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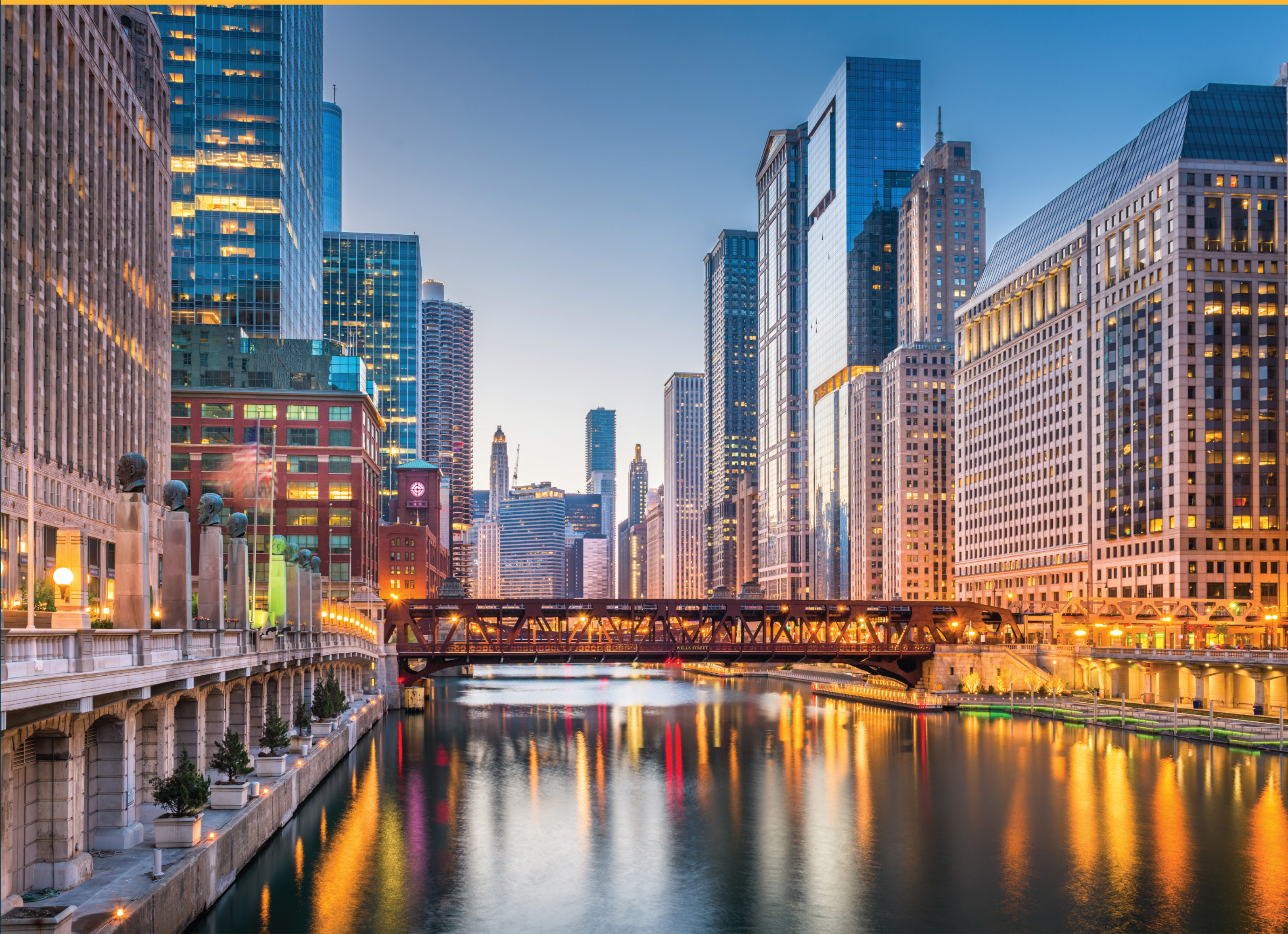
REAL ESTATE FINANCE & INVESTMENTS

Seventeenth Edition



McGraw Hill

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Real Estate Finance and Investments

Seventeenth Edition

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REAL ESTATE FINANCE AND INVESTMENTS

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Preface

Introduction to *Real Estate Finance and Investments*

This book prepares readers to understand the risks and rewards associated with financing and investing both residential and commercial real estate. Concepts and techniques included in the chapters and problem sets are used in many careers related to real estate. These include investing, development financing, appraising, consulting, managing real estate portfolios, leasing, managing property, analyzing site locations, corporate real estate, and managing real estate investment funds. This material is also relevant to individuals who want to better understand real estate when making their own personal investment and financing decisions.

