. 1131, H.D. 1 ("H.B. 1131") violates Section 10, Article I, of the United States Constitution ("Contracts Clause"), that provides in pertinent part as follows: "No State shall... pass any... law impairing the obligation of contracts...."

After reviewing H.B. 1131, which we note has apparently been modified to address perceived problems with commercial/industrial leases, and not to address residential leases, we are of the opinion that H.B. 1131, as applied to commercial/industrial leases, violates the Contracts Clause.

As we indicated in a prior legal memorandum regarding S.B. No. 873 (the predecessor to H.B. 1131), the United States Supreme Court has said with regard to Contract Clause claims that "the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula." United States Trust Co. v. New Jersey, 431 U.S. 1, 21, 97 S.Ct. 1505, 1517, 52 L.Ed.2d 92, 109 (1977). However, the United States Supreme Court stated in Allied Structural Steel Co. v. Apannaus, 438 U.S. 234, 242, 98 S.Ct. 2716, 2721, 57 L.Ed.2d 727, 734 (1978), that "[i]f the Contracts Clause is to retain any meaning at all, . . . it must be understood to impose some limits upon the power of a State to abridge existing contractual relationships, even in the

Source: Maehara, Eric, Real Property Leases, Honolulu, HI: Legislative Reference Bureau, December 2003, Appendix I.

The Honorable Ron Menor
March 22, 2001
Page 2

exercise of its otherwise legitimate police power." [Emphasis in original].

Thus, in analyzing Contracts Clause claims, the United States Supreme Court in United States Trust Co. v. New Jersey, 431 U.S. at 22, 97 S.Ct. at 1517-1518, 52 L.Ed.2d at 109-110, stated the following:

Yet private contracts are not subject to unlimited modification under the police power. The Court in Blaisdell recognized the laws intended to regulate existing contractual relationships must serve a legitimate purpose. [Citation omitted.] A State could not "adopt as its policy the repudiation of debts or the destruction of contracts or the denial of means to enforce them." [Citation omitted.] Legislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption.

The Hawaii Supreme Court in Applications of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 953 (1996) stated the test to be used in determining whether a statute is constitutional under the Contracts Clause 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.

In determining whether the impairment of contract is substantial, courts may consider "the severity of the impairment [and] the extent to which the subject matter has been regulated in the past." Applications of Herrick & Irish, 82 Haw. 329, 341, 922 P.2d 942, 954 (1996), citing from Schieffelin & Co. v. Department of Liquor Control, 479 A.2d 1191, 1199, 194 Conn. 165, 177-178 (1984). With respect to H.B. 1131, the severity of the impairment of the lease would depend upon the amount of lease rent lost by a lessor. This issue cannot be determined in the absence of actual facts surrounding a lease rent renegotiation.

The Honorable Ron Menor
March 22, 2001
Page 3

Nevertheless, it is clear that existing commercial/ industrial leases could be impaired by the provisions of H.B. 1131, and that the consequent loss of lease rent income which the lessors may rely upon to pay mortgages, bills, distributions to trust beneficiaries, and other expenses could be substantial. Consequently, the potential harm to lessors and existing contractual rights and expectations under the bill could indeed be a substantial impairment of their contractual relationships with lessees. Therefore, the only questions remaining are whether the bill "changes the contractual and property rights on reasonable conditions and is of a character appropriate to its public purpose." (Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 120, 736 P.2d 55, 60 (1987)).

The provisions of H.B. 1131 may be found to violate the Contracts Clause unless it can be determined that "the state law was a reasonable and narrowly-drawn means of promoting the significant and legitimate public purpose." Applications of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 953 (1996). See University of Hawaii Profess. Assembly v. Cayetano, 183 F. 3d 1096 (9th cir. 1999) ("whether... the impairment was both reasonable and necessary to fulfill an important public purpose, such that the impairment is justifiable" (citation omitted)); Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 120, 736 P.2d 55, 60 (1978) (whether the statute "changes the contractual and property rights on reasonable conditions and is of a character appropriate to its public purpose.").

