

# Leasehold Land

by George Stott (revised January 2008)

**Leasehold vs. Fee Simple:** In most areas of the United States, land is owned in fee simple. A fee simple owner has ownership of the entire property, including both the land and buildings. Fee simple ownership is the most complete form of land ownership. Subject to local ordinances and deed restrictions, the fee simple owner has the right to possess, use, and dispose of the land as the owner sees fit. The owner can sell it, give it away, trade it for other things, lease it to others and pass it to others upon death.

A leasehold interest is created when a fee simple owner or lessor enters into a rental agreement for the land called a ground lease with someone who will be using the land, called a lessee. A lessee acquires leasehold rights much as one acquires fee simple rights; however, the leasehold interest differs from a fee simple interest in the following five important respects: (1) The buyer of residential leasehold property does not own the land and in almost all cases, pays a ground rent to the lessor. (2) The use of the land by the lessee is limited to the remaining years covered by the lease. (3) When the ground lease ends, the land returns to the owner or lessor. If there is a surrender clause in the ground lease, the buildings and other improvements on the land may also revert to the lessor.

**NOTE: Most of the ground leases on Oahu contain a surrender clause; i.e., the buildings and other improvements revert to the lessor at the end of the lease.**

(4) The use, maintenance, and any alterations of the leased land are subject to local ordinances as well as any restrictions contained in the lease. And (5), in most cases, a lessee can sell or transfer the ground lease to another party, referred to as an assignment of lease; however, the sale or transfer is usually subject to the review and approval of the lessor.

**Background:** Leasehold ownership enables a buyer to purchase a property at far less cost than would exist if the property were being purchased in fee simple. It was a very common method of ownership on Oahu 30-40 years ago with most residential homes being owned in leasehold. Ground leases by the larger lessors were usually written for a 55-year period with 30 or 40 years at a fixed rent and then a slightly higher rent for an additional 25 or 15 years. The lessors were normally very cooperative in providing lease extensions or renewals so that owners or buyers could obtain long-term mortgages for refinancing or purchases.

However, when housing prices soared on Oahu, the large landowners started taking an entirely different view of their leasehold investments. The spiraling land values made long-term land leases a poor investment; e.g., in 1967, we paid \$35,000 for a leasehold house with a 40-year fixed lease (until 2007) at a rent of \$17/mo. When we sold the home ten years later in 1977, the leasehold value had tripled to about \$100,000; however, the lease rent was still only \$17/mo and would remain at that rental rate for 30 more years.

What the large landowners did was to begin making the fee purchases available at high prices and initiate large increases in lease rents whenever leases renegotiated. Early on, there were no provisions for mandatory conversions from leasehold to fee. Therefore, the fee prices (when offered) were usually done on a *"take it or leave it"* basis without any negotiations between the lessees and lessors. Buyers suddenly started paying far more attention to the terms of land leases. To assist buyers in understanding all the ramifications of leasehold, the state passed a leasehold disclosure law in 1990 making it mandatory for sellers to provide full disclosure (usually done by an attorney) on assignment of leases.

Hawaii had passed a state law (Hawaii Land Reform Act) in 1967 that enabled mandatory conversions of houses from leasehold to fee simple via eminent domain. However, the law wasn't tested for a number of years, as it wasn't really necessary until housing prices began soaring. In 1979, Bishop Estate began a long legal process challenging the law. The 9th U.S.

Circuit Court of Appeals declared the law unconstitutional in 1983 in a 2:1 ruling; however, in 1984, the U.S. Supreme Court overturned the ruling by the lower court in a unanimous decision thereby providing judicial approval for mandatory conversion of houses on Oahu. Following that decision, most leasehold houses on Oahu were converted to fee, usually via negotiations between landowners and lessees vice going to court and experiencing the cost and unknown outcome of having a jury establish the fee prices. I was very involved in this a number of years ago, as I chaired a three-person team in successfully negotiating the fee purchases for a group of homeowners in Kailua. Today, there are very few leasehold houses remaining on Oahu.

The Hawaii Land Reform Act deliberately omitted condos (townhouses & high-rises) in view of concern that the different form of ownership of condos compared to houses would create problems in the judicial review process. In 1991, Honolulu passed City Ordinance 91-95 with applicability to condos that basically mirrored the Hawaii Land Reform Act for houses. The law worked its way through the judicial process to the U.S. Supreme Court that in 1998 provided judicial approval by refusing to hear an appeal in view of the law's similarity to the Hawaii Land Reform Act.

