

HAWAII PURCHASE AND SALE ISSUES FOR BUYERS



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This article discusses certain issues to consider when negotiating a contract for the acquisition of real property in Hawaii. Certain Hawaii issues with respect to the business operations of the property are also discussed. The focus is on Hawaii-specific issues and customary practices. In other words, national laws such as the Patriot Act, the Worker Adjustment and Retraining Notification ("WARN") Act, the Comprehensive Environmental Response, Compensation, and Liability ("CERCLA") Act, etc., as well as Hawaii statutes on matters common to most American jurisdictions, such as zoning, subdivisions, land use, the statute of frauds, fraudulent transfer laws, unfair and deceptive practices laws, the regulatory scheme for real estate brokers, and other such common issues, are not discussed.

Two articles that appeared in the Practical Real Estate Lawyer discuss issues that may also be applicable in Hawaii, which include types of deeds and deed warranties, tax withholding, liquidated damages, forms of title insurance policies, mechanic's liens, etc. See Neil S. Kessler, "Virginia Real Estate Purchase and Sale Issues for Buyers," 33 Prac. Real Est. Law. 5 (July 2017); Edward N. Barad, "Colorado Purchase and Sale Issues for Buyers," 33 Prac. Real Estate Law. 43 (July 2017). The discussion in these articles could have applicability in Hawaii, and the reader is urged to consult with a Hawaii lawyer to verify.

DESCRIPTION OF PROPERTY BEING SOLD – LEGAL DESCRIPTION FROM THE TITLE REPORT

The description of the property to be purchased is usually taken from a preliminary title report prepared

by a title company, although at times the contract will use, as a description, the tax map key parcel number instead. A description of the improvements is also added. If the seller has less than a fee simple interest, there will be a description of all of the seller's interests. To this would be added other ancillary properties such as easements, intangibles, tangible personal property, intellectual property, assignable permits, licenses, telephone numbers, warranties, air rights, and development rights, as well as non-real estate assets such as accounts receivables, deposits, etc.

LEASEHOLD PROPERTY

There are a lot of properties in Hawaii that are owned in leasehold, and Buyers may be faced with buying property that is not held in fee simple by the seller. This is less so for residential property, but is frequently true for commercial properties. In an island environment, land is at a premium, and the land owner/lessor usually has the negotiating leverage. If the buyer is buying with the intention of developing the property, the lessor may be willing to negotiate extending the term and providing mortgagee protection clauses in the lease and other amendments. If not, the buyer will need to review and analyze the existing lease, its remaining term, rent, the rent reopening provisions, and other provisions, and whether the lease is financeable. The buyer should not expect that the lessor will subordinate the fee in connection with the financing, whether there is to be new development or not. A purchase of the leasehold will be by way of an assignment of lease, and a conveyance tax will have to be paid.

PURCHASE PRICE

Escrow for the Deposit

The custom in Hawaii is to use a Hawaii licensed escrow agent. Chapter 449 of the Hawaii Revised Statutes (“HRS”) provides that no company may act as an escrow depository to receive, hold, and deliver money or other consideration affecting title to real property unless it is licensed to do so by the State Commissioner. The deposit is usually refundable until at the end of the due diligence period when the buyer chooses not to cancel (i.e. “goes hard on the contract”).

Balance of Price

The balance of the purchase price is paid at closing, except that the purchase price (plus other required closing cost funds) must be delivered to escrow prior to closing because of Hawaii’s long recording process. See discussion below.

Exchange Rate Considerations

This consideration, while not currently relevant, was relevant to a State with foreign owners of real estate selling property when currency exchange rates fluctuated. For many non-American sellers, a long due diligence period or an extended closing date (from the date of contract) presents a problem when the dollar is weakening in relation to the strength of the foreign currency, for example the Yen. In those cases, the contract would provide that the purchase price in American dollars must be valued at a specified or minimum amount of Yen as of the closing date. At times, this is critical to the seller because of the seller’s obligations at home. An alternative is for the seller to purchase insurance to cover the risk of the exchange rate fluctuations.

