

Ground Rents From Maryland to Hawaii: Leasehold Interests in Residential Real Estate

BY BENJAMIN A. NEIL

MARYLAND AND HAWAII, THOUGH GEOGRAPHICALLY DISTANT, are burdened by the same historical remnants of an English feudal land system.¹ In both states, residential property frequently is conveyed by leasehold deeds that require residents to pay a ground rent.

Ground rent agreements require homeowners to rent the land on which their houses sit, often for a term of 99 years, and whoever pays the ground rent has an option to renew at the end of the term. This type of agreement allows the lessor to retain title to the property, meaning that ownership of the dwelling is separate and distinct from ownership of the land.

These systems in Maryland and Hawaii present numerous problems for the residential real estate market, including risks of extreme forfeiture and impairment of alienability. This paper discusses the systems, notes similarities and differences, and describes the impact of the states' peculiar systems on commerce, real estate development, mortgage finance and the right to alienate property rights.

THE LEASEHOLD SYSTEM OF MARYLAND

In Maryland, one of the 13 original states, leasehold deeds for residential property originated in colonial times.² These deeds recite and document the existence of an automatically renewing 99-year lease on the fee-simple interest—allowing unqualified power of disposition—for

the residential property. The lease also specifies a set dollar amount of the ground rent, payable on an annual or semi-annual schedule.

Maryland residential ground rent leases do not provide for an escalation clause, which would increase the leaseholder's rent cost during the term of the lease. People who pay ground rents, also known as leaseholds, can determine the payoff amount by calculating the capitalized value of the ground rent. The state determines the rate of return on a ground rent. Most modern ground rents were created from 1889 to 1982, when the rate of



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return was 6 percent. So a ground rent that costs \$90 a year typically would cost \$1,500 to redeem.

Leasehold deeds in Baltimore and surrounding counties that came into existence since 1884 can be redeemed at any time. Lessees can convert the leases to fee-simple deeds after paying a multiple of the annual rent³—usually 16.66 times or 25 times the annual rent, depending on the amount of interest outlined in the leasehold deed.⁴

In effect, a Maryland leasehold deed is a hybrid instrument that allows a grantor or predecessor in title to retain an interest-only secured loan against land for a fixed interest rate of 4 percent or 6 percent. Security for the loan is the lessor's statutory right to eject a lessee who has defaulted. A ground rent redeemable at a definite future period has most of the same benefits as a mortgage when securing a principal sum, with interest expressed as annual rent.⁵

However, the lessor has no current or residual right to possess the land as long as the lessee pays the ground rent. Foreclosure and ejection can occur only if the lessee falls into arrears. The right to payment is defined as personal property if the rent is paid, and the reversion is defined as realty.⁶ And though the lessee's interest has all the characteristics of realty, courts have traditionally treated it as personal property.⁷

Lessors and lessees freely convey their interests, but lessors typically do not file deeds of assignment that reference particular properties. In Baltimore, it is not unusual for lessees to have difficulty determining the exact identity of the lessor, especially in instances when the lessor dies and his or her heirs do not promptly submit an estate to probate. As a result, lessees cannot locate and pay the party to whom they owe the ground rent. Under such circumstances, the unpaid rent can create a situation where a fairly small indebtedness raises the risk of an extreme default.

THE LEASEHOLD SYSTEM OF HAWAII

In Hawaii, the second youngest state in the U.S., private ownership of land was controlled by the monarchy until 1848.⁸ The concentration of ownership has continued in an altered form to this day. As late as 1984, 49 percent of Hawaii's land was owned by the federal and state governments, and 49 percent of Hawaii's privately owned land was controlled by 72 landowners. A mere 22 landowners

held 72.5 percent of titles to the land on the well-developed island of Oahu.⁹

Historically, a handful of Hawaii's largest landowners used land leases—which did not have automatic rights of renewal—for a fixed term of years as a preferred method of developing dwellings. The law of fixtures governed residential improvements.¹⁰ Hence, at the conclusion of the lease term, a residential lessee had three choices: renegotiate the lease, remove his or her dwelling or forfeit the value of improvements.

The Hawaii legislature, from time to time, attempted to provide protection for lessees. In 1968, the Hawaii legislature enacted the Land Reform Act,¹¹ which empowered the Hawaii Housing Authority to condemn land in developments of five acres or larger, but only upon petition of a fixed number or percentage of affected lessees. After condemnation, the housing authority would resell the fee-simple parcels to the petitioning lessees.¹²

The Land Reform Act also permitted lessees to extend the term of land lease to 55 years, if they did so within the first 20 years of the lease.¹³ The extended leases are limited to a period of 30 years, and afterward can be extended by agreement or arbitration.¹⁴ In theory, the mandatory extension of the lease term allows the residential property owner to obtain a 30-year mortgage without placing the investment—that is, the house—at risk because of the lease's expiration.

