Real Property and Financial Services Section
Hawaii State Bar Association

Newsletter

July 1993

MESSAGE FROM THE EDITOR

By now you have noticed that this issue of the Newsletter is eight pages long. We are fortunate to have the first of two articles to be published in the Newsletter, which were written by UH law students. Each of the students has been awarded a $250 prize for having written the best paper in a law school seminar.

The article published in this issue on the Lucas case was written by Mark Bernardin, who is a graduate of Merrimack College in North Andover, Massachusetts, and of the William S. Richardson School of Law. Mark will join Foley Maehara Judge Nip & Chang in September, 1993.

Space considerations precluded publishing the entire paper which included a scholarly discussion of the development of takings law. The portion of the paper published summarizes the impact of Lucas, which we hope will be interesting and of benefit to the members of the Section. If you would like a copy of the entire paper, please contact me.

We were also fortunate to have had Jeff Grad and John Reilly volunteer to write an article on the new DROA form. John is preparing a realtor's course on contract solutions, and would appreciate receiving your input on DROA problem areas you encounter in your practice.

Finally, the title insurance seminar originally scheduled for August has been rescheduled for early November (probably November 5), and expanded into a half-day seminar. We have recruited an outstanding panel of title insurance experts and look forward to an interesting and informative seminar.

Nancy N. Grekin

LUCAS V. SOUTH CAROLINA COASTAL COUNCIL: Chipping Away at the Takings Riddle

By Mark J. Bernardin

Introduction

In 1922, the United States Supreme Court decided Pennsylvania Coal Co. v. Mahon, which is cited as the genesis of the Supreme Court's regulatory takings doctrine. The Mahon decision recognized that a government regulation can effect a compensable taking merely by restricting a landowner's use of his property. Writing for the Majority, Justice Holmes stated what has become one of the most frequently cited maxims of Supreme Court takings law: "while property may be regulated to a certain extent, if the regulation goes too far it will be recognized as a taking."

Ever since the Mahon decision, those who make their living advising clients about their property rights have wondered how far is too far under the Takings Clause of the United States Constitution. There is no answer to the question. For 70 years, the Court has wrestled with the vague concept of "going too far" and has never been willing or able to develop a formula or set of integrated rules for the resolution of takings claims. Instead, with some notable exceptions, the Court has relied on "ad hoc factual inquiries" and, in the process, has developed a series of different, and often incompatible, tests for determining when state action, without a formal exercise of eminent domain power, amounts to a taking. In short, there was, and still is, much confusion surrounding the Court's interpretation of the Takings Clause.

The Court's decision in Lucas v. South Carolina Coastal Council[1] could eliminate some of the confusion. The case came to the Supreme Court after the Supreme Court of South Carolina held that a statute, which prohibited Mr. Lucas from

building any permanent structures on two beach front lots he had recently purchased, did not effect a taking. The South Carolina court, based on South Carolina's strong interest in preventing erosion of its beaches, reached this conclusion in spite of the fact that Mr. Lucas, under the mistaken assumption he would be able to develop residential units on the lots, paid over $900,000 for the property.

In remanding the case to the state court, the Court created, or, according to the Court, merely applied, a categorical rule that requires the government to pay compensation whenever a regulation prohibits a landowner from using her property in an "economically beneficial" way. The rule, with some exceptions, requires compensation without regard to the nature and importance of the governmental interest advanced by the regulation. Thus, the Court limited the application of the "harmful or noxious uses" doctrine[2] to cases where the regulation in question leaves the property with some economically beneficial use.

However, the categorical rule announced by the Court does have exceptions. The rule does not apply where the proscribed use interest was not part of the landowner's title when he purchased the property. In other words, if the state, or other land owners, could have proscribed the regulated use under the state's preexisting law of nuisance, there is no compensable taking. Further, the Court specifically preserved the state's right to destroy property interests when such destruction is necessary to eliminate grave threats to the lives or property of others. The decision also eliminates some of the confusion regarding the question of what test or tests the Court, and lower courts, should use when addressing takings claims. First, the decision suggests the Court will not, as it has previously stated,[3] use different tests depending on whether the claimant mounts a facial challenge or an as applied challenge. Second, the opinion indicates that when neither of the Court's two categorical rules[4] are applicable, the Court will analyze the claim under the three-prong Penn Central test which requires a court to consider three nebulous factors: the character of the governmental action, the extent to which the government's action interferes with the claimant's reasonable, investment backed expectations, and the economic impact of the governmental action on the claimant.[5]

The impact of the Lucas decision is limited by two important factors. First, the categorical rule only applies to the rare regulation that deprives an owner of all economically beneficial use of his property. Second, the Court declined to define the term "economically beneficial use." Accordingly, lower courts could avoid application of the categorical rule by adopting a broad definition and focusing on non-economic uses remaining in the property.