TITLE ISSUES

Title and Survey

Normally, the seller will provide the buyer with a preliminary title report and will contract to sell the property subject to all of the encumbrances noted (other than monetary liens), and only the encumbrances noted, on the preliminary title report. Similarly, the buyer will review the results of a survey. The contract needs to address the procedures for objecting to the title or survey encumbrances or acceptance of the same.

Title Insurance and Form of Deed

The contract usually provides the form of title insurance that will be required by the buyer, including additional title endorsements that the buyer will require. The contract will specify the form of the deed to be delivered at closing, whether a full warranty deed or a limited warranty deed.

Since the seller usually shares in the cost of the buyer’s title insurance, it is customary for the seller to agree to only provide a limited warranty deed and thereby be responsible only for its own actions and not for the accuracy of the title unrelated to anything the seller has done.

Allocation of Title Costs

The standard in Hawaii seems to have evolved whereby the seller and buyer each pays one half of the costs of a standard form owner’s policy, and the buyer pays 100% of the additional costs to obtain an extended or American Land Title Association (“ALTA”) Owner’s Policy and endorsements as required by the buyer.

VOLUNTARY RESPONSE PROGRAM

If there will be any environmental clean-up, the buyer should consider whether to participate in the State of Hawaii’s Voluntary Response Program under the Environmental Response Law, HRS § 128D-31. Prospective buyers, who, prior to purchasing the property, enter into an agreement with the State to conduct a voluntary response action, could qualify for specific exemptions from liability in connection with specifically addressed contaminants.

DISCLOSURES

Chapter 508D of the HRS is entitled “Mandatory Seller Disclosures in Real Estate Transactions” and applies only to residential real property as defined. Substantively, this statutory law does not significantly change a seller’s obligations to make full disclosure under common law. A disclosure statement is required within a time limit, and, if not delivered, gives the buyer rescission rights. This probably can be waived by contract as the statute provides that the buyer can close even without having received the required disclosure statement. There are rescission rights for failure to provide this statutory disclosure statement which terminates if the buyer closes despite not having received the statutory disclosure statement. There is a damages

provision but it has an odd limitation. It provides for damages only if the seller negligently fails to provide the disclosure statement. So presumably if the failure to provide this statutory disclosure statement is intentional as provided by the terms of the contract, there is no negligent failure to provide the statement and therefore no damages under this statutory law. But there could be damages under the common law for failure to disclose a material fact and the required reliance. In other words, full disclosure in compliance with common law duties takes the sting out of this law but the common law remains.

SURVIVAL OF REPRESENTATIONS AND WARRANTIES

The parties will typically negotiate survival of representations and warranties. Hawaii recognizes the concept of “merger by deed” and the exceptions to the concept. In general, provisions relating to title and the conveyance are considered to have been merged when the grantee accepts the deed. What does not merge and survives the acceptance of the deed is what a court considers collateral and not connected with title, possession, quantity, or emblements of the land. The Hawaii Supreme Court adopted the merger doctrine and the collateral matters exception in *Utsunomiya v. Moomuku Country Club*, 866 P.2d 951 (Haw. 1994).

Title matters that are intended to survive the closing should be addressed in the deed because the survival clause in the contract, with respect to such matters that go to title, could merge with the deed and be extinguished. It should be anticipated that clever litigators will fashion arguments as to what is and what is not additional or collateral. These litigators could attempt to argue that, notwithstanding a survival clause, the representation or covenant at issue does not fall within the exception and should have been restated in the deed, and failing to do so means that the clause has not survived.

CANCELLATION RIGHTS

There are no reported Hawaii court cases on the buyer’s “free look” and unfettered right to cancel. For a discussion of Texas and California court decisions that the free look could create issues of lack of consideration, see Edward N. Barad, “Colorado Purchase and Sale Issues for Buyers,” *supra*.