In 1975, the legislature amended the land reform act to allow lessees, under certain circumstances, to abandon improvements at the end of the term and to compel the lessor to pay the appraised fair market value of the improvements.¹⁵ In 1988, however, the Supreme Court of Hawaii, in *Anthony v. Kualoa Ranch Inc.*,¹⁶ limited application of the 1975 amendments to leases that were signed after enactment of law.

HAWAIIAN LEGISLATURE ADDRESSES DIFFICULTIES, BUT CONTROVERSY CONTINUES

Before the enactment of the Land Reform Act, Hawaii's legislature determined that concentrated land ownership was responsible for skewing the state's residential fee-simple market, inflating land prices and injuring the public tranquility and welfare.¹⁷ In its legislative findings and declaration of necessity, Hawaii's legislature determined that the concentration of ownership led to a serious shortage of reasonably priced fee-simple property

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in urban areas, and that the shortage adversely affected the economy of the state and was contrary to public interest because it undermined health, welfare, security and happiness.¹⁸

Rent increases often are substantial, rising to several hundred times greater than the initial fixed rent.¹⁹ In Hawaii, residential ground rents act almost identically to those in England or commercial ground rents, which exist everywhere. After the 99-year lease ends, the ground rent

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owner can reclaim the land and the buildings on it. The lease, as it is phrased in England, “falls in.”

At that point, the ground rent owner is free to tear down everything, build improvements and set up a new 99-year lease that reflects modern-day prices. And as these leases get closer to expiration, banks become increasingly reluctant to offer financing on the dwellings.

Controversy surrounding proposals to condemn leasehold ownership of condominium buildings in Hawaii and resell the fee-simple interests to individual unit owners continues.²⁰

MARYLAND DEALING WITH MISSING OWNERS AND URBAN RENEWAL

Upon delivering a property, title companies frequently put the lessee ground rent in escrow because they cannot readily ascertain the identity of the lessor from public records.²¹ Because the sale of lessors’ leased-fee interests typically are not noted in public records, lessees who want to redeem and pay ground rents often can’t find the owner.²²

The Maryland legislature recognized this problem and in 2003 changed the laws to allow home purchasers to redeem or purchase lessors’ interests in ground rents if those landowners couldn’t be located. Under the new law, the entity that conveys the title must collect and deposit three years of ground rent into a state escrow fund, along with expenses. After posting notice, the entity either pays the funds to the owner of the leased fee title if that person is found, or arranges for the funds to be kept on deposit and escheated to the state after 20 years.²³

Many ground leases date back to a pre-inflationary era. With fixed principal and interest amounts, the leases typically require payment of 6 percent interest on the stated value of the land.²⁴ In the current state of modern real estate transactions, a foreclosure on such a small amount brings a forfeiture that is grossly out of proportion to the value of a fee-simple interest.

An additional undocumented difficulty could arise from a burst of gentrification activity in Baltimore’s waterfront community, which has spurred urban rehab developers to create numerous new leaseholds and ground rents.²⁵ The practice is at odds with the Truth in Lending Act and its corollary Regulation Z.²⁶ According to the regulations, any party who creates five credit instruments in a calendar year may be subject to disclosure requirements and borrowers’ rights of rescission. So far, no one has filed a lawsuit, but one likely will come in due time.

LEASEHOLD SYSTEMS NO LONGER SERVE THE PUBLIC INTEREST

Given the numerous complications, it appears clear that these leasehold systems are contradictory to sound public policy and should be phased out.

The Hawaii system is a relic from the days of the island’s historic monarchy. Though Hawaii’s history deserves a great deal of respect, the U.S.’s founding principle when establishing ground rents was to avoid monarchical powers, which at the time owned vast amounts of land. The land reform act will gradually bring dissolution of the oligopoly of land ownership, and some argue that the government should expedite the transformation from concentrated ownership of land to a fragmented and individual ownership scheme.

The Hawaiian system of leases defies the national trend, adversely affects amortization of loans, and ultimately deprives ordinary citizens of the privileges of building equity and bequeathing wealth to subsequent generations. Others argue, however, that the only thing that would impede homeowners’ ability to build equity would be if the ground rent escalates above the market norm because a leasehold sale basically constitutes a purchase and a rent for a definitive term.

The Maryland ground rent system is another anachronism that cries out for elimination. Historically, a \$90 or \$180 ground rent with a capitalized rate of \$1,500 or

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\$3,000, respectively, reduced the price of residential property to encourage and facilitate home ownership. As the price of property has increased, however, the Maryland ground rents have become little more than forfeiture traps for the unwary.

