

A Guide to Hawaii's Residential Leasehold

- **Single Family Residences**



Authorized By The Hawaii State Legislature
and the State's
Housing Finance and Development Corporation

About this Brochure

In 1989, the Hawaii State Legislature appropriated funds to the Housing Finance and Development Corporation for the development and publication of these informational brochures on single-family and multi-family forms of residential ownership.

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TABLE OF CONTENTS

OVERVIEW.....	4
Why should I read this brochure?	4
Why should I read the lease?	4
What if I have questions about my lease?	4
Questions to Ask Before You Buy Leasehold Property.....	4
INTRODUCTION	5
Why is it so important for me to understand leasehold issues?	5
BASIC TERMINOLOGY.....	5
What is the difference between leasehold and fee simple?	5
PURCHASING A LEASEHOLD PROPERTY.....	6
What information must be disclosed?	6
Who must disclose this information?	6
When must leasehold information be disclosed?	6
What information about the lease and its consequences should the buyer understand?.....	6
What is the buyer's right to cancel the contract?.....	7
What is the role of the leasehold addendum at the time of signing the sales contract (DROA)?	7
Do I need expert advice?	7
LEASE PROVISIONS	7
What happens upon surrender of the lease?	8
OBTAINING FINANCING FOR LEASEHOLD PROPERTY	8
How do the lease terms affect my ability to obtain financing?.....	8
What is a lease extension?.....	8
What are the lessee's options when the lease term is less than the loan term?.....	9
RENEGOTIATING LEASE RENT PAYMENTS	9
What is the owner's basis?	9
EXPIRATION OF THE LEASE TERM AND SURRENDER	10
What are the different possibilities that can occur at the expiration of the lease?	10
PURCHASING THE LEASED FEE	11
What are the types of leaseholds covered by the Act?	11
What is the role of the state Housing Finance Development Corporation?	11
How does a lessee qualify?	11
How is the purchase price determined?	11
What happens to lessees who do not choose to purchase the leased fee?	12
VOLUNTARY SALES	12
How is the offering price determined?	12
CONCLUSION	12
GLOSSARY	13

OVERVIEW

In the State of Hawaii, many residential properties were developed on a leasehold basis. With a leasehold property, most costs of development are applied towards buildings and other improvements rather than to land acquisition, thus reducing the cost of the single-family residence. As a result, for more than 50 years, residential leasehold projects have been popular with developers, investors and owners, and generally accepted by lenders in Hawaii.

Why should I read this brochure?

If you are considering the purchase of a residential property, it is likely that some of the properties which you may consider buying will be available only on a leasehold basis. Where this occurs, it is also likely that the purchase price of a leasehold property will be less than that for a comparable property available on a fee simple basis. This is because, with a leasehold, the buyer acquires only the right to occupy the land for a limited period of time and, during that time, must also pay land rent and comply with other terms and conditions contained in a lease document. The buyer does not acquire outright or absolute ownership of the land. Rather, the land is owned by another party, called the lessor or fee simple owner, to whom the lessee must pay rent under the terms of the lease. At the end of the lease, the lessee typically surrenders the land back to the lessor.

When a leasehold property is acquired, title is normally conveyed by means of an assignment of lease. This is a relatively short document by which the seller conveys or assigns his interest in the lease to the buyer. In this sense, the assignment's purpose is similar to that of a deed. The legal and practical effect is different, however, because the assignment conveys only the rights and obligations created by the lease to the property, **not the property itself.**

Just as it is important to physically examine the property being purchased, when you purchase leasehold property it is important to examine and understand the terms, conditions, and effects of the lease and the leasehold interest which is being acquired.

Why should I read the lease?

The first step in the examination process is to obtain a complete copy of the actual lease document and any amendments. Hawaii law requires that the seller provide these documents to a prospective buyer, who then has a specified period of time to carefully review the lease document, especially key elements pertaining to rent, rent Negotiation, lease term, surrender of the premises, termination, and expiration. Hawaii law also requires that a sales contract for residential leasehold

property contain an addendum which provides a summary of these key elements of the lease. While such a summary is helpful, it is not a substitute for a detailed review of the lease document itself.

This brochure is intended to assist a prospective buyer in understanding the basic elements of a leasehold arrangement, and the terms of a lease document, so that the buyer may make an informed decision with respect to the purchase of a particular leasehold property. The reader is cautioned, however, that every lease document contains its own unique provisions. Therefore, this brochure and the glossary of terms starting on page 14 should be viewed as a supplement to reading the actual lease itself.

What if I have questions about my lease?

If, in the review of the lease documents, questions are encountered of a factual nature, answers may be obtainable from the seller, from a real estate agent

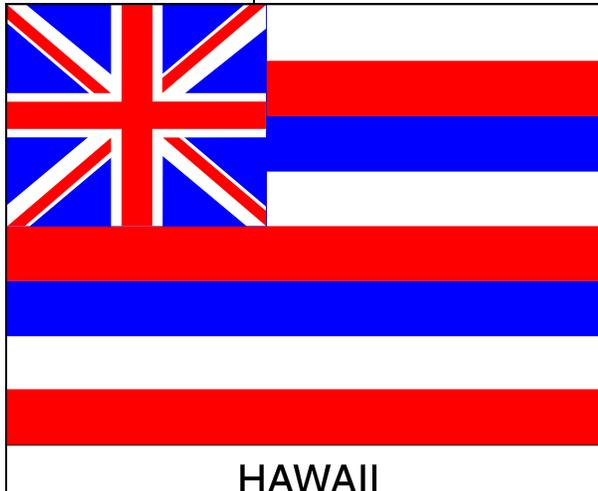
involved in the transaction, or, in some cases, the lessor. Typically the buyer deals with the lessee (seller) and not the lessor. However, it is the lessor who is the other principal party to the leasehold arrangement, and who will ultimately seek to enforce the terms of the lease document with the current lessee.

If there are questions of interpretation, or about the legal implications of a lease document and its terms, the

reader is advised to consult an attorney experienced with residential leases.

Questions to Ask Before You Buy Leasehold Property

- How long is the lease term? When is the expiration date, and is there an extension clause?
- How much is the lease rent?
- When are the lease rent renegotiation dates?
- How will the new lease rent be determined?
- What are the terms of the surrender clause?