Hawaii courts have ruled that there is a duty of good faith and fair dealing in all contracts. *Best Place Inc. v.*

Penn Am. Ins. Co., 920 P.2d 334, 337-38 (Haw. 1996). This creates a risk that a court might require a buyer who wants to cancel to explain the conditions and justify his decision to cancel the contract. Consequently, there are often specific provisions in the contract reflecting a clear agreement that the buyer can cancel in its sole and arbitrary discretion for any reason or no reason at all and has no duty to act reasonably in exercising this discretion. In a commercial lease setting, the Hawaii Supreme Court has ruled that where there are express provisions giving one party discretionary rights, the courts will not impose a duty to be reasonable in the exercise of those rights. *Food Pantry, Ltd. v. Waikiki Bus. Plaza, Inc.*, 575 P.2d 869 (Haw. 1978). Some lawyers, taking a clue from typical California contracts, also include non-refundable consideration for the “free look.”

LONG RECORDING PROCESS

The State of Hawaii, in both its regular system (grantor/grantee index) recording and its Land Court System (Torrens System) recording, has adopted a process of recording that begins in the early afternoon, continues through the night, and ends at 8:00 a.m. the following morning. The recording office in both systems begins stamping the documents in the early afternoon the day before the effective recording date, and the effective recording time is 8:00 a.m. the following day. The title/escrow companies will require that all funds be deposited in escrow, and all closing documents to be recorded be received, no later than 48 hours prior to the scheduled closing date, and they will then deliver the documents to be recorded to the recording office the day before the scheduled closing date. The contract should provide for when closing is effective.

RECORDING OFFICE

Hawaii has two recording systems: one for land court registered land and one for all other lands. Approximately 45 percent of the land on the island of Oahu is land court registered land, and the percentages of land court registered land on the other islands are much smaller. Title to land court registered land is addressed in Chapter 501, and title to all other lands is addressed in Chapter 502 of the HRS. Recordation for land court registered land occurs by filing the document with the Assistant Registrar of the Land Court of the State of Hawaii (the Torrens system) and for other lands by filing in the Bureau of Conveyances of the State of Hawaii. The grantor/grantee recording system in the

Bureau of Conveyances is similar to the race-notice system in other jurisdictions. However, for land court registered land (other than wills and leases with terms not exceeding one year) all deeds, mortgages, leases, or other voluntary instruments that are not recorded in the land court system do not take legal effect and do not bind the land. HRS § 501-101. But these instruments do take legal effect as contracts between the parties. Instruments that do not relate to registered land will not be accepted for recordation with the Assistant Registrar of the Land Court. This rule is strictly enforced by the Assistant Registrar and extends to all non-land court registered lands and to instruments that only affect improvements on land court registered land. There is a procedure for deregistering land court registered land, which many land owners have taken advantage of. HRS § 501-261. One difference between the two systems is that the common law on constructive notice and duty to investigate, and even the law on actual knowledge, in some cases, may not apply to land court registered land.

UCC-1 FINANCING STATEMENTS

Unlike the process in other jurisdictions, Uniform Commercial Code (“UCC”) Financing Statements are not filed with a Secretary of State, but instead are filed in the real property records. HRS § 490:9-501. Since these are not real property interests, they can only be filed in the regular grantor grantee recording system, i.e., the Bureau of Conveyances, and will not be accepted for filing in the Torrens system, i.e., with the Assistant Registrar of the Land Court. There is an exception where a mortgage to be filed with the Assistant Registrar includes, as part of the mortgaged property, fixtures, and the mortgage states that it is also a fixture filing. HRS § 490:9-502(c).