The Maryland ground rents survive challenge under the rule against perpetuities,²⁷ but they nonetheless are perpetual encumbrances on clear title to property. The new statutory scheme of creating a state-operated escrow for escheat is unnecessarily cumbersome.²⁸ In many instances, it will require purchasers to forfeit funds at settlement—a time when most borrowers need as much cash as possible.

A more owner-friendly policy would be to require lessors to convert leasehold deeds into second mortgages, and grant purchasers the right to merge them into primary financing. The indebtedness caused by the ground rents then would be on record, eliminating the need to search for the lessor. The encumbrances would be phased out through payment of principal and over a period of years, the anachronism would disappear.

At the very least, Maryland should require owners of fee-simple titles to place transfers, succession, and other changes of ownership on the public record so owners are documented.

CONCLUSION

These two systems may have different origins and histories, but they have the same effect. Hawaii's land leases and Maryland's ground rents fragment ownership of individual homes and complicate the American dream of home ownership. The same or similar problems exist in Florida, Arizona, Pennsylvania and the place where it all started: London.

To better serve the public interest, each of these U.S. states should find a way to gradually phase out its peculiar system in favor of a system that conclusively and permanently consolidates fee-simple title to land and the improvements located on the land into one instrument. ■

ENDNOTES

- 1 Its original purpose was an attempt by feudal tenants to put themselves in the role of lords over lower tenants.
- 2 *Banks v. Haskie*, 45 Maryland 207 (1876).
- 3 *Jones v. Magruder*, 42 Federal Supplement 193 (District of Maryland, 1941), *Kolker v. Biggs*, 203 MD. 137, 99 A2d 743 (1953)
- 4 Maryland Code, Real Property Section 8-110(b)(1)
- 5 *Posner v. Bayless*, 59 Maryland 56 (1882)
- 6 *Marburg v. Mercantile Building Co.*, 154 Maryland 438, 110A.836(1928)
- 7 *Jones v. Magruder*, *supra*.
- 8 *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984). The Hawaiian Islands were originally settled by Polynesian immigrants from the western Pacific. These settlers developed an economy around a feudal land tenure system in which one island high chief, the ali'i nui, controlled the land and assigned it for development to certain subchiefs. The subchiefs would then reassign the land to other lower ranking chiefs, who would administer the land and govern the farmers and other tenants working it. All land was held at the will of the ali'i nui and eventually to be returned to his trust. There was no private ownership of land. See generally Brief for Office of Hawaiian Affairs as Amicus Curia3-5.
- 9 *id.*, 32-33.
- 10 See Note "Anthony v. Kualoa Ranch Inc.: Statutory Requirements to Purchase Residential Leasehold Improvements Is Unconstitutional as Applied Retroactively," 10 University of Hawaii Law Review 419, 422. This case note provides an excellent history of the development of Hawaii's leasehold system.
- 11 Hawaii Revised Statutes 516, *et seq.*
- 12 The U.S. Supreme Court upheld the Constitutionality of the condemnation regimen in *Hawaii Housing Authority v. Midkiff*.
- 13 Hawaii Revised Statutes 516-65.
- 14 Hawaii Revised Statutes 526-66
- 15 Hawaii Revised Statutes 526-70
- 16 *Anthony v. Kualoa Ranch Inc.*, 69 Hawaii 112, 736 P.2d55 (1987)
- 17 *Hawaii Housing Authority v. Midkiff*, *supra*. at 233.
- 18 See note *Anthony v. Kualoa Ranch Inc.*, *supra*. 10 University of Hawaii Law Review 419, 422 citing Act effective June 24, 1967, N. 307 Hawaii Session Laws 488, 489 Hawaii Revised Statutes 526-83(a) 1985)

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- 19 *Richardson v. City and County of Honolulu*, 124F3d 1150 (9th Circuit Court, 1997)
- 20 “The Constitutionality of a Naked Transfer: Mandatory Lease-to-Conversion’s Failure to Satisfy a Requisite Public Purpose in Hawaii’s Condominium,” 25 *University of Hawaii Law Review* 561.
- 21 Eric Seigel, “Ground rent gives new owner headache,” *The Baltimore Sun*, March 3, 2005.
- 22 Phillip McGowan, “Tradition: Ground rents are as much a part of Baltimore as steamed crabs, but not as simple,” *The Baltimore Sun*, May 2, 2004.
- 23 Maryland Code Real Property Section 8-100(f)
- 24 *id.*
- 25 This is personal observation of the author, who owns and operates a title company active in the redevelopment areas in the city of Baltimore.
- 26 15. U.S.Code 1601, et seq.
- 27 The rule against perpetuities is one of the most complicated parts of estate planning to explain. Basically, common law disfavors and prevents property from being held perpetually in trust and, therefore, voids any agreement (varies from state to state) that does not end 21 years after a life in being, or one generation from lives presently in being plus 21 years.
- 28 Maryland Annotated Code, Real Property Article, Section 8-110.