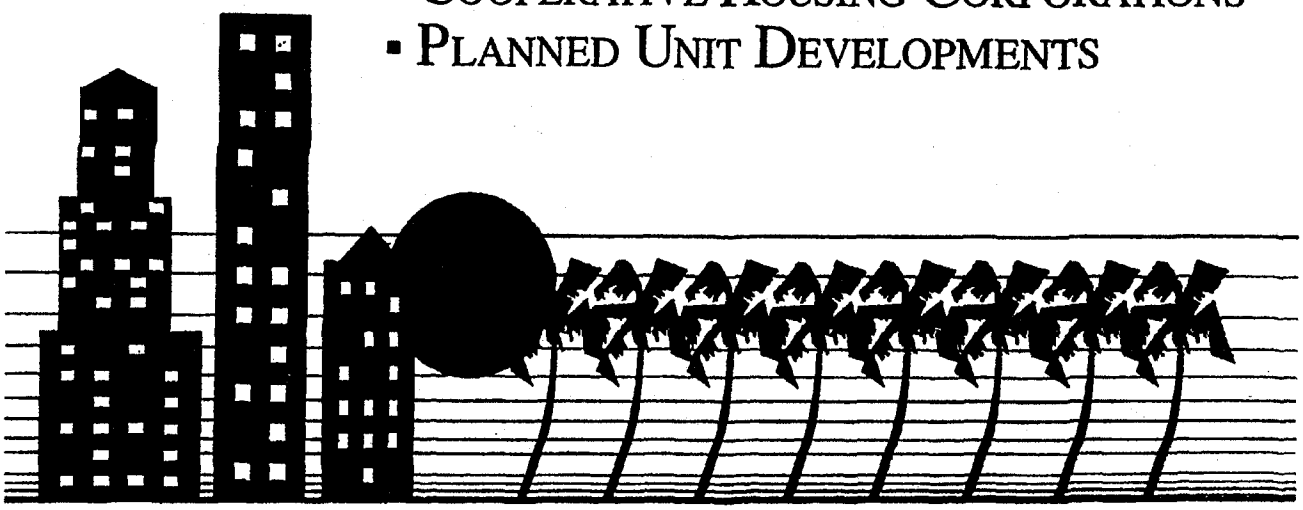
A Guide to Hawaii's Residential Leasehold

- Condominiums
- Cooperative Housing Corporations
- Planned Unit Developments



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Housing Finance and Development Corporation

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OVERVIEW

In the State of Hawaii, many residential condominium and cooperative apartments *(units)* are leasehold. With a leasehold property, most costs of development are applied towards buildings and other improvements rather than to land acquisition. As a result, residential leasehold projects have been popular with developers, investors, and owners, and generally accepted by lenders in Hawaii, for more than 25 years. Buyers have been attracted to certain leasehold apartment units because of location, cost savings, building amenities, and unavailability of comparable fee simple properties.

Why should I read this brochure?

If you are considering the purchase of a residential condominium or cooperative apartment, it is likely that some of the units 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 unit will be less than that for a comparable unit available on a fee simple basis. This is because, with a leasehold, the unit owner acquires only the right to occupy the land for a limited period of time and, during that time, must pay rent and comply with other terms and conditions contained in a lease document. The unit owner does not acquire outright or absolute ownership of the land. Rather, the land is owned by another party, called the lessor or leased fee owner, to whom the lessee must pay rent under the terms of the lease. At the end of the lease, the unit owner typically **surrenders** the unit and the land back to the lessor who now holds title to the land free and clear of the lease.

When a leasehold unit 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.**

Why should I examine the lease?

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.

The first step in the examination process is to obtain a complete copy of the actual lease document(s) and any amendments. Hawaii law requires that the seller or the seller's agent provide the document(s) to a prospective buyer, who then has a specified period of time to carefully review the lease document(s), especially key elements pertaining to rent, rent renegotiation, 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 the key elements of the lease. While

such a summary is helpful, it is **not a substitute** for a detailed review of the lease document(s).

What can I learn from this brochure?

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 17 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 document(s), 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. Yet, 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 unit owner. For some important questions to ask before you buy leasehold property, see page 7.

If there are questions of interpretation, however, or about the legal implications of a lease document and its terms, the reader is advised to consult an attorney experienced with residential leases.