This paper explores the impact of the Lucas decision through an analysis of several lower court opinions decided after Lucas. The paper focuses on the Court's failure to define "economically beneficial use" and discusses some possible interpretations of the term. Finally, the paper presents a summary of the author's conclusions as well as an update on Mr. Lucas's continuing battle with the South Carolina Coastal Council.

The Impact of Lucas

What is an "economically beneficial use?"

In the wake of Lucas, one thing is certain: to support a takings claim, a landowner need not prove the regulation in question deprived his property of all use. The Court's 1987 decision in First English Evangelical Lutheran Church of Glendale v. County of Los Angeles[6] called this statement into question. The Court's use of the expression "all use" in First English led some commentators to suggest there could be no taking unless a regulation deprived the landowner of all use of his property.[7] Clearly, the Lucas decision eliminates that issue Beyond this observation, a bit c speculation is required.

The majority opinion phrases the rule in several different ways. Initially, the opinion states a taking occurs when the landowner is forced to "sacrifice all economically beneficial uses in the name of the public good, that is, to leave his property economically idle."[8] Later, while discussing the nuisance exception to the categorical rule, the opinion speaks of "all economically productive or beneficial uses."[9] It seems likely that the Court, by using these terms, was referring to uses that allow a property owner to realize a present or foreseeable profit or income from the property.[10]

The Court, however, has never defined "economic use." Several state courts have addressed the issue and concluded that an "economic use" is one that allows the landowner a reasonable profit.[11] If the "profit approach" is correct, the categorical rul is applicable even if the regulation allows the land owner to operate a business on the parcel or allows the landowner some non-business use of the property. If, because of the regulation, the owner cannot realize a current or foreseeable income from the use of the land, there is a taking. It is possible, of course, the Court did not intend such a narrow definition of the term. It is also possible the Court expected state courts to mold their own definition based on applicable state law.

This latter possibility finds some support in a footnote to the Court's opinion.[12] In the note, the Court considers the shortcomings of its opinion with regard to what might be called the "fraction" issue. This issue raises the question of how courts should analyze a takings claim when the regulation eliminates all economic use of a mere fraction of a landowner's total parcel. In other words if the regulation eliminates all economic use of fifty percent of a land-

owner's parcel, has the landowner suffered a total and compensable taking of that fraction of her land affected by the regulation, or has she merely suffered a non-compensable diminution in the value of the parcel as a whole? The Court suggested the answer to this difficult question depends on the manner in which state law has shaped the property owner's reasonable expectations.[13] Although this observation is not dispositive of the Court's approach to the definition issue, it does demonstrate the Court's willingness to leave key issues, and the ultimate impact of its categorical rule, in the hands of state courts.

Accordingly, because the Court has not addressed the issue, the term "economically beneficial use" could ultimately take on a much broader meaning than the one proposed by this paper. It is difficult to imagine, however, that Justice Blackmun's observation that Mr. Lucas can use his $975,000 lots to picnic, swim, camp in a tent, or as a trailer site[14] is relevant to the application of the categorical rule. Or is it?

Justices Kennedy and Souter also indicated they and the Majority do not see eye to eye on the definition issue. Justice Souter, in his separate statement, argued the trial court's finding that the regulation deprived Mr. Lucas of all of his "economic interest" in the lots is "highly questionable" in light of the Court's precedent.[15] Justice Kennedy, in his concurring opinion, noted that Mr. Lucas's property probably has resale value. Further, he admitted he was skeptical about the trial court's finding that "a beach front lot loses all value because of a development restriction."[16]

The trial court, however, found that Mr. Lucas was deprived of all "reasonable economic use of the lots,"[17] not "all value." Further, the categorical rule announced by the Court speaks of "economically beneficial uses." Why, then, are Justices Kennedy and Blackmun concerned with ordinary, non-economic uses? The Justices' observations simply are not relevant to the application of the Court's categorical rule.[18] As previously suggested, it is possible that this paper's position on the definition issue is incorrect. If, however, the Court does prefer the narrow "profit" definition, it will have to revisit the issue. Unless the definition and the categorical rule are clarified, lower courts may misinterpret or ignore the rule.