In this regard, H.B. 1131 is similar to the statute at issue in Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 736 P.2d 55 (1987), wherein a provision in section 516-70, HRS, which required lessors to purchase a lessee's leasehold improvements at the expiration of the lease term was struck down as unconstitutionally impairing the obligation of existing leases in violation of the Contracts Clause. In Kualoa Ranch, the Supreme Court noted that the public purpose sought to be advanced by section 516-70 was to accomplish equity. In rejecting this justification for the statute in question, the Supreme Court in Kualoa Ranch, 69 Haw. at 124, 736 P.2d at 63, said:

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.

Like the legislative action that was at issue in Kualoa Ranch, there does not appear to be a broad societal benefit present to support the changes proposed by H.B. 1131. The public purpose discussion in H.B. 1131, with regard to commercial/industrial leases does not appear to be sufficiently compelling to withstand constitutional scrutiny. For example, it is not clear that the situation involving commercial/industrial leases is analogous to the plight of lessees of residential land in Hawaii, in which there was an obvious imbalance in bargaining power between lessors and lessees of residential land that resulted from the oligopoly control of land in Hawaii by a few large landowners. Unlike the widespread use of leases with regard to residential land which was a uniquely Hawaiian phenomenon, leases have typically been utilized, both in Hawaii and on the east and west coasts of the mainland, as a means of making land available for commercial/industrial endeavors.

Additionally, it is presently unclear just how pervasive the alleged problem is, or the actual number of commercial/industrial leases with lease rents locked into valuations based on the "Japanese Bubble." This is because a confluence of factors would be required in order for a commercial/industrial lease to be affected by the "Japanese Bubble:"

a) First, there would have to be a commercial/industrial lease that actually contained provisions that prohibited the reduction of lease rent below previously fixed levels;

b) Second, the lease rent for the commercial/industrial lease in question would have had to be renegotiated during a fairly limited period during the 1990's, "Japanese Bubble" period in order to be affected; and

c) Third, the commercial/industrial lease in question would have had to have been of the type of property that was the subject of Japanese investments during the "Japanese Bubble" period.

Furthermore, developers and other businesses seeking ground

The Honorable Ron Menor
March 22, 2001
Page 5

leases for land upon which they will construct substantial improvements, involving significant capital investments, are generally sophisticated individuals and entities that can and do negotiate the terms of the leases they enter into, and have the option of negotiating with several competing lessors to obtain more favorable terms. Therefore, the potential lessee may not have been subject to an imbalance in bargaining leverage that would have forced the potential lessee to accept less than favorable terms.

Finally, even assuming arguendo that some commercial/ industrial leases may in fact contain the restrictive language prohibiting the reduction of lease rent, and have lease rents that may be high based on their renegotiation during the "Japanese Bubble" period, there has been no concrete evidence or incidences cited wherein the lessees have attempted to raise this alleged inequity to the lessors, but the lessors have absolutely, and unreasonably refused to discuss the problem with the lessees or to attempt to negotiate an appropriate and fair adjustment in the lease rent.

Consequently, it appears that a court could find that the changes proposed in H.B. 1131, "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" without advancing any broad societal interest, and are premised on mere supposition and speculation. Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 124, 736 P.2d 55, 63 (1987). H.B. 1131, as presently worded, does not appear ". . . to promote a significant and legitimate public purpose," and does not appear to be ". . . a reasonable and narrowly-drawn means of promoting the significant and legitimate public purpose," thereby failing the final two criteria for determining whether a law is violative of the Contracts Clause. Applications of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 953 (1996).