RECORDING REQUIREMENTS

The Office of the Assistant Registrar requires a buyer who is a corporation, partnership, limited liability company, or other legal entity buying property registered in the Land Court (Torrens system) to provide a certificate of good standing from its place of organization before a deed to that buyer can be recorded. Hawaii Rules of the Land Court Rule 58 (2017). If the buyer intends to do business in the state, it will have to register as a foreign entity.

TAX ISSUES

Sales Tax

There is no sales tax on the sale of the real estate. However, Hawaii does impose a tax on the sale of consumables, such as liquor and food. The seller and buyer may be required to make an allocation of the sale price between the real property and the liquor and food. See discussion below on the General Excise Tax.

Conveyance Tax

Hawaii previously imposed a conveyance tax (HRS § 247-2) at the rate of 0.1% of the amount of the consideration. In 2005, this law was amended to provide for an increased rate depending on the amount of the consideration. It is still 0.1% if the amount is less than \$600,000, but, effective as of July 1, 2009, for amounts of \$600,000 or more, it is 0.25%; for amounts of \$1,000,000 or more, it is 0.30%; for amounts of \$2,000,000 or more, it is 0.50%; for amounts of \$4,000,000 or more, it is 0.75%; for amounts of \$6,000,000 or more, it is 0.90%; and for amounts \$10,000,000 and greater, it is 1%.

There are also different rates for condominium or single-family residence transfers where the transferee is ineligible for a county homeowner’s exemption on real property tax.

If the property involves several lots, there may be a requirement to allocate the conveyance tax to the different lots. The parties sometimes prefer not to allocate amongst the different lots and can apply to the State Tax Office to obtain an exemption to the allocation.

Bulk Sales Law

Hawaii has a bulk sales law that could expose the buyer to liability for the seller’s taxes. The buyer will want the seller to provide a tax clearance certificate showing that the tax office has notice of the sale. HRS § 237-43 states that the seller shall make a report of the bulk sale “no later than ten days” after the closing. Often the contract will require the report to be made before the closing, and a tax clearance certificate issued on or prior to the closing, so that there would be no need for the buyer to withhold any portion of the purchase price. But note that the certificate only protects the buyer as to taxes due as of the date of the clearance certificate. Typically, the seller will agree to indemnify the buyer against liability for the seller’s taxes, and the buyer will evaluate the strength of this indemnity and

consider the seller's financial condition and whether it is a single purpose entity that will soon distribute its moneys and liquidate before relying on this indemnity.

Hawaii Real Property Tax Act ("HARPTA")

Another state law that raises the issue of buyer's potential exposure for the seller's taxes and possible withholding of a portion of the purchase price is the State's version of the federal Foreign Investment in Real Property Tax Act ("FIRPTA"). HRS § 235-68 requires the buyer to withhold five percent of the amount realized from the sale unless the seller is a "resident person" or the seller is not required under tax laws to realize gain or loss. Hawaii residents and Hawaii business entities are "resident persons." Non-resident person sellers can apply to the State tax office for a withholding certificate that will state the amount to be withheld. In determining the amount, the tax department will examine whether no gain will be realized or whether there will be insufficient proceeds to pay the tax.

State Tax Lien

The State of Hawaii has a lien on the seller's property for the payment of State taxes. However, if the State has not recorded its Tax Lien Certificate in the Bureau of Conveyances before the buyer closes and takes title, the buyer takes free and clear of the tax lien. It's a race to record.

HRS § 231-33 provides a mechanism for the buyer to provide the tax office with notice of the purchase. Once the tax office receives the notice, the tax office has 15 days to record its certificate. The benefit of providing this notice to the tax office is that the buyer will take free and clear of the tax lien even if the buyer closes up to ten days after the tax office records its certificate. In other words, there is value in giving the notice if the buyer is leery of the seller's situation and wants the protection of this procedure on the chance that closing will occur after the State records its tax lien certificate. In the usual situation, buyers will rely on title insurance as the escrow company/title insurer will customarily be under escrow instructions to only record if the title company can insure the title without exception for such tax lien.