INTRODUCTION

This brochure will help you understand some of the issues involved in buying and owning residential leasehold condominium and cooperative apartments, as well as dwelling units within planned unit developments *(PUDs)*. This brochure uses the term *apartment unit* to refer to all three forms of ownership. It is important, however, to check the glossary of terms at the end of this brochure so you understand how the three differ. Anyone buying a leasehold residential apartment should be aware of all of 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 residential leasehold apartment unit, there are additional considerations than there are in the event that you were contemplating the purchase of a comparable fee simple apartment unit. For example, you will be concerned with the length of the remaining lease term, what happens to your unit at the end of the lease term, and how increases in the rent payments are determined. Answers to these types of questions will influence your decision to buy.

Affects your ability to obtain a loan. As an owner of a leasehold apartment unit, you some day may want to refinance your leasehold apartment unit. A short time remaining on the fixed period or term of the lease could create obstacles to obtaining the needed financing. This could be a problem if you were seeking to refinance either an agreement of sale or a mortgage that is soon to become due and payable in full. Refer to page 10.

Affects your ability to resell. If you want to sell your leasehold apartment unit, you could find the apartment unit 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.

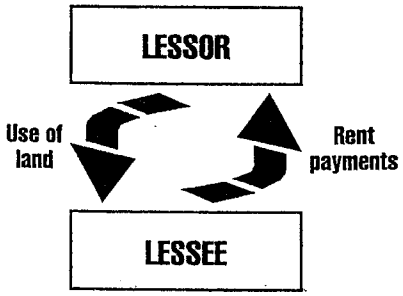
Also, lease provisions regarding such matters as the increase of rent and the expiration date of the lease term may seriously affect the willingness of some lenders to finance the proposed purchase of the apartment unit. If, due to the length of the lease term, buyers have difficulty obtaining financing, a seller may need to make concessions in order to sell the apartment unit. The value of a unit could decrease as the lease term nears the expiration date.

BASIC TERMINOLOGY

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

What does leasehold mean?

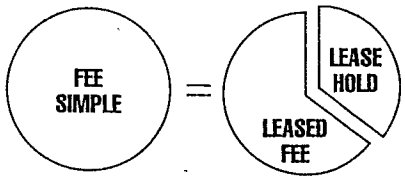
As the purchaser of leasehold property, you acquire the right to occupy and use the leased property for the time period stated in the lease agreement. In return for this right, you agree to make rent payments to the lessor and abide by the other terms of the lease.



This brochure is concerned with the *ground* lease and with those leases related to the ground lease, such as an apartment lease. The ground lease is a lease of land only, usually for a long term (55 years or more, from the original date of the lease). It is a means used to separate the ownership of the land from ownership of the buildings and other improvements constructed on the land. In many cases, a developer enters into a master ground lease with the fee simple owner, agreeing in the lease to construct a residential project within a certain period of time. The developer or cooperative corporation, or in some cases the ground lessor, then enters into a sublease or a new lease of the land with the apartment owner. The developer may lease the improvements to the apartment owner by way of an apartment lease or sublease, or sell the improvements to the apartment owners by way of a condominium conveyance or apartment deed.

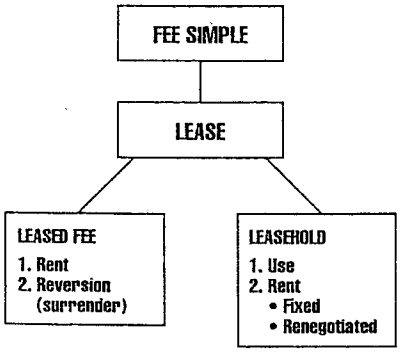
The long-term lease should be distinguished from the short-term rental of an apartment where, for example, a tenant rents an apartment from a landlord for six months to a year and makes monthly rent payments. In the latter case, the tenant receives no ownership in the land or the unit. The tenant only enjoys the right to use the apartment 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 buyers of residential property, especially on the Mainland. Fee simple is sometimes called *fee simple absolute* because it is the most complete form of ownership. 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, but does pay maintenance fees and real property taxes. 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 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. Thereafter, the land returns to the lessor, and is called *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 property and the payment of taxes, assessments, and insurance, and the 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(s): At a minimum, the buyer must receive a copy of the lease document or documents which contain the major provisions of the lease. The lease document(s) could be any one of the following:

- the master lease and any amendments; or
- the apartment lease and any amendments; or
- for buyers of new condominium apartments, a copy of the condominium public report.