Lucas' Impact on Lower Courts

Will Lucas get the attention it deserves from lower courts? Clearly, it is too soon to tell. To this point, the results are mixed. There are several cases that indicate the Lucas opinion is not having a tremendous impact. For example, approximately one month after the Supreme Court decided Lucas, the eleventh circuit decided Reahard v. Lee County.[19] Reahard deals with a takings claim filed by a land owner who inherited forty acres of land in Lee County, Florida.[20] Mr. Reahard intended to develop the land for construction of single-family homes.[21] In December of 1984, approximately one month after he inherited the land, Lee County enacted a land use plan that classified Reahard's property as a resource protection area.[22] The plan greatly diminished the value of the parcel by prohibiting the development of more than one residence on the forty acre lot.[23] After Reahard filed suit against the county, the case was removed to federal court where a magistrate found that the use plan effected a compensable taking by causing a "substantial deprivation" of the value of Mr. Reahard's property.[24]

On appeal, the circuit court remanded the case and instructed the trial court to make additional factual findings necessary for an ad hoc inquiry into Reahard's claim.[25] The court assumed that Reahard's claim was a partial taking[26] analogous to the situation, described by the Supreme Court in a footnote to the Lucas decision,[27] where a regulation substantially diminishes the value of a parcel.[28] The court, therefore, focused on the concept of diminution in value and, although it cited the two-part Agins test, did not instruct the trial court to analyze the claim under the categorical rule of Lucas.

The court's approach seems odd because, as the Lucas case illustrates, a regulation can prevent a landowner from using his lot in an economically beneficial way without eliminating all of the parcel's value. Thus, even if the regulation eliminated only 95% of the value of Reahard's lot, the categorical rule may still apply. The key question, which was not addressed by the court, is whether the regulation deprived Mr. Reahard of all economically beneficial use of his lot.

Similarly, the Supreme Court of New Jersey discounted the importance of Lucas in Bernardsville Quarry Inc., v. Borough of Bernardsville.[29] In Bernardsville, a quarry owner mounted a takings challenge against a municipal licensing ordinance that, among other things,[30] imposed depth limitations on the facility's operations and, thus, limited the amount of mineral the owner could extract.[31] A New Jersey court declared the quarry operation a non-conforming use in 1963, but a previous owner continued to operate the quarry, a cement facility, and a stone crushing operation until the mid-1980's.[32] The present owner bought the entire operation at a foreclosure sale on March 2, 1987 for $3,825,000.[33] Immediately thereafter, the borough took a keen interest in the site and, on July 20, 1987, adopted the ordinance in question.[34] After the borough refused the owner's application for a permit to quarry below the level allowed by the ordinance, the owner sued the borough.35 The complaint alleged, among other things, the ordinance effected an unconstitutional taking of property.[36]

The New Jersey Supreme Court denied relief to the plaintiff and upheld the unpublished opinions of the trial court and the court of appeal. The court, applying a Penn Central type test,[37] determined the ordinance advanced a valid public purpose[38] and allowed the owners to use the property for other "economically-viable uses."[39] The court cites the trial court and appellate court opinions for the proposition, admitted by the plaintiff, that the property was still worth approximately $2,700,000.[40] but does not clearly address the issue of whether the restrictions allowed the owners to realize an actual profit from the property.

The case is interesting because the court barely mentions the Lucas decision. The New Jersey court cited Lucas for the proposition that the "nuisance exception" to the Takings Clause is not applicable "to [a] regulation designed to protect beaches and dunes from erosion by prohibiting construction along the beach."[41] Beyond this incredibly narrow reading of Lucas, the court does not seem at all interested in the categorical rule or in considering what the Supreme Court meant when it used the term "economically beneficial use."