As this current edition is being revised, there is a lot of uncertainty as to the impact that COVID-19 will have on different sectors of the commercial real estate market and it is more important than ever to be able to evaluate the risk and return for lenders and investors. This requires an understanding of the legal issues that can impact the rights of lenders and investors, the characteristics of the various vehicles for lending and investing in real estate, the economic benefits of loans and investments, and how local economies may affect the investment performance of properties as well as the goals of lenders and investors. Managers of real estate funds need to understand how the risk of the fund may be changing and how current economic events might impact the future performance of the fund and the need to change allocations across property types and geographic areas.

This book is designed to help both students and other readers understand these many factors so that they can perform the necessary analysis and make informed real estate finance and investment decisions. As the book's title suggests, we discuss both real estate *finance* and real estate *investments.* These topics are interrelated. For example, an investor who purchases a property is making an investment. This investment is typically financed with a mortgage loan. Thus, the investor needs to understand both how to analyze the investment and how to assess the impact that financing the investment will have on its risk and return.

Similarly, the lender, by providing capital for the investor to purchase the property, is also making an investment in the sense that he or she expects to earn a rate of return on funds that have been loaned. Therefore, the lender also needs to understand the risk and return of making that loan. In fact, one of the risks associated with making loans secured by real estate is that, if a borrower defaults, the lender may take ownership of the property. This means that the lender also should evaluate the property using many of the same techniques as the investor purchasing the property.

Organization of the Book

From the above discussion it should be clear that many factors have an impact on the risk and return associated with property investments and the mortgages used to finance them. This is true whether the investment is in a personal residence or in a large income-producing investment such as an office building.

Part I begins with a discussion of the legal concepts that are important in the study of real estate finance and investments. Although a real estate investor or lender may rely heavily on an attorney in a real estate transaction, it is important to know enough to be able to ask the right questions. We focus only on those legal issues that relate to real estate investment and financing decisions.

Part II begins with a discussion of the time value of money concepts important for analyzing real estate investments and mortgages. These concepts are important because real estate is a long-term investment and is financed with loans that are repaid over time. This leads to a discussion of the primary ways that mortgage loans are structured: fixed rate and adjustable rate mortgage loans.

Part III considers residential housing as an investment and covers mortgage loan underwriting for residential properties. This is relevant for individuals making personal financial decisions, such as whether to own or rent a home, as well as for lenders who are evaluating both the loan and borrower.

Part IV covers many topics related to analyzing income property investments. We provide in-depth examples that include apartments, office buildings, shopping centers, and warehouses. Many concepts also may be extended to other property types. These topics include understanding leases, demonstrating how properties are appraised, how to analyze the potential returns and risks of an investment, and how taxes impact investment returns. We also consider how to evaluate whether a property should be sold or renovated. Finally, we look at how corporations, although not in the real estate business per se, must make real estate decisions as part of their business. This could include whether to own or lease the property that must be used in their operations, as well as other issues.

While the first four parts of this book focus on investing or financing existing properties, **Part V** discusses how to analyze projects proposed for development. Such development could include land acquisition and construction of income-producing property of all types to acquisition of land to be subdivided and improved for corporate office parks or for sale to builders of residential communities. This section also includes how projects are financed during the development period. Construction and development financing is very different from the way existing, occupied properties are financed.

Part VI discusses various alternative real estate financing and investment vehicles. We begin with joint ventures and show how different parties with specific areas of expertise may join together to make a real estate investment. We use, as an example, someone with technical development expertise who needs equity capital for a project. A joint venture is created with an investor who has capital to invest but doesn't have the expertise to undertake the development. We then provide a financial analysis for the investment including capital contributions from, and distributions to, partners during property acquisition, operation, and its eventual sale. In this section, we also discuss how both residential and commercial mortgage loan pools are created. We then consider how mortgage-backed securities are (1) structured, (2) issued against such pools, and (3) traded in the secondary market for such securities. This also includes a discussion of the risks that these investments pose. **Part VI** also includes a discussion of real estate investment trusts (REITs). These public companies invest in real estate and allow investors to own a diversified portfolio of real estate by purchasing shares of stock in the company.