In addition to the minimum legal requirement, buyers should review other relevant lease documents. For example, the buyer of a cooperative apartment may want to review the Master Lease in addition to the Proprietary Lease on the apartment.

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 term of the lease, lease rent provisions, 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. Buyers also must be informed that current law does not give condominium and cooperative lessees the right to require that the lessor sell them the leased fee interest in the land under their apartment. 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 public record office in Honolulu.

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 should the buyer understand?

As a buyer, you should read the lease carefully and be sure you understand its terms and conditions and how they 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 apartment unit. 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 there is any right to extend.

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, 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 amount. Also find out whether or not your maintenance fee payments include the lease rent.

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 lease rent: Understand how the new rent payments will be determined upon renegotiation, including any procedures involving the use of arbitration. The lease often contains a formula for calculating the new lease rent. This 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. For rules applicable to cooperatives, see page 12.

Surrender clause: Read the surrender clause carefully. It tells you what will happen to your apartment unit when the lease comes to an end. Most leases provide that the buildings on the land, including your apartment, become the property of the lessor upon the expiration of the term of the lease—automatically and without any payment.

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.

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?

What is the buyer's right to cancel 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 that 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 familiar with real estate leases. The attorney can help you understand how the lease and its consequences affects you and your use of the property.

TYPES OF APARTMENT UNIT LEASES

When you acquire a unit in a cooperative, you receive a *Proprietary Lease*. When a leasehold apartment unit in a condominium or a PUD is originally conveyed, this is done by an *Apartment Lease*. Upon resale, that lease will be transferred by an *Assignment of Lease*. The heading on the original apartment lease may have one of several descriptions: Apartment Lease, Apartment Lease and Ground Lease, Condominium Conveyance Document, Apartment Deed and Ground Lease, or Dwelling Lease. Regardless of the type, the consequences of your leasehold ownership will be substantially similar to those described in this brochure.

What are the typical provisions of an apartment lease?

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. Some of the more common provisions of residential apartment unit leases are the following:

Lease term: The length of the term of an apartment unit 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.

How much lease rent must I pay?

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 apartment unit, 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. 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. 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).

What are other provisions I should be aware of?

Assignment of the lease: The transfer of a leasehold interest is accomplished by a document called an assignment. When you sell your leasehold apartment unit to a new buyer, you assign the lease to the buyer, (also called the assignee). Your lease may require the consent of the lessor prior to any assignment of the lease. Courts have held, however, that the lessor may not unreasonably withhold consent. Even after an assignment, you may remain responsible under the lease unless the lessor releases you and agrees to allow the buyer to assume all the responsibilities of the lessee.

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 condemnation occurs, the lease specifies what happens to your apartment unit and how you are

compensated for loss of your leasehold interest. Read your lease carefully.

What happens to my unit at the end of the lease?

Surrender: The surrender clause provides what happens to the apartment unit and other improvements when the lease expires. At the end of the lease term the lessee must surrender or deliver to the lessor possession of the land. What happens to the apartment units and other improvements on the land depends on the language of the surrender clause. Be sure to read the surrender clause carefully. Most surrender clauses can be divided into three types:

> **Apartment unit to lessor:** The first type of surrender clause gives the apartment units and common elements to the lessor upon expiration of the lease. If the lessor desires to remove the apartment unit, the lessor is responsible for any costs involved in demolition and removal.
>
> **Apartment unit to lessee:** The second type of surrender clause gives the apartment unit to the lessee. However, because the lessee must return the land to the lessor in its original condition when the lease ends, the lessee is responsible for the proportionate costs of the demolition and removal of the apartment unit. This could be a disadvantage to lessees if they must pay for the demolition and removal. If the building is still in good condition or can be refurbished, the lessor may be willing to purchase the apartment units and improvements from the lessees.
>
> **Lessor purchases apartment unit:** 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 apartment unit and its share of the common elements upon expiration of the lease.

What other obligations do I have?

Events of default: The lessee incurs many obligations under the lease such as maintaining the building, paying real property 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 and maintenance fees could result in money damages or even termination of your 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 apartment 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 apartment unit, 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, or refinance, and 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 number of 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 fixed rent period of the lease.