State Unemployment Tax Reserve

Especially when the buyer is creating a new entity to buy the property and take over the seller's business,

it could be advantageous to the buyer to adopt or assume the seller's unemployment tax reserve record. In such cases, the seller should agree that upon closing, seller shall (i) assign its rights to the reserve held by the State of Hawaii in connection with state unemployment taxes ("Unemployment Tax Reserve"), and (ii) use commercially reasonable efforts to cooperate with the buyer, without the seller being required to incur any liability or cost or expense, to assist the buyer in seeking to maintain the unemployment tax rate applicable to the seller.

GENERAL EXCISE TAX

Hawaii has a unique General Excise Tax ("GET") that should be considered in the buyer's due diligence. HRS Chapter 237. The GET applies to almost everything and to more than what other States typically impose their sales tax on. For example, the GET is imposed on rents, commissions, and services. The GET is imposed on taxable gross income received by the taxpayer. The rate is 4.5% for business conducted on Oahu and 4.0% for business conducted on the other islands. There is no deduction for business costs. There is even pyramiding, and the same dollars can be taxed more than once. For commercial properties, the GET is even imposed on the share of real property taxes that a tenant pays to the landlord. For written leases, there is a special deduction for a lessee/sublessor that collects rent from a subtenant and then pays rent to his master lessor. This lessee can deduct a large portion of the rent that he pays to the master lessor.

BUSINESS REGISTRATION

A buyer who buys real estate need not register to do business in the State unless that buyer intends to conduct business in the State. For example, if the buyer intends to use the property as a residence or use it for vacation visits, then the buyer will not be required to register. However, if the buyer rents the property, the buyer will be doing business in the State and will need to register. Upon a sale of the property, if the buyer is a non-resident person or has not registered to do business in the State, there could be a withholding requirement for state taxes.

STATE "WARN ACT"

The State of Hawaii has its version of the federal WARN Act called the Hawaii's Dislocated Workers Law ("DWL"), HRS Chapter 394B. The buyer needs to ensure

that the seller has complied with this law prior to closing. The buyer should also comply with the law for any employees who it lays off due to the transaction after the closing. Under the state DWL, covered employers must provide to each employee and local government officials "written notification of a closing, divestiture, partial closing, or relocation at least sixty days prior to its occurrence." HRS § 394B-9. The DWL applies to employers that employed 50 or more employees in the State of Hawaii in the last 12 months. Unlike the WARN Act, DWL notice is required even if employees are immediately rehired by a buyer and suffer no actual loss of employment.

One purpose of the DWL is to afford employees who may choose not to work for the buyer to have 60 days in which to find new employment. Normally, a seller has no desire to give such notice until after the buyer goes hard on the contract. Due to confidentiality or other considerations, both sellers and buyers may prefer not to delay closing for another sixty days after the buyer has gone hard on the contract. In this case, the State Labor Department has ruled that in lieu of the 60 days' notice, the seller may instead pay wages to the employees for the 60 days. These wages are in addition to the dislocated worker allowance, which is the difference between the employee's average weekly pay and unemployment insurance weekly benefit amount for four weeks, which will also be payable if the employee is not rehired by the buyer. If the buyer hires the employee, there is no unemployment, so the dislocated worker allowance will not be payable.

Consequently, in order to preserve confidentiality and/or to avoid the sixty-day delay in closing, the seller will pay the equivalent of two months' salary without the benefit of receiving work. The buyer, who hires the employee, gets the benefit of the employee's work and pays the employee for that work, but there is no dislocated worker allowance to be paid. Another method to avoid holding up the closing, pending the 60-day notice, is to enter into a subleasing of the employees or a subcontract arrangement whereby the seller agrees to have the seller's employees continue working at the property for a period of time following the closing.

LIQUOR LICENSE

If the property is operated with a liquor license, it is of paramount importance to the buyer that the sale of alcohol not be suspended because of a lack of a

liquor license. Normally, liquor licenses are not readily transferable, and the buyer has to apply for and has to qualify for a liquor license in its own right. Each County administers its own liquor license rules and regulations.