INTRODUCTION

This brochure will help you understand some of the issues involved in buying and owning a leasehold residential property. It is specifically addressed to owners and purchasers of leasehold single family dwellings, as opposed to condominium or cooperative apartment units. The Hawaii Legislature has enacted laws which clarify the rights of many residential property lessees. Some of these laws allow certain lessees to extend their lease in order to obtain a mortgage, limit the amount of lease rent upon renegotiation, or require the lessor to sell the leased fee interest in the land. Anyone buying a leasehold residential property in Hawaii should be aware of all the consequences of leasehold ownership.

Why is it so important for me to understand leasehold issues?

- **Affects your decision to buy.** If you are contemplating the purchase of a leasehold residential property, there are additional considerations than there are if you were contemplating the purchase of a comparable fee simple property. For example, you will be concerned with the length of the remaining lease term, what happens to your improvements (house, fixtures, pool, landscaping) at the end of the lease term, and how increases in the rent payments will be determined. Answers to these types of questions may influence your decision to buy.
- **Can affect ability to obtain a loan.** As an owner of a leasehold residential property, you some day may want to refinance your property. The terms of the lease could create obstacles to obtaining the needed financing. A short time remaining on the fixed period or term of the lease could be a problem if you were seeking to refinance an agreement of sale or mortgage that is soon to become due and payable in full. Refer to page 9.
- **Affects your ability to resell.** If you want to sell your leasehold residential property, you could find the property becomes more difficult to sell as the lease term approaches its rent renegotiation and expiration dates. Naturally, a buyer would be more attracted if the lease had a longer period until rent renegotiation or expiration.

Also, lease provisions regarding such matters as the increase of rent and the expiration date of the lease term may seriously affect the willingness of some lenders to finance the proposed purchase of the property. If, due to the lease terms, buyers have difficulty obtaining financing, sellers may need to make concessions in order to sell their property. The value of

a property could decrease as the lease term nears the expiration date.

BASIC TERMINOLOGY

In order to understand the leasehold issues, it is helpful to review some basic terminology. This is also a good point for you to review the terminology found in the glossary at the end of this brochure.

As the purchaser of leasehold property, you acquire the right to use the leased property for the time period stated in the lease agreement.

In return for this right, you agree to make rent payments to the lessor and abide by the other terms of the lease.

This brochure is concerned with the ground lease—a lease of land only—usually for a long term (55 years or more from the original date of the lease). The ground lease is a means used to separate the ownership of the land from ownership of the buildings and other improvements constructed on the land.

When you purchase a residential leasehold property in Hawaii, you are buying the improvements and, in addition, the right to use the land. Thus, the ground lease should be distinguished from the short-term rental of a residence where, for example, a tenants rents a house from a landlord for six months to a year and makes monthly rent payments. In the latter case, the tenant receives no ownership in the land or the dwelling

The tenant only enjoys the right to use the property during the period of the short-term rental. In contrast, the lessee of a long-term lease enjoys the right to sell the leasehold interest to a new buyer.

What is the difference between leasehold and fee simple?

Fee Simple: Fee simple ownership is probably the most familiar form of ownership to purchasers of residential property, especially on the

Mainland. Fee simple is sometimes called fee simple absolute because it represents the most complete form of ownership of land. A fee simple buyer acquires ownership of the entire property, including both the land and buildings. The fee simple owner does not pay ground rent. The fee simple owner has the right to possess, use the land, and dispose of the land as he wishes—sell it, give it away, trade it for other things, lease it to others, or pass it to others upon death.

Leasehold: The leasehold interest is created when a fee simple landowner enters into an agreement or contract called a ground lease with a person called a lessee. A lessee buys leasehold rights much as one buys fee simple rights; however, the leasehold interest differs from the fee simple interest in several important respects. first, the buyer of residential leasehold property does not own the land and must pay ground rent. Second, his use of the land is limited to the remaining years covered by the lease. Hereafter, the land returns to the lessor and is called the reversion.



Depending on the provisions of any surrender clause in the lease, the buildings and other improvements on the land may also revert to the lessor. Finally, the use, maintenance, and alteration of the leased premises are subject to any restrictions contained in the lease.

Leased Fee Interest: After a lessor leases his land to a lessee, the lessor retains an interest called the leased fee. Thus, once the fee owner leases the land to the lessee, the lessor's rights to the land are subject to the rights of the lessee under the lease. The lessor's rights include the right to receive rent payments, the right to enforce the lease conditions, such as maintenance of the improvements, payment of taxes, assessments, and insurance, and a right to recover complete possession and control of the property when the lease term expires.

PURCHASING A LEASEHOLD PROPERTY.

Because it is so important that buyers understand the terms of the lease before purchasing a leasehold residence, Hawaii law requires that the seller furnish the buyer with certain information about the lease.

What information must be disclosed?

- **Copy of Lease Document:** At a minimum, the buyer must receive a copy of the original recorded lease and any amendments.
- **Receipt or Contract:** The buyer must sign a receipt or a copy of the sales contract to acknowledge receiving the lease document(s). The receipt or contract must also include a summary of the major provisions of the lease in plain language, such as the length of the lease, lease rent terms, lease rent renegotiation dates, how renegotiated lease rents will be calculated, and surrender clause provisions. Normally this will be accomplished in a separate addendum attached to the contract or receipt. Finally, the buyer needs to acknowledge that he or she has read and understands the terms of the lease document(s).

Who must disclose this information?

It is the responsibility of the seller to furnish the buyer with a copy of the lease document(s) and other information about the lease. The seller may provide the information directly or through an agent, most likely the seller's real estate agent. Copies of the recorded lease and amendments are available at the Bureau of Conveyances.

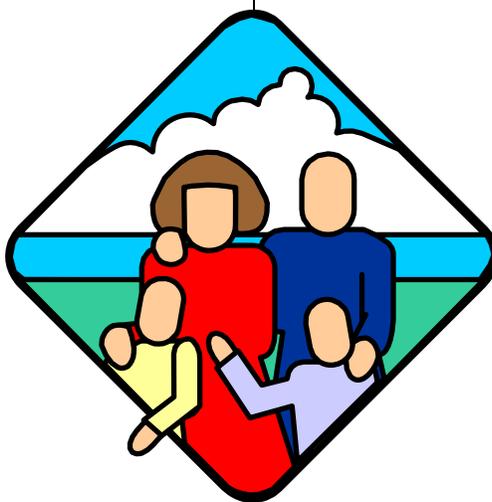
When must leasehold information be disclosed?