These policies may make it more difficult for an apartment unit owner to sell the unit as the fixed rent period or the entire lease term 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.

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

If you are considering purchasing a leasehold apartment unit and only a few years remain on the fixed rent period of the lease, it may be helpful to contact an appraiser to estimate approximately what the lease rent would be if renegotiated at this time.

Shorter loan term: 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 inquire whether the lessor is willing to extend the lease term.

Purchase the fee: Finally, the lessee can inquire whether it is possible to purchase the leased fee interest from the lessor. The lessor may decide to make a voluntary sale of the leased fee interest to some or all of the apartment unit owners in the project, but the lessor is under no obligation to do so.

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). The majority of leasehold apartment units in the State of Hawaii are due to renegotiate lease rents between the years 1990 and 2019.

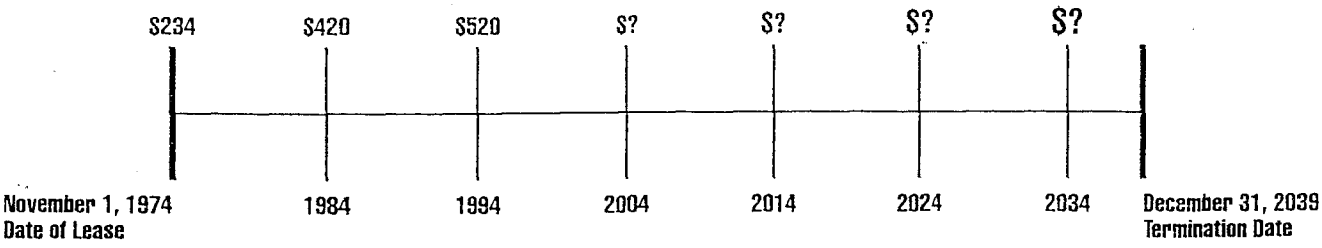
Most leases contain a formula for determining the new lease rent. Because the formula is frequently based on rent and market conditions existing on the renegotiation dates, the rent could rise dramatically and is not known with certainty until the actual time of renegotiation. As a buyer, it is important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

Most general leases provide a formula for the renegotiated rents to be based on a stated *rate of return* on the market value of the land under the project at the time of rent renegotiation. For example, if at the time of renegotiation, the value of the land under a 100-unit condominium is $5,000,000 and the stated rate of return is 7%, then the formula would result in a renegotiated rent of $3,500 per year or $291 per month ($5,000,000 x 7% x 1%, assuming your unit represented a 1% common interest in the land).

In other cases, the rate of return is an amount to be negotiated based on current land values and current rates of return. Two other less common methods for determining renegotiated rent are: (1) basing the new rent on current market rent for similar buildings; and (2) increasing the current rent by the change in the consumer price index over the preceding fixed rent period.

Under all but the last method, leases generally provide that if the lessee and lessor cannot agree on the new lease rent before the beginning of the renegotiated rent period, the rent will be determined by an arbitration procedure. For example, the lease may specify that the market value of the land will be decided by three impartial real estate appraisers, one to be chosen by the lessee, one by the lessor, and the third selected by the first two. In deciding the market value, the land is usually treated as though it had no structures on it.

LEASE RENT TIME LINE



After the market value of the land is determined, it is multiplied by a percentage rate of return specified in the lease (or, if not, then determined by the appraisers) to compute the rent for the entire apartment unit project. Then this figure is multiplied by the lessee's percentage share of the common interest in the project to determine the amount of the lessee's individual rent.

Many leases have the rate of return set at a specific rate. Other leases may provide that the rate be based on the prevailing rate of return for similar properties at the time of renegotiation. The prevailing rate of return for similar properties will depend on market conditions existing at the time of renegotiation.

As you can see, this method of calculating renegotiated lease rent is 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 will reflect the rise in land values since the beginning of the lease 25 to 35 years ago.

What is Mandatory Arbitration?

Hawaii law provides that all ground leases for condominium and cooperative projects must contain a provision for the mandatory arbitration of any renegotiated rent. This means that if the lessee and the lessor cannot agree on a new rent before the renegotiation date, either may request that the rent be decided by an impartial party. For example, this impartial party would include a panel of real estate appraisers.