Depending on the County, the buyer will be able to, and should plan to, obtain a temporary permit on or before the closing date. The timing as to issuance of the temporary permit depends on how long it takes first to complete the application forms, file the same, and then how long it takes the first law enforcement agency to respond positively to the Liquor Commission. The seller will have to relinquish its permit, which should be covered by the cooperation language in the contract. The buyer may have to assume any liabilities of the seller, such as unpaid fines and penalties, and so the seller should agree to indemnify the buyer against those.

SPECIFIC PERFORMANCE

In Hawaii, a defaulting buyer may be entitled to the remedy of specific performance even if time is made of the essence. Specific performance may be a remedy that is available to a buyer who is not able to close by the closing date. In order to avoid a forfeiture of the deposit, the courts might rule in favor of a buyer who is able to close after the specified closing date, so long as the delay was not caused by the buyer's gross negligence or due to deliberate or bad faith conduct on the buyer's part. Even in a situation where the seller offers to refund the deposit, the defaulting buyer may be entitled to specific performance. *Shanghai Inv. Co. v. Alteka Co., Ltd.*, 993 P.2d 516 (Haw. 2000); *Scotella v. Osgood*, 659 P.2d 73 (Haw. Ct. App. 1983); *Kaiman Realty, Inc. v. Carmichael*, 655 P.2d 872 (Haw. 1982); *Jenkins v. Wise*, 574 P.2d 1337 (Haw. 1978). These cases indicate that it will be up to the equitable discretion of a trial judge as to whether a buyer might be entitled to specific performance when the seller proposes to cancel the agreement and refund the buyer's deposit.

UNIFORM VENDOR AND PURCHASE RISK ACT

Hawaii has enacted the Uniform Vendor and Purchaser Risk Act, HRS Chapter 508, which should be examined to see whether it should be waived and substituted in its place with other specific, agreed provisions with respect to casualty and repair.

HISTORIC PROPERTIES

Buyers need to be aware of properties with historic significance and the need to engage professional archaeologists that will not only identify such historic sites, but who can also provide valuable interface with the State Historic Preservation Division of the State Department of Land and Natural Resources (“DLNR”). These often involve ancient Hawaiian religious sites (“heiau”), burials, and even historic habitation sites. Approvals could be required from this State office in connection with sales of such properties and definitely in the case of development. Lineal descendants and other cultural practitioners cannot be excluded from access to certain historic sites to continue traditional practices. In certain circumstances with already developed land, title insurance can be obtained that will not have an exception for such rights. The DLNR Division of Forestry and Wildlife may also need to be involved if there are historic trails located on the property. The title companies are well versed in these matters and customarily identify these issues in their title reports. Local attorneys versed in these matters can also provide valuable assistance.

OCEANFRONT PROPERTY

Today, there is much talk about climate change and sea level rise, and Hawaii has recently seen a phenomenon called “King Tides.” A buyer of oceanfront property needs be aware that the property does not include the beach, and the shoreline boundary is subject to change. The public has the right of transit seaward of the shoreline. The shoreline boundary is the upper reaches of the waves, usually evidenced by the vegetation or debris line. HRS § 205A-1. The State requires that the shoreline boundary be certified by submitting a surveyor’s map of the shoreline. HRS § 205A-42. Generally, these are only good for one year for development purposes. Even if the ocean restores land by accretion, the accreted land will still be owned by the State. HRS § 501-33.

MINERALS

The State of Hawaii reserves all rights to minerals. HRS § 182-2. There is a permitting process for waivers, such as for sand mining.

WATER

All water in the State is owned by the State, and the digging of wells and creation of water sources is regulated by the State. HRS Chapter 174C. Hydrologists are often hired as consultants in connection with the acquisition and development of the property. 🌿