The seller or seller's agent must provide the required information to the buyer within 10 days from acceptance of the sales contract (that is, no later than 10 days from the date the buyer and seller reach a final agreement for sale of the property).

What information about the lease and its consequences should the buyer understand?

As a buyer, you should read the lease carefully and be sure you understand its terms and how they will affect you and relate to your plans and goals. The best time to do this is before you make an offer to purchase your leasehold property. To obtain a copy of the lease, ask the seller, the seller's agent, or your own adviser. In reviewing a lease it is especially important to find out the following information:

- **Lease term:** Find out the length of the lease, how many years are remaining until the lease ends, and whether any extensions are permitted.
- **Lease rent:** Be sure you understand how much lease rent you will have to pay (which often includes general excise tax), when it is payable and to whom, and what penalties are prescribed for late payment. Lease rents typically adjust periodically every 10 or 15 years. Find out when the rent adjusts and to what amounts.



- **Lease rent renegotiation dates:** At some point the rent may adjust, but to an amount which will be negotiated at that time. Know when the rent payments are scheduled to be renegotiated. The lease likely contains more than one renegotiation date, such as every 10 or 15 years.

- **Calculation of new rent:** Understand how the new rent payments will be determined upon renegotiation. The lease often contains a formula for calculating the new lease rent. The formula is generally based

on a percentage of the market value of the unencumbered fee simple land existing at the time of renegotiation. If market value increases significantly, so will your future lease rent.

- **Surrender clause:** Read the surrender clause carefully. It tells you what will happen to your residential buildings when the lease comes to an end. Most leases provide that the buildings on the land become the property of the lessor upon the expiration of the lease term— automatically and without payment.
- **Use of premises clause:** Know what you can and cannot do on the property. Be sure you understand any restrictions on your right to construct buildings and improvements.
- **Amendments to lease:** Leases are sometimes amended to reflect a change in the lease terms or an extension of the term of the lease. The best way to tell if there have been amendments is to examine a recent title report on the property prepared by a licensed title company.

What is the buyer's right to cancel the contract?

The law also provides that, within five days of acknowledging receipt of the lease documents, the buyer has the right to cancel the contract and recover all deposit money. The seller and buyer may agree in writing to reduce or extend the time periods required for the seller to provide the lease documents and the buyer to review them.

What is the role of the leasehold addendum at the time of signing the sales contract (DROA)?

Your standard sales contract (also called the Deposit Receipt, Offer and Acceptance or DROA) may contain a detailed addendum that informs you about leases in general and specifically about your own lease. Ask the sales agent for a copy of any standard leasehold addendum so you can review it in advance of your making an offer. Be sure to ask questions if you do not understand any part of the addendum.

Do I need expert advice?

If, after reading the lease document and the summary of its major provisions provided by the seller, and discussing this with your real estate agent, you still have questions about the lease, you should see an attorney experienced with real estate leases. The attorney can help you understand how the lease affects you and your use of the property.

LEASE PROVISIONS

The written lease spells out all the terms; conditions, and restrictions binding on the lessee, and all subsequent assignees or successor lessees. These terms generally are not negotiable. For example, the lease includes such items as the total number of years in the lease term, the rent (both fixed and renegotiated), termination or renewal dates, conditions of possession and use, and rights regarding the lessee's ability to make, and to later remove, improvements (such as buildings, fences, landscaping). Some of the more common provisions of a residential ground lease are the following:

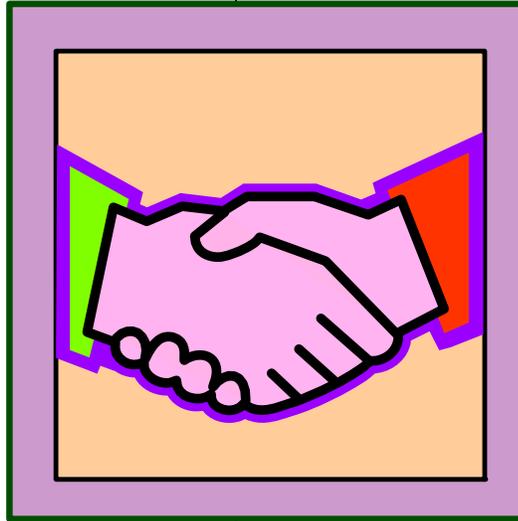
Lease term: The length of a residential ground lease may be for whatever the original lessor and lessee agreed upon, however, the typical length is at least 50 years, and usually is within a range of between 55 and 75 years.

Lease Rent: Typically, the rent will be fixed for the early years of the lease term and afterward will be renegotiated periodically.

- **Fixed Rent:** Most leases have a fixed rent period of between 25 and 35 years. During this period the rent is fixed or predetermined. There may be one or

more step up increments during the fixed rent period. For example, the rent may be fixed at a certain amount for the first 15 years, and then be fixed at a higher amount for the next 10 years. However, during the fixed rent period you know exactly how much your lease rent payments will be.

- **Renegotiated Rent:** At the end of the fixed rent period, the lease rent is renegotiated, or adjusted. This is sometimes referred to as reopening. When you purchase your leasehold property, it is very important to realize that you don't usually know the exact amount of rent you will have to pay over the entire life of the lease. This is because the renegotiated rent is generally based on a certain rate of return on the value of the unencumbered fee simple land in the future (at the time of renegotiation). As you can imagine, this is an important factor for both you and your lender to consider, as your ability to pay monthly mortgage payments may be directly affected by changes to the lease rent payments.



Assignment of the lease:

The transfer of a leasehold interest is accomplished by a document called an assignment. When you sell your leasehold property to a new buyer, you assign the lease to the buyer (also called the assignee).

Hawaii law gives a right of free assignability to certain lessees of leasehold residential lots. This law allows you to assign the lease at any time without the lessor's consent, provided that:

1. You give the lessor written notice or an executed copy of the assignment; and
2. The new lessee agrees in writing to perform all the obligations of the lessee under the lease.

You are still obligated under the lease, however, unless the lessor agrees to the assignment. The lessor may not withhold consent unreasonably, or require any payment other than a reasonable service fee.