With some notable exceptions, most of the larger lessors began to offer the fee interest in their condos for purchase following the Supreme Court ruling. Mandatory conversion of condos, though, created a different situation than the mandatory conversion of houses. With houses, large estates such as Bishop Estate (now known as Kamehameha Schools) owned most of the underlying land in large tracts. With condos, many were relatively small buildings owned by Hawaiian families. The underlying land often had been in the family for years, with its potential loss creating a huge emotional issue, as owning land has significant cultural ties to Hawaiians. Therefore, the Hawaiian family lessors would often turned out in large numbers whenever there was a public hearing. It was subsequently discovered there was a flaw in the wording of the condo law. A ruling by the Hawaii Supreme Court in 2002 eliminated the law's applicability to almost all of the condos on Oahu. Faced with ongoing pressure from the Hawaiian community and in view of the fact that the fee had been offered voluntarily in most of the larger complexes, in 2005 the City negated the mandatory conversion of condos law choosing not to start the legal process all over again. So in summary, the fee is available for most leasehold condos on Oahu, but certainly not all of them. There are numerous buildings where the fee has never been offered and may never be offered.

So, what happens when the ground lease on a condo expires where the fee has never been offered? Answer: no one knows. The ground leases on the first two leasehold complexes expired in 2007. It was hoped that a precedence would be set by these first two complexes, but that did not occur. Both complexes were quite small. The first lessor reluctantly caved-in to community pressure and agreed to sell the fee interest to the leasehold owners. The second lessor went to court where a judge ruled early in 2008 that the lessees would have to surrender their homes. Unusual circumstances existed with each of these complexes but similar unusual circumstances are likely to exist with other complexes. At the end of this article is a list of the Oahu condos where the ground leases will expire by 2018. The next expiration does not occur until 2010 when the leases in six different complexes expire.

**Considerations:** Leasehold ownership on Oahu has become increasingly unpopular in view of all the uncertainty. If the fee is available, many buyers will purchase it simultaneously with purchasing a unit in leasehold. Therefore, the leasehold value for a unit is usually the fee value for a comparable unit less the cost of the fee and fee closing costs. The cost to buy the fee is a combination of the unencumbered value of the land offset by the remaining years on the lease. As the lease gets progressively shorter, the fee price usually gets progressively higher, particularly near the end of the lease.

Mortgage financing also becomes an issue. As the lease gets progressively shorter, it becomes increasingly more difficult to find lenders that make loans on the property. When there are less

than ten years remaining on the lease, the leasehold property is virtually unsellable except to a buyer that is willing to pay cash at a very discounted price.

Also a consideration is the 30-year requirement on the land lease for a leasehold property to qualify for a 1031 exchange; i.e., there must be at least 30 years remaining until the expiration of the lease (not renegotiation). This has already impacted on some of our clients who wanted to conduct 1031 exchanges.

If you are the owner of a leasehold property, we advise you, in most cases, to buy the fee as soon as practicable, as the cost of the fee will continue to increase with time. If buying the fee is impracticable, in most cases, you should sell your property in leasehold as soon as practicable, as the leasehold value will likely continue to decline with time. If you decide to wait to sell for the next period of rising prices on Oahu, you may find that the cost of the fee has increased more than the increase in value of your leasehold home; i.e., you will net less from the sale. This general advice obviously varies with the leasehold property and the owner's situation. For additional information, contact us toll free (1-800-922-6811) or locally (808-254-1515) or via e-mail ([team@stott.com](mailto:team@stott.com))

So who buys in leasehold (excluding very long leases)? Leasehold is considerably less expensive than fee. Granted, the value of leasehold will decline near the end of the lease. But, some buyers are more concerned about what they're able to do today than what may happen tomorrow. The fact that a home is leasehold has no impact on the rent that it produces. So, some investors opt to buy in leasehold. The mortgage payment for some leasehold homeowners (offset by tax deductions) is less than the cost to rent a comparable home. So, some homeowners also opt to buy in leasehold. It may enable them to own in a complex that otherwise would be too expensive. The important thing about either owning or buying in leasehold is to understand what you're doing and the limitations of leasehold ownership. If you are a potential buyer of leasehold property, contact us toll free (1-800-922-6811) or locally (808-254-1515) or via e-mail ([team@stott.com](mailto:team@stott.com))