Granted, it is not clear from the opinion how the plaintiff plead the case or whether it claimed the ordinance deprived it of all economically beneficial use. It is possible the court did a Lucas-like analysis by applying state law. The opinion cites New Jersey law and asserts that a regulatory scheme will be upheld unless, among other things, it does not allow an adequate or reasonable return on investment.[42] The court makes this assertion, however, in the context of a "multifactor balancing test that serves to weigh the public interest in enacting the regulation against the private property interests affected by it."[43] Further, the court announced that regulatory takings cases are "too fact-specific to be governed by a single, all inclusive rule."[44] So much for Lucas.

Other courts have limited the impact of Lucas through misinterpretation of the holding. In Save The Pine Bush Inc., v. Common Council of Albany,[45] for example, the court cited Lucas for the proposition that "a regulatory taking challenge fails on the merits where the regulation advances a significant state interest."[46] This interpretation simply does not square with the holding of Lucas.

Finally, other courts have avoided the reach of Lucas by interpreting the Court's holding narrowly. In Millcreek Township v. N.E.A. Cross Company,[47] the court refused to apply Lucas to a case involving an alleged taking of a leasehold interest.[48] Also, in Woodbury Place Partners v. City of Woodbury, Minnesota,[49] the court rejected a takings claim presented by property owners who were prohibited from developing their land by an interim moratorium on, among other things, subdivision approval.[50] In Woodbury Place, the court reversed a trial court's determination that the moratorium effected a compensable temporary taking.[51] To reach its conclusion, the court distinguished between the regulation in Lucas, which was presumptively permanent, and the moratorium at issue, which, under state law, could not exceed thirty months.[52] Thus, according to the court, the economic viability of the plaintiffs' property was merely delayed rather than destroyed.[53] It is difficult to understand this distinction, especially if one considers the possibility that the city could renew the moratorium after three years or pass another "temporary moratorium" on other city actions related to land development.

On the other hand, there are some indications that Lucas may have an impact on lower courts. The Supreme Judicial Court of Massachusetts recently rejected a takings claim after citing the Lucas categorical rule and addressing the question of profitability. In Steinbergh v. City of Cambridge,[54] the claimants argued a rent control ordinance, which deprived them of the right to sell individual condominium units unless th rent control board granted a permi effected a temporary taking[55] of their property.[56] The court held the categorical rule of Lucas did not apply because the claimants, while the ordinance was effective, collected rents, received a return on their investment, and could have applied for rent adjustments to insure receipt of a fair net operating income from the units.[57]

Similarly, in Iowa Coal Mining Company, Inc., v. Monroe County, Iowa,[58] the Supreme Court of Iowa noted the importance of the Lucas decision and equated the categorical rule of Lucas with the categorical rule of physical invasions.[59] In Iowa Coal, the company claimed a regulation that prohibited the use of its leased coal mining cites for landfill operations effected a compensable taking of their property interest.[60] The court, after discussing Lucas, held the categorical rule was not applicable because the coal mining cite: under the regulation, were still profitable and economically viable. The court then proceeded to analyze, and reject, the claim under the three-prong Penn Central test.[61]

In considering the impact of Lucas, in is interesting to note that the courts that cite and apply Lucas with alacrity are dealing with situations where it is reasonably clear that the regulation has not deprived the owner of all economically beneficial use of his property. In cases that raise serious questions about the deprivation of all economically beneficial use, such as Bernardsville[62] and Reahard,[63] the citations to Lucas become more oblique and the opinions more difficult to understand.[64] Quite possibly, there is a direct correlation between the weight given to the Lucas opinion by a given court and the probability that such weight will yield a result favored by the court. Accordingly, those who value property right will have to keep their fingers crosse and hope the Court gets another

chance to broaden the impact of Lucas by defining "economically beneficial use" clearly and narrowly.

Conclusion

The Lucas Opinion

The Lucas decision eliminates some of the confusion surrounding the issue of when a regulation effects a compensable taking. The Court created, or, according to the Court, merely applied, a second categorical rule that requires the government to pay compensation whenever a regulation prohibits a landowner from using her property in an "economically beneficial" way. The rule, with some exceptions, requires compensation without regard to the nature and importance of the governmental interest advanced by the regulation. Thus, the Court limited the application of the "harmful or noxious uses" doctrine to cases where the regulation in question leaves the property with some economically beneficial use.