Free Assignability

Section 516~3, HRS

- Residential lots (two acres or less and used as principal residence for one or two families)
- Lease term 20 years or more
- Written notice to lessor
- New lessee agrees to perform all obligations under the lease

Public condemnation: Occasionally all or a portion of the leased property is taken by a government authority for a public purpose such as road widening or sewer installation. When this type of condemnation occurs, the

lease specifies what happens to your property and how you are compensated for loss of your leasehold interest. Read your lease carefully.

What happens upon surrender of the lease?

Surrender: The surrender clause provides what happens to the property when the lease expires. At the end of the lease term the lessee must surrender to the lessor possession of the land. What happens to the building and other improvements on the land depends on the language of the surrender clause. Read the surrender clause carefully. Most surrender clauses can be divided into three types:

- **Building to Lessor:** The first type of surrender clause gives the building and other improvements to the lessor upon expiration of the lease. If the lessor desires to remove the improvements, the lessor is responsible for any costs involved in demolition and removal costs.
- **Building to lessee:** The second type of surrender clause gives the building to the lessee. However, since the lessee must return the land to the lessor in its original form when the lease ends, the lessee is responsible for removing the building or paying for removal. This could be a disadvantage to lessees if they must pay for removal. If the building is still in good condition or can be refurbished, the lessor may be willing to purchase the improvements from the lessee.
- **Lessor Purchases Building:** The third, and least common, type of surrender clause is one where the lessor and lessee have agreed on a price the lessor will pay for the building and other improvements upon expiration of the lease.
- In some cases, Hawaii law may require the lessor to purchase the improvements upon expiration of the lease. This law is discussed on page 11 of this brochure.

Events of default: The lessee incurs many obligations under the lease such as maintaining the improvements, paying taxes and lease rent, and maintaining insurance. Failure to abide by the terms of the lease, including failing to pay real property tax and lease rent could result in money damages or even cancellation of the lease.

Maintenance and Insurance: The lessee is usually held responsible for the maintenance and upkeep of the property, including paying all real property taxes and assessments, insuring the dwelling against loss or damage by fire, and for maintaining public liability insurance.

Termination: The lease terminates on the expiration date specified in the lease agreement. A lease may also be terminated by mutual agreement of the lessee and

lessor, or by eviction because of a breach of a lease provision.

OBTAINING FINANCING FOR LEASEHOLD PROPERTY

Unless you have the cash to pay the full price to buy your residential property, you will need to obtain a loan to finance the difference between the cash down payment and the sales price. The terms of the lease can affect your ability to obtain a loan, especially if the lease is due to expire in less than 30 years, or if there are only a few years remaining on the fixed rent period.

How do the lease terms affect my ability to obtain financing?

Most banks and other lending institutions have policies for approving loans on leasehold property that can affect a buyer's ability to finance, refinance, or an owner's

subsequent ability to resell. Certain lenders require that there be at least 10 years remaining on the fixed rental portion of the lease, or that the term of the lender's loan be no longer than the remaining years on the lease, less two years.

In addition, the Veterans Administration will not guarantee a mortgage beyond the actual time remaining on the fixed rent period of the lease, and the Federal Housing Administration insures mortgages only up to five years beyond the expiration of the fixed portion of the lease.

These policies may make it more difficult for an owner to sell the residential property as the fixed rent period or the entire lease shortens. Lenders are cautious about loaning money against leases with short fixed rent periods because they are concerned that the borrower may not be able to make the monthly mortgage payment if the renegotiated lease rent increases substantially.

If you are considering purchasing a leasehold residential property and only a few years remain on the lease, it may be helpful to have an appraiser estimate approximately what the lease rent would be if renegotiated now.

What is a lease extension?

Check your lease to see if it covers your right to extend the lease term. Even if not required under the lease, the lessor may be willing to extend the fixed portion of the lease to meet the requirements of the lender. In return for this, the lessor will likely want either to increase the lease rent or to charge a premium for the extension. With extensions, some lessors base their rents on existing lease rents for comparable properties.



You may have the right to extend your lease under Hawaii law if your lease originally was signed and took effect **after** June 24, 1967. Section 516-65, Hawaii Revised Statutes (HRS), allows you to extend the lease term up to 55 years during the first 20 years of the lease term if the following requirements are met:

- You give written notice to the lessor
- Less than 50 years remain on the lease term
- The extension is for the purpose of obtaining a mortgage on your leasehold interest in the property
- You are not in default under the lease

The lessor may charge a reasonable fee for the extension.

The law provides a formula for determining the new lease rent for the first 30 years of the extended lease. For the remainder of the extended term, the rent is decided by mutual agreement between the lessee and lessor. If the lessee and lessor cannot agree, the rent will be decided by an impartial third party through arbitration proceedings.

Extension of Lease

Section 516-65, HRS

- Residential lots
- Lease dated after June 24, 1967
- During first 20 years of lease
- Less than 50 years remaining
- For purpose of obtaining a mortgage

What are the lessee's options when the lease term is less than the loan term?

- **Shorter term loan:** The buyer could apply to a conventional lender for a loan with a shorter term.
- **Owner Financing:** The lessee-seller may be willing to finance the purchase through an agreement of sale or mortgage, with the seller in essence acting as the lender.
- **Extending the lease:** The lessee can attempt to obtain an extension of the lease term, either through negotiating with the lessor, or under Section 516-65, HRS.
- **Purchasing the fee:** Finally, the lessee can inquire whether it is possible to purchase the leased fee interest from the lessor, sometimes referred to as fee conversion. The lessor may decide to make a voluntary sale of the leased fee interest, or the lessee may qualify to purchase the fee under the Land Reform Act which gives certain lessees of residential lots the right to require the lessor to sell the leased fee interest. See pages 11 & 12.

RENEGOTIATING LEASE RENT PAYMENTS

As we've already seen, in most leases, the rent is not fixed, or predetermined, for the full term of the lease. Rather, at certain dates (called renegotiation dates) the lessor and lessee must agree on a new lease rent.

Lease rent renegotiations are usually scheduled in 10 or 15 year intervals after the initial fixed rent period (usually 25 to 30 years).

Most leases contain a formula for determining the new lease rent. Because the formula is frequently based on rent and market conditions existing on the renegotiation dates, the rent could rise dramatically and is not known with certainty until the actual time of renegotiation. As a buyer, it is important to read the lease document(s) carefully so that you understand when and how the new lease rent payments will be calculated upon renegotiation.