Also, we continue to note that H.B. 1131 fails to provide for a pass-through of any reduction in lease rent to sublessees. The lack of a pass-through requirement contradicts the statement of public purpose included in the bill, which statement talks about the negative impact of lease rent renegotiation provisions on sublessees. Under the bill, only the holder of the master ground lease, usually the developer, will benefit, thereby

The Honorable Ron Menor
March 22, 2001
Page 6

denying the benefits of the bill to the people most in need of the bill's assistance, namely the sublessees, who are the ultimate tenants and users of the land.


Additionally, H.B. 1131 provides that if the parties are unable to resolve the lease rent dispute by negotiation, then either party can request that the dispute be resolved through an unidentified appraisal process of the lessee's choosing. The failure of the bill to designate a specific process to resolve disputes, and the provision allowing only the lessee to select an appropriate process to resolve the dispute (albeit a process "in conformance with the Uniform Standards of Professional Appraisal Practice"), will almost certainly lead to further disputes, and probable litigation over the appropriateness of the process selected, as well as the manner in which that process was determined.

In conclusion, H.B. 1131, as presently worded, will substantially impair existing leases without furthering any significant public purpose, "...such that the impairment is justifiable." University of Hawaii Profess. Assembly v. Cayetano, 183 F.3d 1096 (9th Cir. 1999). The deletion of the requirement that any reduction in lease rent be passed on to sublessees by sublessors denies the benefits of H.B. 1131 to those smaller lessees who would apparently be most in need of rent relief, and make it unlikely that H.B. 1131 will be found to be a "reasonable and narrowly-drawn means of promoting . . . [a] significant and legitimate public purpose." Applications of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 953 (1996). Consequently, it appears that H.B. 1131, as presently worded, would be found to violate the Contracts Clause.

Very truly yours,


Jeffery Kato
Deputy Attorney General

Approved:


Earl T. Anzai
Attorney General

Appendix I



STATE OF HAWAII
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COPY

April 11, 2002

The Honorable Ron Menor
Chairperson, Senate Committee on Commerce,
Consumer Protection and Housing
Twenty-first State Legislature
State Capitol, Room 219
Honolulu, Hawaii 96813

Dear Senator Menor:

Re: House Bill No. 2245, H.D. 1, S.D. 1

Pursuant to the request stated in House Standing Committee Report No. 3301, we have reviewed the above bill and offer our opinion as to its legality and constitutionality.

Briefly, the bill provides that:

1. Notwithstanding lease provisions, lessee may request a one-time lowering of lease rent based on fair market value;
2. USPAP be used to calculate fair market value in lease renegotiation; and
3. Disputes in renegotiation be settled not by arbitration but by a method chosen by the lessee only.

We believe that the bill results in an unconstitutional impairment of contractual obligations and relationships. Like two other bills that passed the legislature in previous sessions (Senate Bill No. 873 in 2000 and House Bill No. 1131 in 2001) and were vetoed by the governor because of constitutional concerns, this bill also fails to meet the test set forth by the Hawaii Supreme Court in Application of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 954 (1996).

The contracts clause of the United States Constitution prohibits the impairment of the obligation of contracts. U.S. Const. art. I, § 10. However, the United States Supreme Court said: "the prohibition is not an absolute one and is not to be read with literal exactness like a mathematical formula." United States Trust Co. v. New Jersey, 431 U.S. 1, 21, 97 S.Ct. 1505, 1517, 52 L.Ed.2d 92, 109 (1977). On the other hand, the Court also stated: "If the Contracts Clause is to retain any meaning at all . . . it must be understood to impose some limits

Source: Maehara, Eric, Real Property Leases. Honolulu, HI: Legislative Reference Bureau, December 2003, Appendix K.

The Honorable Ron Men
Chairperson, Senate Committee on Commerce,
Consumer Protection and Housing
April 11, 2002
Page 2

upon the power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power." [Emphasis in original]. The Court further stated in United States Trust that the State could not repudiate debts or destroy contractual rights or deny the means to enforce them. United States Trust, 431 U.S. at 22. "Legislation adjusting the rights and responsibilities of the contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption." Id.