If the lease does not provide for the arbitration of lease rent and if the parties are unable to agree on the rent upon renegotiation, then the law specifies the process to follow. The law does not, however, specify or limit the amount or rate of rent to be paid. Here is the required procedure:

- The new rent shall be determined by three impartial arbitrators who are recognized real estate appraisers.
- The lessee and lessor will each select one appraiser. The first two appraisers will select the third.
- The three appraisers will determine the renegotiated rent and their decision will be final and binding.
- The lessee and lessor will share the costs equally.

What are the lease rent renegotiation formulas for cooperatives?

Hawaii law provides a ceiling for renegotiated rent for cooperative apartment projects that qualify under the law. This law does not apply to rent renegotiation of units in condominium and PUD projects.

The law applies to all cooperative Proprietary Leases which call for rent renegotiation. It provides that renegotiation of rent cannot take place more than once every 10 years and the first renegotiation can be no sooner than 15 years following the commencement date of the lease. It also provides a formula for determining the maximum

amount of renegotiated lease rent to be paid by the cooperative housing corporation.

If the lessee corporation and the lessor cannot come to an agreement on the new lease rent, the law requires that the rent be determined by an impartial third party through arbitration proceedings conducted by the State Housing Finance and Development Corporation.

EXPIRATION OF THE LEASE TERM AND SURRENDER

Several possibilities exist at the expiration of the lease term, and most leases contain a reversion and surrender clause:

Reversion: The typical apartment 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 an apartment unit on leased land, it is important to consider what happens to the unit after the lease expires.

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

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

Attempt to negotiate 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 project 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 the land and the apartment unit, as both became the property of the lessor at 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 apartment unit to the lessor and move out.

Removal of improvements: The surrender clause may instead require the apartment lessees to remove the structure and restore the leased land to its original condition at the end of the lease term. In the case of a condominium or cooperative, the individual apartment owner would be legally required to pay his or her proportionate share of the expense of removal of the building that contains the apartment unit when the lease expires.

PURCHASING THE LEASED FEE

Hawaii does not have a law requiring the lessor to sell to the lessee the leased fee interest under a condominium, cooperative, or PUD leasehold project. Still, some lessors decide voluntarily to offer for

sale the leased fee interest to apartment owners (referred to as a *fee conversion*).

How is the offering price determined?

The price at which the fee may be offered is not subject to any legal restrictions. This price may be determined by mutual agreement between the parties or set by an impartial panel of one or more appraisers. In some cases, the lessor may want a certain price, leaving little room for negotiation.

Appraisers typically use the income approach to value the leased fee interest in the land under a leasehold apartment unit. In addition to lease rent payable over the period of the lease, the owner also will receive the return of the land at the end of the lease *(reversion)*.

LEASED FEE = LEASEHOLD RENT + 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. This reflects the fact that lease rent dollars received in the future are worth less than dollars received today. In essence, the appraiser asks how much would a person need to invest today (as in an annuity) to receive a stream of income equal to the amount of rent projected for the entire lease term.

Next, the appraiser evaluates the worth of the reversion of the land, by calculating the projected value of the land at the end of the lease but then discounting that amount to present value. An example follows:

Determining the Value of Leased Fee

Projected ground rent over remaining lease term (discounted to present worth):		
Present value of fixed rent		$600,000
Present value of renegotiated rent		$900,000
plus		
Present value of reversionary interest in land (market value of raw land discounted to present worth):		$500,000
	equals	$2,000,000
times		
Lessee's percentage of common interest		x1%
Value of Leased Fee Interest		$20,000

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 apartment unit 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 money.

What is the right of first refusal for condominium associations and cooperative corporations?

In 1988, the Hawaii State Legislature enacted a law to give condominium owners associations a right of first refusal to buy the leased fee interest if the lessor decides to sell to anyone other than the existing individual apartment owners. At least 75% of the unit lessees must approve of the purchase, or the lessor can complete his sale of the fee to another party. The intent of this law is to encourage negotiations for a leased fee sale between lessors and condominium or cooperative owners or their associations or corporations.

CONCLUSION

As described in this brochure, leasehold ownership of apartment units involves a unique relationship and agreement between the parties to the apartment lease. Everyone considering the purchase of a leasehold apartment unit 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, and to your real estate agent and attorney.