Some residential property lessees may be eligible to take advantage of a lease rent renegotiation formula specified by Hawaii law. Like most leases, the statutory formula is based on a percentage of the market value of the land existing at the time of renegotiation. Thus, while the lease rent renegotiation law provides some protection to lessees, the rent may still rise greatly.

Hawaii law provides a maximum limit for rent renegotiation for leasehold residential property. Section 519-2, HRS, may apply to you if your lease: (1) has a term of 20 years or more, and (2) calls for rent renegotiation. Section 519-2 provides that renegotiation of rent cannot take place more than once every 15 years and the first renegotiation date can be no sooner than 15 years following the commencement date of the lease.

Rent Renegotiation

Section 519-2, HRS

Qualifications:

- Residential lots
- Lease term 20 years or more
- Lease provides for rent renegotiation

Law provides:

- Rent renegotiation no more than once every 15 years
- First renegotiation no sooner than 15 years
- Formula for maximum lease rent

Section 519-2 also provides a formula for determining the maximum amount of renegotiated lease rent to be paid by the lessee. The new annual lease rent cannot exceed the owner's basis times four percent.

What is the owner's basis?

The owner's basis is based on the current market value of the lot valued as if it were fee simple, and not including the house, landscaping, walls, pools, or other onsite improvements. From this amount is subtracted any of the lessee's share of the current replacement



cost of existing off site improvements serving the lot, such as roads and sewer connections. Once the owner's basis is determined, that figure is multiplied by four percent.

You will require the assistance of a qualified real estate appraiser in estimating the approximate market value of the unencumbered fee simple land and the current replacement cost of the off site improvements. If the lessee and the lessor cannot come to an agreement based upon the foregoing formula, the law requires that the rent be determined by an impartial third party through arbitration proceedings conducted by the Housing Finance and Development Corporation.

Calculation of Renegotiated Rent for Residential Lots

If the fee simple value of the land, excluding onsite improvements, is \$200,000 and the current replacement cost of the offside improvements is \$30,000, then the maximum new lease rent would be \$6,800 per year.

Fee simple value of land	\$200,000.
Off-site improvements	<u>- 30,000.</u>
Owner's Basis	170,000.
	<u>x 4%</u>

Ceiling on Renegotiated Lease Rent \$ 6,800.

As you can see, this method of calculating renegotiated lease rents tied closely to current land values. Since there is no upper limit on land value other than current market conditions, the new rent may increase greatly. This increase reflects the rise in land values since the beginning of the lease 25 or 35 years before.

EXPIRATION OF THE LEASE TERM AND SURRENDER

Several possibilities exist at the expiration of the lease term, and most leases contain the following clauses:

Reversion: The typical residential ground lease provides that the land reverts to the lessor at the end of the lease term. In other words, when the lease expires, the lessor retakes possession of the land. When you buy a house on leased land, it is important to consider what happens to the house after the lease expires.

Surrender Clause: Ground leases typically contain a surrender clause providing that, upon expiration of the lease, the land and the building become the property of the lessor. The clause generally requires that the lessee surrender to the lessor, upon expiration of the lease term, the dwelling, garage, roads, landscaping, and swimming pools, even if these improvements were built and maintained at the lessee's expense.

What are the different possibilities that can occur at the expiration of the lease?



• **Attempt to renegotiate an extension or new lease:** The lessee could attempt to negotiate a new ground lease or extend the ground lease even though the lessor may not be legally obligated to do so. The lessor may be unwilling to extend or enter

into a new lease if the lessor has plans to redevelop the property. On the other hand, a lessor who plans to maintain the property as a residential property may be willing to grant a new lease. In this situation, however, the new lease rent could be the market rental price of both the land and the house as both become the property of the lessor at the expiration of the original lease.

• **Surrender improvements to lessor:** If the lessee is unable to negotiate an extension of the

existing lease or a new lease, the lessee may be forced to surrender the dwelling to the lessor and move out.

• **Removal of Improvements:** The surrender clause may instead require the lessee to remove the dwelling and restore the land to its original condition at the end of the lease term. The lessee would be required to pay the cost of removing the dwelling and any other improvements when the lease expires.

• **Lessor purchases improvements:** If the residential lease was executed after July 1, 1975, Section 516-70, HRS, may provide some protection from the surrender clause in the lease. For the law to apply, the lease must be for a term of 20 years or more. Despite any lease provisions to the contrary, Section 516-70 allows the lessee to remove the dwelling and any other onsite improvements which were paid for by the lessee. Section 516-70 also provides that the lessor must pay the lessee the current market value of the improvements if:

- The lessor refuses to extend the lease or issue a new lease for a term of at least 30 years
- The lessee is not in default under the lease
- The lessee notifies the lessor in writing 60 days before the lease expires that the lessee does not plan to remove the improvements.

The market value of the improvements will be determined by an appraisal paid for by the lessee. The lessee and the lessor must mutually agree on the selection of the appraiser. If the parties cannot agree on the selection of an appraiser or on the value of the improvements, the matter will be determined by an impartial third party through arbitration proceedings.

Reversion of Improvements

Section 516-70, HRS

Removal

- Residential lots

- Lease term 20 years or more
- Lease executed after July 1, 1975
- Purchase by Lessor

Purchase by Lessor

- Residential lots
- Lease term 20 years or more
- Lease executed after July 1, 1975
- Lessor refuses to grant extension or new lease
- Written notice to lessor

The Hawaii Supreme Court recently held that Section 516-70 does not have retroactive effect and thus is valid only as applied to leases executed **after** July 1, 1975, the effective date of the statute.

PURCHASING THE LEASED FEE

As the owner of a leasehold residential property, you probably have heard of the Hawaii "Land Reform Act" and may wonder if you are eligible to purchase the leased fee interest in your lot under this law. The Act permits qualified lessees to purchase their leased fee with the assistance of the State Housing Finance and Development Corporation (HFDC) by following certain procedures specified in Chapter 516, HRS.

The provisions of the Act are quite complex. If you are contemplating a leased fee purchase under the law, you should consider consulting a qualified real estate appraiser, who can assist in estimating the value of your leased fee, and an experienced attorney to assist in legal matters. However, it is not necessary to do so in order to apply with HFDC.

What are the types of leaseholds covered by the Act?