However, the categorical rule announced by the Court does have exceptions. The rule does not apply where the proscribed use interest was not part of the landowner's title when he purchased the property. In other words, if the state, or other land owners, could have proscribed the regulated use under the state's preexisting law of nuisance, there is no compensable taking. Further, the Court specifically preserved the state's right to destroy property interests when such destruction is necessary to eliminate grave threats to the lives or property of others. The decision also eliminates some of the confusion regarding the question of what test or tests the Court, and lower courts, should use when addressing takings claims. First, the decision suggests the Court will not, as it has previously stated, use different tests depending on whether the claimant mounts a facial challenge or an as applied challenge. Second, the opinion indicates that when neither of the two categorical rules are applicable, the court will analyze the claim under the three-prong Penn Central test.

The impact of the Lucas decision is limited by two important factors. First, the categorical rule only applies to the rare regulation that deprives an owner of all economically beneficial use of his property. Second, the Court declined to define the term "economically beneficial use." Accordingly, lower courts could avoid application of the categorical rule by adopting a broad definition and focusing on non-economic uses remaining in the property.

Update on Mr. Lucas

Happily for Mr. Lucas, the Supreme Court of South Carolina did not reconsider the question of whether the Beachfront Management Act deprived him of all "reasonable economic use" of his property.[65] After reciting the history of the case, the court stated, "the United States Supreme Court had created for Lucas a cause of action for a temporary deprivation of the use of his property, unless coastal council can demonstrate that Lucas's intended use of his land was not part of the bundle of rights inhering in his title."[66]

By this statement, the court implicitly accepted the trial court's finding that Mr. Lucas had been deprived of all reasonable economic use of his land for some period of time.[67] The court then concluded, under South Carolina law, there is no common law basis for preventing Mr. Lucas from using his land for the construction of residences.[68] Accordingly, the court remanded the case to the trial court with instructions to make "specific findings of damages appropriate to compensate Lucas for the temporary deprivation of the use of his property."[69] Because Mr. Lucas could not put his land to "economic" use while he appealed his case, the court instructed the trial court to assess damages based on the period beginning with the enactment of the 1988 Act and continuing through the date of the court's order.[70]

Finally, the court cleared the path for Mr. Lucas to pursue future actions against the Coastal Council. The court emphasized it made its order without prejudice to the rights of the parties to litigate any actions resulting from the Coastal Council's possible refusal to grant Mr. Lucas a special permit exemption from the prohibitions of the Beachfront Management Act.[71] It appears, therefore, that Mr. Lucas will prevail. Given the tenor of the South Carolina Supreme Court's order, and the court's refusal to reconsider the issue of whether Mr. Lucas was deprived of all economically beneficial use of his lots, he will, apparently, be entitled to compensation if the Coastal Council denies his permit request.

So, after several years of legal wrangling, the ordeal of Mr. Lucas ended with a just and equitable result.[72] In the midst of all the legal arguments on both sides of the many and complex legal issues presented, it is easy to lose sight of the simple truth behind the case. South Carolina, for a very good cause, was prepared to take the equivalent of hundreds of thousands of dollars from one citizen. The state should not force individual property owners to pay for its public policy. Such actions by the state not only offend the Constitution, but also offend basic concepts of fairness. Rather, the economic burden of the regulation, along with its benefits, must be shared by the community.

Endnotes

1. 112 S.Ct. 2886 (1992).

2. The doctrine, developed in a series of Supreme Court cases, excuses the constitutional compensation requirement when a valid regulation is enacted to prevent serious public harm.

3. In what this paper refers to as the "Hodel rule," derived from Hodel v. Virginia Surface Mining & Reclamation, 452 U.S. 264 (1981), the Court drew an important distinction between "as applied" and "facial challenges." The Hodel opinion indicates that cases presenting "facial challenges" to regulations should be analyzed under an economically beneficial use test. (That is, does the mere enactment of the regulation deprive the claimant of all economically beneficial use of her property?) Conversely, cases presenting

"as applied challenges" should be analyzed under what is commonly referred to as the "thee-prong, Penn Central test.

4. In its first categorical rule, the Court held that any physical invasion of an owner's property, by the government or one authorized by the government, no matter how insignificant, constitutes a taking. See Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982).