NOTES

GLOSSARY

Agreement of Sale

A written agreement to secure performance by the buyer and seller 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 a leasehold apartment unit 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 interest, 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 under a leasehold apartment project for purposes of calculating the new lease rent upon rent renegotiation. See **Market Value.**

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 handled 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. See **Proprietary Lease.**

Common Areas

Areas of a condominium or cooperative designated for use by all residents. Common areas frequently include hallways and stairways, elevators, barbecue areas, and swimming pools.

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.

Condominium

A form of real property ownership consisting of (1) ownership of an individual apartment unit; and (2) an undivided interest in the common elements. The common elements include the land (either in fee simple or leasehold), and those parts of the building intended for common use such as foundations, roofs, halls, elevators, and the like. Each condominium apartment may be sold separately from all other units.

Owners of condominium apartments generally belong to an association of apartment owners, an organization comprised of all unit owners to oversee the common elements and enforce the bylaws. Association members are entitled to vote on decisions involving changes in the bylaws and other matters.

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 an unencumbered fee simple estate.

Cooperative

A form of real property ownership in which a corporation is the lessee. Buyers who wish to own the cooperative housing project purchase shares of stock in the corporation and receive a Proprietary Lease from the corporation (as lessor) granting the right to occupy a specific unit and, in some cases, a parking stall. The cooperative housing corporation serves a function similar to the association of apartment owners of a condominium. Normally, the owner of a co-op apartment unit may sell his or her interest only with the approval of the directors of the corporation.

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 payment, 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.

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, upon the sale of the leased fee interest to the party who holds the leasehold interest, or termination of the leasehold interest and the 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 periods.

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. This definition is a much broader definition than the type of remodeling or upgrading improvements the apartment unit owners might accomplish in their own unit.

Land Reform Act

A State of Hawaii law designed to allow lessees of single family residential lots to purchase the leased fee 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, an apartment lease, a master lease, a ground lease, a condominium conveyance document, a proprietary lease, or any other kind of lease.

Lease Rent

Periodic rental payments, exclusive of any other payment received 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 construct an apartment building, and the developer in turn subleases the units 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.

PUD

Planned Unit Development. A form of development permitted under zoning controls allowing a greater density of dwellings or a mix of unit types not found in the conventional subdivision. Buildings may be clustered together to leave more open space for parks and recreational areas. Like a subdivision, the land may be divided into lots. Unlike condominium owners, owners of leasehold PUDs lease the lot directly under their home, but like condominiums, owners would have an undivided interest in the common elements. A community association is usually organized to provide for maintenance of common areas. Without checking the legal documents it is sometimes difficult to tell looking at a townhouse project whether it is a PUD or a condominium.

Proprietary Lease

A written lease between the corporation which holds a cooperative apartment building and the lessee who purchases shares in the corporation. The proprietary lease gives the lessee the right to use and occupy a particular unit, and, in some cases, a particular parking stall.

The proprietary lease sets forth all the rights and responsibilities of the lessee, and frequently includes the restriction that an owner may sell his or her interest only with the approval of the directors. The lease may be subject to a Master Lease between the land owner and the corporation.

Public Report

A report issued by the State Real Estate Commission disclosing all material facts that the prospective purchaser of a new condominium project should know before buying a unit. The public report may take the form of a preliminary, final, or supplemental report.

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. Individual lessees would be required to pay a proportionate share of the expense of removal. The lease typically provides that the improvements will become the property of the lessor if not removed by the lessee within the specified time.

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 lessee and lessor 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 arbitration panel. Renegotiation, also called reopening, usually occurs in intervals of 10 or 15 years until the lease ends.

Reopening Provision

See **Renegotiation of Lease Rent.**

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 **Surrender Clause.**

Right of First Refusal

The right to have the first opportunity to purchase or lease real property. A right of first refusal might give a lessee the right to purchase the leased fee interest, if it is offered for sale. The lessee who has a right of first refusal has no right to purchase until the owner actually offers the property for sale or entertains an offer to purchase from some third party. At that point the lessee may match the offer. Under Hawaii law, the homeowners association of a condominium or cooperative has a right of first refusal to buy the leased fee interest if the lessor decides to sell.

Sublease

See **Master Lease.**

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 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.