The Hawaii Supreme Court has also spoken on the matter. It set forth the test to be applied in determining whether a statute is constitutional under the Contracts Clause. Application of Herrick & Irish, 82 Haw. 329, 340, 922 P.2d 942, 954 (1996).

In deciding whether a state law has violated the federal constitutional prohibition against impairment of contracts, [citation omitted], 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.

Id. The Court further stated that courts may consider "the severity of the impairment [and] the extent to which the subject matter has been regulated in the past." Id.

It is clear that this bill changes contractual obligations. Lessors will be affected by the loss of revenue that they depended upon to pay their mortgages, bills, distributions to trust beneficiaries, and other expenses. The severity of the loss will depend on the procedure used and the amount of lost revenue. Accordingly, the potential harm to the lessors under the provisions of this bill could indeed be a substantial impairment of their contractual obligations and relationships with the lessees.

That being the case, the next step is to determine whether the law is designed to promote a significant and legitimate public purpose. The Hawaii Supreme Court clarified this by requiring that the public purpose serve to further a broad societal interest and not to accomplish equity by providing a remedy for a certain few. Anthony v. Kualoa Ranch, Inc., 69 Haw. 112, 123, 736 P.2d 55 (1987). In Anthony, the law required lessors to purchase the leasehold improvements upon termination of the lease regardless of any provision of the lease to the contrary. The Court noted that the purpose of the law was to provide equity. The Court held that this stated purpose did not meet the test of broad societal interest and found that the law was unconstitutional. Anthony, 69 Haw. at 124. In section 1, the bill states that the legislature intends to promote economic stability. The bill may impose an economic loss to the lessors and an economic gain to the lessees. But it is not clear why this one-time re-opening of existing contracts would promote economic stability. In spite of the findings in section 1, we cannot

The Honorable Ron Mer
Chairperson, Senate Committee on Commerce,
Consumer Protection and Housing
April 11, 2002
Page 3

conclude that the bill meets its stated purpose of economic stability or furthers a broad societal interest. To the extent the bill merely seeks to accomplish equity, Anthony indicates that the provision of equity for some lessees does not meet the test of broad societal interest. And as such, the bill does not meet constitutional muster.

Even assuming arguendo that the bill is designed to promote a significant and legitimate public purpose, the bill does not appear to provide a reasonably and narrowly-drawn means to accomplish the significant and legitimate public purpose. Even though the legislature limited its inquiry to the problem created by the Japanese bubble economy, it did not limit the application of the bill to those leases directly affected by this phenomena. Also, although the problem of the oligopoly and residential leases in Hawaii is unique and found nowhere else in the United States, this problem does not apply to commercial leases. Most businesses lease their property rather than purchase them in fee simple. Furthermore, the businesses that construct major improvements involving significant capital investments are generally run by managers with the knowledge and skill to negotiate terms of leases that are favorable. Those businesses with less investment in their property are more likely to be able to relocate. Furthermore, agreeing to a fixed rent even though land values may fluctuate over the fixed rent period is a business risk that businesses in seeking a profit should take into consideration in negotiating a lease in the first place. In addition, the lessees have options available to them. They may continue to lease at the higher than market value rent, sell their leasehold and move elsewhere, negotiate a more favorable lease with another lessor because the fair market value of land at this time is lower, or in the case of the residential lessee, he may seek condemnation of the leased fee. Lastly, if this is an emergency measure, there must be a "limitation on the duration of the change," and there appears to be none. Anthony, 69 Haw. at 124.

Hence, in applying the test of Application of Herrick & Irish, we believe that House Bill No. 2245, H.D. 1, S.D. 1 violates the Contracts Clause of the United States Constitution in that it substantially impairs contractual relationships without promoting a significant and legitimate broad societal interest.

Very truly yours,



Carolee M. Aoki
Deputy Attorney General

APPROVED:



PA Earl I. Anzai
Attorney General