5. Penn Central Transportation Co. New York City, 438 U.S. 104, 124 (1978).

6. 482 U.S. 304 (1987).

7. For a debate on what the Court meant in First English when it used the expression "all use" see Callies, Takings Clause--Take Three, 73 A.B.A. J. 48, 53 (1987); and Berger, Happy Birthday, Constitution, 20 The Urban Lawyer 735, 770 (Vol no 3. 1988).

8. 112 S.Ct. at 2895.

9. Id. at 2901.

10. See Berger, supra note 15, at 761.

11. See Orion Corp. v. Washington, 747 P.2d 1062, 1073 (Wash. 1987) (regulation must allow some reasonably profitable use); Ranch 57 v. City of Yuma, 731 P.2d 113, 118 (Ariz. 1986) (permitted use must yield a reasonable return on the property); National Merit, Inc. v. Weist, 361 N.E.2d 1028, 1034 (N.Y. 1977) (same); and Kempf v. City of Iowa City, 402 N.W.2d 393, 400 (Iowa 1987) (ordinance is unreasonable if it requires owner to leave property unproductive and to suffer expenses from taxes).

12. 112 S.Ct. at 2894, n.7.

13. Id.

14. 112 S.Ct. at 2908 (Blackmun J. dissenting.)

15. Id. at 2925 (Souter, J., arguing for dismissal or writ).

16. Id. at 2903 (emphasis added).

17. Id. at 2890.

18. Such observations are relevant, however, to the determination of damages owed to Mr. Lucas and other similarly situated property owners. For example, if his lots, as restricted, are still worth $200,000 because of the non-economic uses discussed by the Justices, then the damages should be reduced by that amount. In awarding damages, a court need not deliver to the landowner all of the "profit" taken by the regulation, but should at least place the owner back in the position he was in immediately after he purchased or otherwise came into possession of the property. (This statement assumes the property owner paid fair market value). In other words, the profit analysis is relevant to the question of whether there was a taking but need not enter into the damages calculus. In terms of equity, there is a tremendous difference between limiting a property owner's potential profit for the common good, and forcing him to suffer a loss of hard earned capital invested legally and in good faith.

19. 968 F.2d 1131 (11th Cir. 1992).

20. Id. at 1133.

21. Id.

22. Id.

23. Id.

24. Id.

25. Id. at 1135-37. The court cited Penn Central and indicated that Mr. Reahard's claim should be analyzed under an ad hoc factual inquiry. Id. at 1135.

26. The court stated that the magistrate's order could not stand because it misapplied the legal standard regarding partial takings. Id. at 1134.

27. See supra note 20 and accompanying text.

28. 968 F.2d at 1134 n.5.

29. 608 A.2d 1377 (1992).

30. The ordinance also limits the hours of operation, requires buffer zones, and imposes licensing requirements. Id. at 1379.

31. Id. at 1378-1379.

32. Id. at 1379.

33. Id. at 1378.

34. Id. at 1379.

35. Id. at 1380.

36. Id.

37. Id. at 1382.

38. Id. at 1386.

39. Id. at 1387.

40. Id. at 1386.

41. Id. at 1385.

42. Id. at 1386.

43. Id. at 1382 (citing Keystone Bituminous Coal Association v. DeBenedictis, 480 U.S. 470 (1987)).

44. Id. at 1382.

45. 591 N.Y.S.2d 897 (1992).

46. Id. at 899.

47. 193 WL 3571 (Pa. Cmwlth).

48. Id. at 4 n.8.

49. 492 N.W.2d 258 (Minn. App. 1992).

50. Id. at 259.

51. Id. at 259.

52. Id. at 261.

53. Id.

54. 1992 Mass. LEXIS 586.

55. A Massachusetts court declared the ordinance invalid and the legislature subsequently repealed it. Id. at 100.

56. Id. at 100-101.

57. Id. at 103.

58. To be reported at 494 N.W.2d 664 (1993). Page citations are not yet available for this document.

59. Id.

60. Id.

61. Id.

62. 608 A.2d 1377 (1992).

63. 968 F.2d 1131 (1992).

64. In Bernardsville and Reahard, for example, neither court directly addresses the issue of whether the regulation in question deprives the landowner of all economically beneficial use. Although there is nothing to indicate the courts are avoiding the issue, the decisions, in the author's opinion, are more difficult to understand because of the omission.

