

LEASEHOLD REVERSION:
THE KAILUAN & A LOOMING SOCIAL ISSUE

By

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The 18-unit Kailuan is the first multi-family project (co-op) to have its lease expire (12/31/07) and the residents are still occupying the property. The first was Kahala Garden Apartments, Inc. (16-unit co-op in Kahala), but its fee owner, Kamehameha Schools, sold the property to Kahala Gardens just prior to the lease expiration date (7/31/07).

The brewing fight between Kaneohe Ranch and The Kailuan has the usual mixed public reaction. Some see the public benefit of avoiding the displacement of residents over contractual obligations of the lease. Others see it the other way around. However, residents of The Kailuan believe there is one key issue in this case that gives them the right to buy their fee - the law.

Chapter 514C, Hawaii Revised Statutes, provides condo and co-op projects with the right of first refusal to buy the property if the landowner wants to sell it to a third party. If a landowner is going to sell to a third party, it must offer it to the co-op or condo first. Kaneohe Ranch has publicly declared it will sell the property to a third-party after The Kailuan's lease expires.

The residents of The Kailuan say Kaneohe Ranch is trying to circumvent the law, depriving the lessees of their opportunity to buy the fee. Kaneohe Ranch says it has a variety of reasons why it won't sell to The Kailuan. Whether or not Kaneohe Ranch breached the law, the spirit of the law or has done nothing wrong is for a court to decide. It shouldn't have to come to that, but this is yet another example of the inability of lessors and lessees to amicably resolve their differences in the marketplace.

Lessors and lessees are generally reasonable people that can understand each other's positions. However, naturally lessors tend to see the lease contract as paramount and want its terms adhered to, while lessees are more focused on their homes and feel the social implications. This disparate view often creates conflict and controversy, but neither lessor or lessee is at fault. They were thrust into this situation by an ill-conceived system that misapplied commercial leasehold concepts to a residential context – notably market lease rent increase tied to unknown land value fluctuation and reversion (surrender) of the property at the end of the lease. Businesses are accustomed to these terms, but not the average apartment owner. We should remember that key occupants of apartments are young people starting out, people with limited affordability and seniors who need the convenience of apartment living.

Hawaii's residential leasehold system was born from an acute housing shortage after WW II. About 70,000 apartments and 25,000 single-family homes were built on leased land. If you wanted to own property, chances were you had to buy leasehold at some point. There just was not enough fee simple property available.

Today, there are about 500 condo and co-op projects statewide that have about 19,000 leasehold units. All the leases contain reversionary clauses, which require surrender of the property back to the fee owner when the lease expires. This is a key social dilemma created by our antiquated

residential leasehold system. It will exist until we are completely out of residential leasehold. A sale of the fee to the lessees creates probably the best win-win resolution, but unfortunately some don't see it that way.

Most fee owners are just landowners, not developers. As such, the best options at the end of the lease for them are to sell the property for redevelopment or, if the improvements are still viable, lease it again. Interestingly, both lead right to the current lessees who would be the best buyer (typically pay more than developable value) or the best continuing lessees (pay market rent and take the improvements as is). As such, most fee owners and lessees should be able to reach an agreement before the end of their leases.

However, while it might appear that the marketplace can resolve some of these reversion cases, lessors and lessees have generally shown an acute inability to work out their situations, mostly because of their very disparate views and interests.

Kaneohe Ranch versus The Kailuan is just the start of many potential disputes which will likely arise around expiring co-op and condo leasehold interests (about 30 projects with 1,500 units in just the next 10 years). No doubt there could be many more situations and problems with reversion in the years ahead. We've all known these reversion events are coming, but no one knows exactly what will happen. While we all wish these can be resolved in the marketplace, history has shown it doesn't usually happen and government will likely be forced to intervene.

Government has struggled with Hawaii's leasehold system from almost its inception - passage of the Land Reform Act in 1969, the first legislation aimed at mitigating the adverse social effects of our residential leasehold system. When compelled to action, government has tended to side with social conscience and both the U.S. Supreme Court and the Hawaii Supreme Court have upheld the legal concept of mandatory leasehold conversion. Social conscience over the lease contract.

In 2007 the Legislature passed Act 166, tax exemption incentive for fee owners to sell. It is a "carrot" incentive in an effort to avoid the "stick" of a statewide mandatory conversion law for condos and co-ops. Although proven quite effective at getting us out of residential leasehold, mandatory fee conversion has distasteful effects. Nevertheless, if the problem of reversion is not resolved in the marketplace (if we can't get out of residential leasehold ourselves), government will likely have to intercede, again.

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