You may be eligible to purchase the leased fee interest under the Land Reform Act if your leasehold is of the following type:

1. Your leasehold property must be a "residential lot," two acres or less in size, used as a principal residence for one or two families;
2. Your residential lot must be part of a "development tract," meaning a single area of at least five acres which has been developed and subdivided into residential lots;
3. The lease term must be 20 years or longer;
4. For leases signed after June 24, 1967, at least 10 years must remain on the lease term, and 90 percent of the leases to the lots in the development tract must have been executed.
5. Twenty-five or more qualified lessees in a development tract must apply to purchase the leased fee interest in their residential lots. If there are fewer than 25 lessees in a development tract, then more than 50 percent of the lessees in the tract must apply. For example, if a development tract consists of 10 residential lots, then six of the lessee/owners must apply.

What is the role of the state Housing Finance Development Corporation?

The State Housing Finance and Development Corporation is the state agency responsible for administering the Land Reform Act. Lessees in a development tract who desire to purchase the leased fee interest under the Act must first apply to HFDC.

In lease-to-fee conversions under the Act, HFDC first acquires the leased fee interest through court action and then sells it to qualified lessees. HFDC can acquire the leased fee interest through voluntary court proceedings as agreed to by the parties, or by contested court action if necessary.

How does a lessee qualify?

Owners of leasehold single family homes must meet the following qualifications in order to purchase the leased fee interest in their lots through the State Housing Finance and Development Corporation:

1. Be at least 18 years of age;
2. Reside in Hawaii or intend to live in the development tract after buying the fee;
3. Own the dwelling on the residential lot;
4. Have proof that the lessee can pay the full purchase price of the lot, such as a certificate of deposit or an approved application from a lending institution;
5. Submit an application and execute a contract for purchase of the fee as required by HFDC; and
6. Not own in fee simple any other land suitable for residential purposes in the same county. This includes land owned by the lessee's spouse.

Purchase of Leased Fee

Chapter 516, HRS

- Residential lots
- Within a development tract
- Lease term 20 years or more
- At least 10 years left on leases dated after June 24, 1967
- 25 or more qualified lessees; or more than 50% of lessees in tract, must apply
- Hawaii resident
- Owner of the leasehold interest
- Proof of financing
- Do not own in fee simple any other residential land in same county

How is the purchase price determined?

As the owner of a leasehold residential property, you are probably concerned about the cost of acquiring your lot. If you participate in a leased fee purchase through HFDC, you will have to pay the value of your leased fee, as determined under the Land Reform Act, plus any additional administrative costs incurred by HFDC for surveying, appraisal, legal fees, and the like, and a share of any costs of negotiation or court proceedings.

The deposit previously paid with the application to HFDC is applied first towards these costs, and then if anything is left, the remainder is applied to the purchase price. The lessee is required to pay his or her full pro rata costs which may exceed the initial deposit.

Under the Land Reform Act, the amount you pay for the leased fee interest is called the owner's basis. The owner's basis is defined as the market value of the lessor's leased fee interest. This value may be determined by two methods provided in the statute, or by any other method normally used by qualified real estate appraisers. An important technical point to note is that this owner's basis is not the same as the owner's basis used to set maximum lease rents upon renegotiation under Section 519-2, HRS.

The method most commonly used to determine the market value of the leased fee interest is the income approach. The owner of the leased fee has two sources of income: (1) lease rent over the period of the lease and (2) return of the land at the end of the lease (reversion). The appraiser calculates the amount of lease rent due over the fixed period of the lease and estimates the projected rent over the renegotiated lease periods. This amount is then reduced (discounted) using present value tables reflecting the fact that lease rent dollars received in the future are worth less than dollars received today. Next the appraiser evaluates the worth of the reversion of the land by discounting the current market value of the land as if it were raw land unencumbered by any leases or liens. The sum of the two equals the value of the leased fee interest.

Value of Leased Fee

Projected ground rent over remaining lease term discounted to present worth):

Present value of fixed rent	\$5,000.
Present value of renegotiated rent	+\$25,000.
Present value of reversionary interest in land (market value of raw land discounted to present worth)	+\$30,000.
Value of leased fee interest	\$60,000.

What happens to lessees who do not choose to purchase the leased fee?

You may wonder what will happen if the other lessees in your development purchase their lots through HFDC, but you choose not to participate. Will you have another chance to purchase the fee?

The law allows you to apply again. However, if you decide to purchase your lot at a future time, you will have to follow the procedure outlined above which requires 25 or more lessees (or 50%) in the development tract to apply. It may not be possible to obtain the required number of qualified lessees.

You may still be able to negotiate a voluntary purchase with your lessor; however, the offering price may not be as favorable as that obtained by the lessees who participated in negotiations or court action with the assistance of HFDC. Also, for various reasons, includ-

ing tax concerns, the lessor may not be willing to offer the fee more than once.

VOLUNTARY SALES

Some lessees do not qualify to purchase the leased fee interest in their residential lot under the procedure described above. Still, some lessors decide voluntarily to offer for sale the leased fee interest.

How is the offering price determined?

The price at which the leased fee may be offered is not subject to any legal restrictions. In some cases, the lessor may want a certain price, leaving little room for negotiation. However, one or more appraisers may be asked to appraise the market value of the lessor's leased fee interest. Appraisers typically use the income approach when they value the leased fee under a leasehold residence, as discussed above. As you can see, it is not easy to determine what price you may have to pay for the leased fee interest, assuming the lessor is willing to sell and you are willing to buy. If the lessor does offer to sell the leased fee interest, you may want to consult an expert to advise you about the pros and cons of the offer. If the lessor has not committed to sell the leased fee interest, you should carefully consider the possible impact of this on present and future value.

Sometimes preliminary negotiations for the voluntary sale of the leased fee are underway when the sellers list their property for sale. One of the questions you as a buyer want to ask your seller is whether there is an ongoing or planned leased/fee conversion. If so, the sales contract (DROA) should address such issues as seller cooperation and transfer of any deposit monies.

CONCLUSION

As described in this brochure, leasehold ownership of residential property involves a unique relationship and agreement between the parties to the lease. Everyone considering the purchase of a leasehold residential property needs to understand the advantages and disadvantages of leasehold ownership in general, especially the impact of rent renegotiation and lease expiration.

Reading this brochure is one step in that process. The next step is to obtain and carefully read all applicable lease documents. Then if you have questions or need professional advice about the terms or implications of that lease, address your questions to the seller or the seller's agent, the lessor, your real estate agent, and your attorney.