65. Lucas v. South Carolina Coastal Council, 1992 WL 358097 (S.C.).

66. Id. at 2.

67. Id. at 1-2.

68. Id.

69. Id. at 2.

70. Id. at 2. The order is dated November 20, 1992.

71. Id.

72. It is an equitable result if one is willing to overlook the legal nightmare foisted upon Mr. Lucas solely because he happened to buy a piece of property in the wrong place and at the wrong time. ■

THE NEW DROA

By Jeffrey S. Grad and John Reilly

At the beginning of June the Hawaii Association of Realtors (HAR) published new forms of the Deposit Receipt, Offer and Acceptance (DROA), Seller's Counter Offer and the Cooperating Broker's Separate Agreement. These new forms were drafted over a three year period by HAR's Standard Forms Committee of which the authors are members.

In this Article, we will (a) describe principally the new DROA, (b) explain why the new DROA was drafted and (c) point out the more important differences between the new DROA and the previous DROA and Standard DROA Addendum (which was often attached to the DROA.)

Description of the New DROA

The new DROA is divided into four basic sections, which are lettered as A, B, C and D. Section A contains a list of additional documents (called "addendum" if one, and "addenda" if more than one) which are attached to and are intended to be made a part of the DROA. Section A also contains the legally required agency disclosure as to which of the Brokers represents each of the parties in the transaction.

Section B is the form of receipt for the Buyer's initial deposit. It also addresses whether the Buyer or Escrow will earn the interest on the Buyer's deposits.

Section C is the major portion of the new DROA form. It contains seventy-nine paragraphs numbered C-1 through C-79. The new longer DROA was created, in part, by combining the provisions from the previous official four-page "Standard DROA Addendum" with the previous official two-page DROA.

The new DROA also includes a larger number of alternative provisions than were found in the previous DROA and Standard DROA Addendum. Previously, alternatives to a provision found in the DROA or the Addendum had to be added to the DROA as part of a new addendum or as a special term. Because of these conceptual changes, the DROA now consists of seven pages, much of it in fineprint. However, the "good news" is this is only one page longer than the combined previous DROA and Standard DROA Addendum.

Finally, Section D is the portion of the DROA where the Seller will accept the Buyer's offer or if desired, the Seller will indicate a counter offer is being made on an attached form called "Seller's Counter Offer." Section D also confirms the Seller's agreement to pay the agreed upon brokerage commission.

If the Seller wishes to make a counter offer, the Seller would do so on the Seller's Counter Offer and would attach it to the DROA.

Finally, although not legally part of the DROA, the HAR standard form called the "Cooperating Broker's Separate Agreement" is physically attached to the DROA.

Why the New DROA?

Since the 1970's, HAR has published standard forms of a DROA. The original standard forms were simple, and reflected the doctrine of "caveat emptor" - let the buyer beware! However, as years passed, the transactions became more complex, and the courts and the legislature gradually imposed requirements that sellers of real property disclose all material facts to potential buyers. To meet these requirements and to reflect the complexity of the transactions, real estate firms created their own "standard form" of addendum, which was used to supplement or modify the terms in the HAR official DROA.

As more and more firms utilized their own "standard form" addendum and attached it to the DROA, the principal advantages of having a standard form DROA in the first place were lost. To negotiate and to prepare a sales agreement became increasingly more difficult.

During the 1980's HAR attempted on several occasions to meet the problem by revising the form of DROA or by preparing a new standard form of additional terms which could be attached as a Standard Addendum to the DROA. These attempts did not prove to be successful, however, as firms continued to utilize their own unique forms.

In 1990, the Standard Forms Committee was requested again to prepare a new form of DROA.

The Major Changes in the DROA

The new DROA makes a number of non-substantive changes which resulted from the reorganization of its paragraphs, the combination of the previous DROA and Standard DROA Addendum, and the inclusion of several alternative provisions addressing important issues often negotiated by the parties.

However, despite its length the new DROA contains only about eighteen major substantive changes from the previous DROA and Standard DROA Addendum.

We will discuss here only six of the eighteen changes which we believe would be of particular interest to attorneys.