Finally, in **Part VII,** we discuss how to evaluate real estate in a portfolio that also includes other investments such as stocks and bonds. This includes understanding the diversification benefits of including real estate in a portfolio as well as ways to diversify within the real estate portfolio (including international investment). This is followed by a chapter on real estate investment funds that are created for high net worth individuals and institutional investors. We discuss different fund strategies and structures and how to analyze the risk and performance of the funds relative to various industry benchmarks.

Wide Audience

From the above discussion, it is clear that this book covers many topics. Depending on the purpose of a particular course, all or a selection of topics may be covered. If desired, the course also may emphasize either an investor's or a lender's perspective. Alternatively, some courses may emphasize various industry segments such as housing and residential real estate, commercial real estate, construction and development, mortgage-backed securities, corporate real estate, or investment funds. In other words, this book is designed to allow flexibility for instructors and students to cover a comprehensive range of topics or to emphasize only those topics that are the focal point of a specific subject.

Changes to the Seventeenth Edition

Many of the examples through the book have been updated to reflect the current interest rate and tax environment. Newer financial instruments such as Collateral Loan Obligations (CLOs) have been incorporated into the discussion of mortgage-backed securities.

The new accounting regulations requiring operating leases to be included as an asset and liability on the balance sheet was added to Chapter 15 on corporate real estate.

This edition continues to expand the discussion of the role of real estate in a multi-asset portfolio in Chapter 22. Up to date data on the performance of different asset classes was used to illustrate creation of "efficient frontiers" and the reduction of risk through diversification. The capital asset pricing model (CAPM) was added in this edition to provide a link to the importance of beta as a way to determine whether a real estate fund was able to "beat the market" on a risk-adjusted basis and earn alpha.

We also continued to expand Chapter 23 that deals with the private equity real estate funds. The discussion of when time-weighted returns are more relevant than IRRs for certain types of funds was expanded. The calculation of preferred returns and promotes was extended to incorporate calculations based on more than one property sale and the need for clawbacks and holdbacks. The concept of "risk adjusted attribution analysis" was also introduced as a way to better understand why a fund may have performed differently than a benchmark.

Also new to this edition, select end-of-chapter problems are assignable online in Connect.

Excel Spreadsheets and RealNex Software

This book is rigorous yet practical and blends theory with applications to real-world problems. These problems are illustrated and solved by using a blend of financial calculators, Excel spreadsheets, and specialized software designed to analyze real estate income property. Excel spreadsheets, provided on the book's website at **www.mhhe.com/bf17e,** are an aid for students to understand many of the exhibits displayed in chapters throughout the text. By modifying these exhibits, students also may solve many end-of-chapter problems without having to design new spreadsheets. The book's website also contains additional helpful materials for students and instructors. Using a password-protected instructor log-in, instructors can find a solutions manual, test bank, and PowerPoint presentations.

Students can also register online to get free access to a cloud-based real estate valuation program called RealNex. We chose this program because it is very easy and convenient to use by anyone with an Internet connection (including iPads and other mobile devices). RealNex is used in several chapters to supplement the use of Excel spreadsheets when doing investment analysis and solving valuation problems. Once students (or professors) register, they will also have access to data files that replicate examples in the book. Students can register at the following website: **http://info.realnex.com/edu**

Supplements

Several ancillary materials are available for instructor use. These include

- **Solutions Manual**—developed by Jeffrey Fisher and William Brueggeman
- **Test Bank**—developed by Joshua Kahr, Columbia University
- **PowerPoint slides**—developed by Stephanie Yates, University of Alabama

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Many people contributed to the textbook over the past 16 editions. But we want to especially thank those who made a significant difference on this 17th edition. Mike Harris, analyst at Halstatt Real Estate Partners and recent graduate from the University of Florida's MSRE program, helped update the textbook examples and related spreadsheets that accompany the book to reflect the current tax and interest rate environment. Ron Donohue, PhD, CRE who is President of Hoyt Advisory Services contributed substantially to the revision of the chapter on Real Estate Investment Trusts. Robert Singer, PhD, CPA and Professor of accounting at Lindenwood University helped with the explanation of the new lease accounting regulations affecting real estate lessees. We also wish to thank Jeanne Milazzo for her help editing the text.