GLOSSARY

Agreement of Sale: A written agreement to secure performance by the buyer of a promise to purchase real property from the seller. The buyer takes possession of the property and is said to have equitable title, while the seller retains legal title. The purchase price is paid in installments over the period of the agreement with the balance due at maturity. When the buyer completes the required payments, the seller of leasehold property must deliver good legal title to the buyer by way of an assignment of lease.

Amendment of Lease: A document reflecting a formal change to the original terms of the lease, such as new lease rent amounts or expiration date.

Appraisal: An opinion or estimate of the value of property, usually made by a qualified real estate appraiser in a written report. An appraisal may be used to determine the offering price of the leased fee interest. An appraisal is frequently required to determine the value of the land for purposes of calculating the new lease rent upon rent renegotiation.

Arbitration: A method of settling legal disputes other than litigating the matter in court. The matter is submitted to an impartial third party called an arbitrator (or a panel of arbitrators) whose decision is final.

Lease documents often specify a fixed rent for a certain period, followed by renegotiations based on the appraised value of the land. If the parties cannot agree on the appraised value, the matter is resolved by arbitration by a panel of appraisers. Normally, the lessor and the lessee each select an appraiser, and those two appraisers agree on a third appraiser to help them determine the final appraised value.

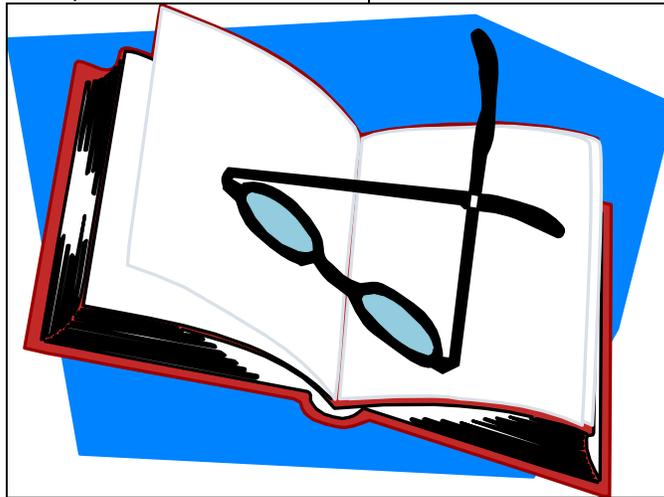
Assignment of Lease: The transfer of a lessee's interest in leased property to another. When a lessee sells a leasehold property to a new buyer, the lease is assigned to the buyer, and the document used to accomplish the sale is called an assignment of lease. Many leases require the consent of the lessor prior to any assignment of the lease. The new buyer ("assignee") assumes the rights and responsibilities of the lessee.

Condemnation: The forced sale of private property to the government when needed for a public use. Condemnation is exercised by the government under the theory of eminent domain, and the owner of the property condemned must usually be reimbursed with just compensation.

Conversion: The process of transforming a leasehold interest in land to an unencumbered fee simple interest through sale of the leased fee interest to the owner of the leasehold interest (the lessee). Conversion involves the merging of the leasehold and the leased fee interests to form a fee simple estate.

Development Tract: A single piece of land at least five acres in size which has been developed and subdivided into leasehold residential lots. Separate areas can be considered as one development tract if separated by roads, streams, fee simple lots, or similar barriers. A single family leasehold residential lot must be part of a development tract to qualify for purchase of the leased fee interest under the Land Reform Act.

DROA: Deposit Receipt, Offer and Acceptance. A sales contract form most frequently used in Hawaii for real property transactions. It is a written agreement between the seller and buyer in which the buyer agrees to buy certain real property and the seller agrees to sell upon terms in the agreement. The DROA is one of the most important documents in a real estate transaction. It contains such provisions as the amount of the earnest money deposit, the purchase price and down payments, financing terms, closing date, and conditions of sale.



Expiration Date: The date the lease term will expire (cease to exist) as specified in the lease agreement. The lessee's right to possess the property will end on the expiration date unless the lease is extended, the lessee purchases the lessor's leased fee interest, or other arrangements are made. A lease may terminate prior to the expiration date. See Termination.

Extension of Lease: An agreement between the lessee and the lessor to make the lease effective for an additional period of time beyond the expiration date. The lessee may seek an extension of the total lease term, or the fixed rent portion of the lease, in order to obtain financing on the property due to the requirements of banks and other lending institutions. In most leases, the lessor has absolute discretion whether or not to agree to a request for extension. Hawaii law gives certain qualified lessees of residential leasehold properties the right to extend their lease for the purpose of obtaining a mortgage.

Fair Market Value: See Market Value.

Fee Simple: The highest degree of ownership in real property recognized by law. Fee simple ownership may be transferred by gift, sale or succession and includes most rights to the enjoyment and use of the property, indefinitely, subject to federal, state and local laws. When land is leased, the unencumbered fee simple interest and the right to possession are held separately until the leasehold and leased fee interests are again merged; for example, through the sale of the leased fee interest to the party who holds the leasehold interest, or termination of the leasehold interest through reversion of all property rights at the end of the lease term.

Fixed Rent: An amount of lease rent which is fixed or predetermined in the lease document. During the fixed rent period of a ground lease (typically 25 to 35 years), the lessee knows exactly how much the lease rent payments will be. The fixed rent period may contain one or more step up increments which provides that the rent may be fixed at a certain amount for the first 10 years, and then be fixed at a higher amount for the next 10 years. The lease rent may also be subject to rent renegotiation at the end of the fixed rent period.

Ground Lease: A lease of land only, and not the buildings or other improvements constructed on the land. Ground leases are usually for a long term of 55 years or more. Generally, the rent is fixed for the early years of the lease term and then is renegotiated periodically. Typically, ground leases provide that the land reverts to the lessor at the end of the lease, including any building or other improvements on the land.

HFDC: Housing Finance and Development Corporation. The state agency responsible for administering Hawaii's Land Reform Program.

Improvements: Buildings or other permanent structures or additions attached to land which may increase the value of the land. Examples of improvements include: construction of buildings, dwelling units, fixtures such as built-in appliances and carpeting, fences, sidewalks, roadways, sewers, swimming pools, and landscaping.

Land Reform Act: A State of Hawaii law designed to allow lessees of single family residential lots to purchase the fee simple interest in their lots. The Land Reform Act was first adopted by the Hawaii Legislature in 1967 and is found in Chapter 516, Hawaii Revised Statutes.