- ***Closing Date.*** Paragraph C-7 and Paragraph C-8 modify the infamous Paragraph K on the reverse side of the previous DROA. The parties now have an option to select either (a) Paragraph C-8 which would make closing by the Scheduled Closing Date to be "of the essence" or (b) Paragraph C-7 and allow extensions for causes beyond a party's control. In the latter case, the parties may now specify for how long a period the closing may be extended. Under Paragraph K of the previous DROA, any extended closing date was always for 30 days.

- ***Contingencies and Conditions.*** Under the previous form of DROA, the party for whose benefit a condition or contingency (called a "Contingency") was imposed always had five days after the expiration of the Contingency Period to give the notice to terminate the DROA if the contingency had not been satisfied. Under the new DROA, the general rule is that the "Benefited Party" must give the termination notice before the expiration of the Contingency Period or by the specific time period set forth in the Contingency.

Therefore, it becomes particularly important that a party be vigilant with time deadlines if he or she intends to rely upon a condition in order to terminate the DROA if the condition is not satisfied.

- ***Mediation and Arbitration.*** Under Paragraph C-32 of the new DROA, non-binding mediation is now compulsory. Arbitration, on the other hand, continues to be an optional provision. The new DROA, in contrast to the previous Standard DROA Addendum, makes the arbitration and mediation provisions applicable to claims and disputes involving the parties and either or both of the brokers. The brokers, in turn, are also required to mediate and arbitrate under the Listing Agreement (as to the Listing Broker) and under the revised Cooperating Broker's Separate Agreement (as to the broker assisting the Buyer).

These provisions are intended to increase the number of disputes resolved through mediation and arbitration, and to decrease the number of disputes resolved through litigation.

- ***Title.*** If selected by the parties, Paragraph C-37 of the new DROA will greatly increase the right of the Buyer to terminate the DROA. Under Paragraph C-37 the Buyer may decide to terminate the DROA if not "satisfied" with the title to the Property. Under Paragraph B of the previous DROA, (which is similar to Paragraph C-36 of the new DROA) the Buyer could terminate the DROA only if the Seller was unable to deliver title as promised. Also, under the new DROA, the Seller is required to provide a current title report to the Buyer early during the escrow period.

If Paragraph C-37 has been selected by the parties, the Seller should require the Buyer to decide whether he or she is satisfied with the title within a short time period after receipt of the title report.

- ***Disclosure of Material Facts.*** Paragraph C-44 of the new DROA makes mandatory that the Seller disclose material facts and provide a Disclosure Statement to the Buyer. Under the previous Standard DROA Addendum, this requirement was optional with the parties. The new DROA omits as a Buyer's Contingency, the Buyer's right to reject the Seller's Disclosure Statement. However, under Paragraph C-51, the Buyer has the broad right to terminate the DROA within a certain period of time if not satisfied with the Property after inspecting it.

Paragraph C-51 is very open-ended. The Buyer should ensure that the required Disclosure Statement is provided to the Buyer within the period during which the Buyer has the right to disapprove the Property and terminate the DROA.

- ***Termite Provisions.*** The new DROA does not give the Buyer the right to terminate the DROA if the Buyer is not "satisfied" with the Termite Inspection Report ("TIR"). The Buyer's Contingencies in the new DROA are that (a) the TIR which is provided indicate no visible evidence of termite infestation or (b) eradication of termites be undertaken as recommended by the Pest Control Company.

The new DROA also allows the parties to decide between them whether the Seller or Buyer will select and pay for the TIR. (In the previous form of DROA and Standard DROA Addendum the Seller selected the Company to provide the TIR and the Buyer had the right to accept or reject the TIR.)

Finally, if the TIR reveals termite damage, the Seller is not required to repair the damage. Instead, either party may terminate the DROA. This was done intentionally, as it is difficult to determine ahead of time the extent of any termite damage which may be discovered and the cost of repairing it. The better approach, it was believed, was to have the parties work out the problem on a case-by-case basis.

Conclusion

The Standard Forms Committee has almost two dozen members, many of whom have a distinct point of view. Each member also represents constituents who may also have differing points of view. Under such circumstances, drafting of the new DROA was at best a difficult process. A wag once said that "A camel was a horse put together by a committee." Although in a few instances the new DROA and related forms may reflect that they were assembled by a committee, the new DROA represents a marked improvement over the previous forms. ■

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