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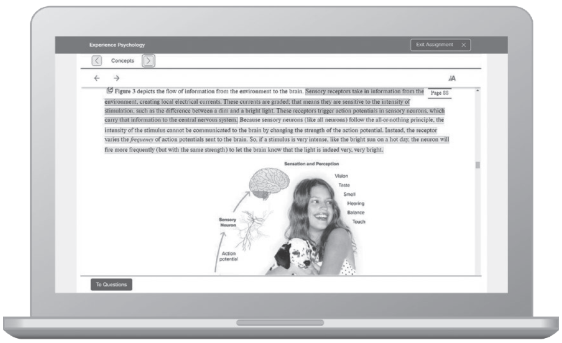

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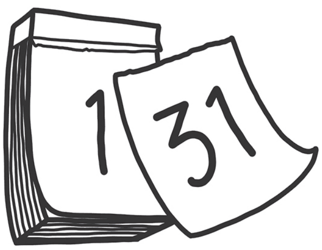

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Chapter 1

Real Estate Investment: Basic Legal Concepts

This is not a book about real estate law; however, a considerable amount of legal terminology is used in the real estate business. It is very important to understand both the physical nature and property rights being acquired when making real estate investments. In this chapter, we survey many important terms pertaining to real estate. Additional legal terms and concepts will appear in later chapters of this book on a "need to know" basis.

Many of the legal terms currently used in the real estate business have evolved from English common law, which serves as the basis for much of the property law currently used in the United States. For example, the term *real* in real estate comes from the term *realty,* which has, for centuries, meant land and all things permanently attached (the latter would include immovable things such as buildings and other structures). All other items not considered realty have been designated as *personalty,* which includes all intangibles and movable things (e.g., automobiles, shares of stock, bank accounts, and patents). The term *estate* has evolved to mean "all that a person owns," including both realty and personalty. Hence, the portion of a person's estate that consists of realty has come to be known as *real estate.* However, in current business practice, although the term "realty" is sometimes used, we generally use the term *real estate* to mean land and all things permanently attached.

Understanding the distinction between realty and personalty is important because our legal system has evolved in a way that treats the two concepts very differently. For example, long ago in England, disputes over real estate usually involved issues such as rightful ownership, possession, land boundaries, and so forth. When such disputes were brought before the court, much of the testimony was based on oral agreements, promises, and the like, allegedly made between the opposing parties, and these disputes were difficult to resolve. Decisions that had to be rendered were extremely important (recall that England's economy was very heavily dependent on agriculture at that time) and affected people's livelihood. Court decisions may have required one of the parties to vacate the land plus turn over any permanent improvements that had been made (houses, barns, etc.) to other parties. As the number of disputes increased, a pragmatic solution evolved requiring that all transactions involving real estate be evidenced by a *written, signed contract* in order to be enforceable.[1]

Parallel developments included (1) a system, whereby land locations and boundaries could be more accurately surveyed and described in contracts, and (2) an elaborate system of public record keeping, whereby ownership of all realty within a political jurisdiction

[1] This requirement was included as part of the *Statute of Frauds and Perjuries,* which was passed in England in 1677 with the intent of reducing the number of disputes and questionable transactions brought before the court.

could be cataloged. Any transactions involving realty could then be added to this record, thereby creating a historical record of all changes in ownership and providing notice of such changes to the general public and especially to any parties contemplating purchasing or lending money on real estate. Similar practices continue today in the United States as we require written contracts, requirements, survey methods, and public record systems detailing the ownership of real estate within all counties in every state. We should note that many transactions involving personalty are not subject to the same contractual requirements as real estate and that oral contracts may be enforceable.