Lease: A written agreement by which the owner of property (lessor) gives possession of it to another person (lessee) for a definite period of time in return for the payment of rent. The lessor retains the right to retake possession at the end of the lease term. The specific type of lease may be a sublease, a master lease, a ground lease, or any other kind of lease.

Lease Rent: Periodic rental payments exclusive of any other payment required under the lease made by the lessee to the owner (lessor) in return for the right to use and occupy the property. The lease rent is specified in

the lease agreement. The lease usually also specifies where and when lease rent payments are to be made.

Lease Term: The length of time, as specified in the lease, during which the lessee may rightfully use and occupy the leased property. A ground lease typically has a term of 55 years or more.

Leasehold Interest: The rights and obligations of the lessee in the property as controlled by the lease agreement.

Leasehold Mortgage: A mortgage on the lessee's leasehold interest in the property. The lessee may obtain a leasehold mortgage from a bank or other lending institution in order to finance the purchase of the property or obtain a loan to make home renovations. If the lessee defaults, the bank may foreclose on the mortgage. The mortgage will be lower in priority to the ground lease because the ground lease provides that the lease rent has priority over mortgage payments.

Leasehold Property: A property held under the terms of a lease agreement. The holder of a leasehold interest (lessee) usually pays the owner of the leased fee interest (lessor) a stated amount of lease rent over a specified lease term in consideration for the right to use and occupy the property.

Leased Fee Interest: The property interest retained by a landowner who has leased the rights to the use of the fee simple land for a definite period of time. The value of a leased fee interest includes the receipt of lease rents throughout the lease term and the reversion of the fee simple rights to the landowner at the end of the lease term.

Lessee: The person to whom property is rented or leased. The lessee possesses the right to use or occupy the property (the leasehold interest) in return for the payment of rent over the term of the lease agreement.

Lessor: The person who rents or leases property to another (the lessee) under a lease agreement. The lessor retains an interest in the property called the leased fee interest.

Market Value: The most probable cash price a property would sell for on the open market given a willing seller and a willing buyer, neither being under abnormal pressure, both being fully informed, and given reasonable time. Market value should be distinguished from purchase price, the price actually paid for a property, which may be influenced by other factors such as negotiating ability and time pressures.

Master Lease: The dominant, or controlling, lease of real property. For example, a landowner might lease land to a developer to subdivide and construct residential homes, and the developer in turn subleases the residential lots to individual lessees. The subleases must conform to the terms of the master lease. Thus, if the master lease is for a 55-year term, a sublease cannot legally exceed 55 years.

Merger: The uniting or combining of two or more interests into one. Merger occurs at the end of the lease term when the leasehold interest reverts to the lessor, and the lessor once again owns the property in fee simple.

Merger also occurs in a lease-to-fee conversion when the lessee purchases the leased fee interest from the lessor. The leasehold interest and the leased fee interest merge together and the lessee becomes the fee simple owner. However, if there is a leasehold mortgage, merger does not occur until the mortgage is fully paid off and the mortgage is released.

Off Site Improvements: Physical improvements which are constructed or placed for the benefit of a subdivision away from the residential lots and intended for the benefit of all residents in a particular area. Off site improvements may include streets, sewer lines and sewage treatment plants, gutters, curbs and sidewalks, underground electric cables, and land given to the public for park and schools.

On Site Improvements: Physical improvements placed on a residential lot for the benefit of residents of that lot. Included in on site improvements are dwelling units, service buildings, garages, stairs, walkways, driveways, walls, trees, shrubs, landscaping, and pools.

Owner's Basis (For Lease Rent): Part of the formula provided law for determining maximum lease rent at the time of renegotiation. Owner's basis means the current fair market value of the residential lot valued as if it were a fee simple lot, not including onsite improvements such as the house, less the lessee's share of the current replacement cost of existing off site improvements, such as roads and sewers. The new lease rent may not exceed four percent of the owner's basis.

Owner's Basis (For Purchasing the Leased Fee Interest): Part of the formula in the Land Reform Act for determining the purchase price of fee interest.. Owner's basis means the market value of the lessor's leased fee interest. This value may be determined by the methods provided in the Act, or any other method normally used by qualified real estate appraisers.

Removal Clause: Provision in the lease requiring the lessee to remove all buildings and other improvements and restore the leased land to its original condition at the end of the lease term. The lease typically provides that the improvements will become the property of the lessor if not removed by the lessee within the specified time. See **Surrender Clause**.

Renegotiation of lease Rent: The review of lease rent after a specified period of time to negotiate the rent anew. Most long-term ground leases require the renegotiation of lease rent payments after an initial fixed rent period. In the event that the lessor and lessee cannot agree on a new lease rent, many leases contain a formula for determining the renegotiated rent. This formula is frequently based on a specified rate of return to the lessor on the market value of the land as

determined by an independent appraisal. Renegotiation, also called reopening, usually occurs in intervals of 10 or 15 years until the lease ends.

Reopening Provision: See **Renegotiation of Lease Rent**.

Residential Lot (Land Reform Act): A parcel of land two acres or less in size intended for use as a principal residence for one or two families.

Lessees of residential lots may be eligible under Hawaii's leasehold laws to exercise certain rights such as: purchasing the leased fee interest in their lot, extending their lease term in order to obtain a mortgage, or limiting the amount of lease rent the lessor can charge upon renegotiation.

Reversion: The right of a lessor to retake possession of leased property upon the termination of a lease. The typical ground lease provides that the land reverts to the lessor at the end of the lease term. The general rule is that all buildings and other improvements placed on the land by the lessee will also revert to the lessor. The lease document may require the lessee to remove the improvements. See Em_a_

Surrender Clause: A provision of the lease which describes what will happen to the property, including any buildings or other improvements, when the lease term ends. At the end of the lease term, the lessee must surrender or deliver to the lessor possession of the land. In some cases, the surrender clause may provide that the improvements automatically become the property of the lessor. Other leases provide that the lessee may, or must, remove improvements paid for by the lessee. Others provide that the lessor may purchase the improvements from the lessee.

Termination: The cancellation of a lease. For example, a lease terminates at the end of the lease term. The expiration date is specified in the lease agreement. A lease may also terminate by mutual agreement of the lessee and lessor, a breach of a condition of the lease, or an eviction.

Unencumbered: A title to real property that is free and clear of encumbrances such as leases, restrictions, mortgages and other liens.