

# WALT FLOOD REALTY

## Leasehold and Fee Simple Ownership in Hawaii

- [INTRODUCTION](#)
- [BASIC TERMINOLOGY](#)
- [PURCHASING A LEASEHOLD PROPERTY](#)
- [TYPES OF APARTMENT UNIT LEASES](#)
- [OBTAINING FINANCING FOR LEASEHOLD PROPERTY](#)
- [RENEGOTIATING LEASE RENT PAYMENTS](#)
- [EXPIRATION OF THE LEASE TERM AND SURRENDER](#)
- [PURCHASING THE LEASED FEE](#)
- [CONCLUSION](#)

## A Guide to Hawaii's Residential Leasehold

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

### INTRODUCTION

This article will help you understand some of the issues involved in buying and owning residential leasehold condominium and cooperative apartments. This article uses the term apartment unit to refer to all three forms of ownership. 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 were contemplating the purchase

of a residential Leasehold apartment, there are additional considerations than there are in the event that you were contemplating the purchase of a Fee Simple apartment. For example, you will be concerned with the length of the remaining ground lease term, what happens to your unit at the end of the lease term, and how increases in the ground rent payments are determined. Answers to these questions will influence your decision to buy, or not to buy.

**AFFECTS YOUR ABILITY TO OBTAIN A LOAN.** As an owner of a leasehold apartment, you may some day want to refinance, or take out a second mortgage, or use your equity for a line of credit. A short time remaining on the fixed period or term of the ground lease could create obstacles to obtaining the needed financing. This also 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.

**AFFECTS YOUR ABILITY TO RESELL.** If you want to sell your leasehold apartment, you could find the apartment becomes more difficult to sell as the ground lease term approaches its rent renegotiation and explicit expiration date. Naturally, a potential buyer would be more attracted if the lease had a longer period until ground rent renegotiation and/or the final expiration of the lease (see Surrender clause).

Also, ground 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 short length of the ground lease term, buyers may have difficulty obtained financing, and 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.

Furthermore, real estate firms and agents may avoid taking the property listing. Of, if they do take the listing, they may negotiate a higher commission, and/or a bonus to the buyer's agent (paid by the seller). It also may take longer to sell the leasehold apartment, additional expenses, and the incident of "buyer's remorse" is more prevalent, after the buyer has had a opportunity to review the leasehold documents, and/or the disclosure statements.

## **BASIC TERMINOLOGY**

In order to understand leasehold issues, it is helpful to review some of the basic terminology.

# What does leasehold mean?

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

This article 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 sells the improvements to the apartment owners by way of a condominium conveyance or apartment deed.

The long-term ground lease should be distinguished from the short-term rental of an apartment where, for example, a tenant rents the 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 the long-term ground 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 USA 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 (improvements). The Fee Simple owner does not pay ground rents, but does pay association 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 land-owner 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 ground lease. Thereafter, the land returns to the lessor, and this 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 (Landlord) leases his land to a lessee (viz. buyer), the lessor retains an interest called the Leased Fee. In other words, once the fee owner (Landlord) leases his 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 ground rent payments, the right to enforce the lease conditions such as maintenance, 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 DOCUMENTS:** 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 documents 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 Document. 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 documents. The receipt or contract must also include a summary of the major provisions of the lease in plain language, 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 (buyers) the right to require that the lessors sell them the leased fee interest in the land under their apartments. Finally, the buyer needs to acknowledge that he or she has read and understands the terms of the lease documents.

## **Who must disclose this information?**

It is the responsibility of the seller to furnish the buyer with a copy of the lease documents 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 reached 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.

**Note:** in reality, the Seller, or the Seller's agent typically does not provide the lease documents "prior" to your making an offer to purchase the leasehold apartment. If that is the case, ask your agent, or representative to provide a Leasehold Disclosure Statement outlining the known facts about the project, the ground lease: fixed periods, renegotiation dates, expiration date, and the surrender clause.

Then, when reviewing the Ground Lease, within those days as noted on the DROA, 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 extent.

**LEASE RENT:** Be sure you understand how much lease rent you will have to pay (which often includes Hawaii general excise tax), when it is payable and to whom, and what penalties are prescribed for late payment. Lease rents typically adjust every 10 years, for the next 10 years, after the first "fixed period(s)". Find out when the rent adjusts, and to what amount. Also find out whether or not your maintenance fee payments include the ground lease rent.

**LEASE RENT RENEGOTIATION DATES:** At some point the lease rent may adjust (increase), but to an amount which will be renegotiated at that time. Know when the lease rent payments are scheduled to be renegotiated. The ground lease likely contains more than one renegotiation date, such as every 10 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 master 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 value 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 apartment unit when the master lease comes to an end (expiration date). Most leases provide that the buildings on the land including your apartment, and all its improvements, become the property of the lessor (Landlord) upon the expiration of the term of the lease--automatically and without any payment.

**AMENDMENTS TO MASTER 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 the contract (DROA)?**

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 period 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 ground leases in general and specifically about your own ground 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 ground 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. If the sale is a cash sale, you will receive a share of stock in the co-op corporation. If the sale is financed, either by the seller or a mortgage firm, you will receive a share of stock upon satisfaction of the debt.

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 article.

## 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 lessees 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 ground 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. Their may be one or more step up increments during the fixed rent. 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 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 value in the future (at the time of renegotiation).

## What are other provisions I should be aware of?

**ASSIGNMENTS 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 specifics 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, or the whole building, 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. Note: This arrangement is NOT common, and you should read this document very carefully.

**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, or earlier. This may happen if the lessor has an opportunity to re-develop the land, with a larger building, with many additional apartment units.

## 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 ground 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 damages by fire, and for maintaining public liability insurance.

**TERMINATION:** The lease terminates on the expiration date specified in the master 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 affects 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 7-10 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 insurers mortgages only up to 5 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 lending money against leases with short fixed rent period 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 contacts 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. For this to happen, you may need a larger downpayment, a higher interest rate, and a shorter time frame.

**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 have 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 to 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 documents 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 ( $\$5,000,000 \times 7\% \times 1\%$ , assuming your unit represented a 1% common interest in the land).

In other cases, the rate of return is an amount to be renegotiated based on current land value and current rates of return. Two other less common methods for determining renegotiation 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.

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 in 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 value. 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 Corp.

## 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 initial 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 leased 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).

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 period. 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 evaluate the worth of the revision 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 X 1%

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 advice 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 values.

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 the 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 negotiation for a leased fee sale between lessors and condominium or cooperative owners or their associations or corporations.

## **CONCLUSION**

As described in this article, 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 article is one step in that process. The next step is to obtain and carefully read the 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 to the seller's agent, the lessor, and to your real estate agent and attorney.



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