When investing in real estate, in addition to acquiring the physical assets of land and all things permanently attached, investors also acquire certain *rights*. Examples of these rights include the right to control, occupy, develop, improve, exploit, pledge, lease, exclude, and sell real estate. These have come to be known as *property rights*. Hence, the terms *real property* and *real property rights* have evolved.[2] As a practical matter, in business discussions, the terms *real estate* and *real property* are sometimes used interchangeably. However, as we will see, many of the property rights acquired when investing in real estate are independent and can be separated. For example, real estate may be leased or pledged to others in exchange for rent or other consideration. This may be done without giving up ownership. Indeed, understanding the nature of property rights and how they can be bundled and creatively used to enhance value is one goal of this textbook. The reader should refer to Exhibit 1–1 for an outline of these concepts.

Property Rights and Estates

As pointed out above, the term **real estate** is used to refer to things that are not movable such as *land* and *improvements* permanently attached to the land, and **ownership rights** associated with the real estate are referred to as **real property.** Real property has also been contrasted with **personal property.**[3]

It is important to distinguish between physical real estate assets and ownership rights in real property because many parties can have different ownership rights in a given parcel of real estate. Our legal system offers ways for the person financing or investing in real estate to be creative and to apportion these various interests among parties.

We generally refer to **property rights** as the right of a person to the possession, use, enjoyment, and disposal of his or her property. With respect to its application to real estate, *interest* is a broad legal term used to denote a property right. The holder of an interest in real estate enjoys some right, or degree of control or use, and, in turn, may receive payment for the sale of such an interest. This interest, to the extent that its value can be determined, may also be bought, sold, or used as collateral for a loan.

The value of a particular parcel of real estate can be viewed as the total price individuals are willing to pay for the flow of benefits associated with all of these rights. An individual does not have to be an owner per se to have rights to some of the benefits of real estate. For example, a person who leases land, a **lessee,** may have the right to possession and

[2] For nonrealty, the term *personal property* has evolved, and personal property rights would include the bundle of rights which are similar to those listed above but pertaining to personalty.

[3] We should also point out that there are some items known as *fixtures*. These are items that were once personal property but have become real property because they have either been attached to the land or building in a somewhat permanent manner or are intended to be used with the land and building on a permanent basis. Examples include built-in dishwashers, furnaces, and garage door openers. There is significant case law on the subject of fixtures. In practice, when properties are bought and sold, a detailed list of all items that could be considered as either personal property or as a fixture will be documented and included as a part of the contract for purchase and sale. This is done to reduce ambiguity as to the property being conveyed from the seller to the buyer.

EXHIBIT 1–1 Basic Property Concepts Important in Real Estate Finance and Investment

(1) The General Nature of Property	(2) Classification of "Things"	(3) Examples	(4) Property Ownership: Evolution of Legal Requirements/Evidence
Any "thing" tangible or intangible that can be possessed, used, enjoyed, controlled, developed, or conveyed and that has utility or value is considered to be property.	A. Real Property (Realty)	A. Land and all things permanently affixed (buildings, sidewalks, etc.). Immovables. Fixtures.	A. Written contracts, legal descriptions, surveys, deeds, wills, possession. Public notice.
	B. Personal Property (Personalty)	B. Intangibles and all movable things (e.g., autos, stocks, patents, furniture, etc.).	B. Contracts, oral or written, purchase orders/invoices, and so on.
Property Rights			
Rights that can be exercised by the property owner. These include possession, use, enjoyment, control, and the creation of estates in property.		C. Property owner leases the use of realty to tenant, creates a leasehold estate.	C. Written document (lease) describing realty and the terms of possession in exchange for rent.
Interests in Property			
Created by owners of real estate who pledge and encumber property in order to achieve an objective without giving up ownership.		D. Property owner pledges real estate as security for a loan.	D. Mortgage liens, easements, and so on.
		E. Property owner grants an easement to another party to cross land in order to gain access to another site.	

exclusive use of a property for a period of time. This right of use has value to the lessee, even though the term of the lease is fixed. In exchange for the right to use the property, the lessee is willing to pay a rent for the term of the lease. A holder of a mortgage also has some rights as a nonowner in real estate pledged as security for a loan. These rights vary with state law and the terms of the mortgage, but in general, the lender (or mortgagee) has a right to repossess or bring about the sale of a property if the borrower defaults on the mortgage loan. Although a lender may not possess or use the real estate, the mortgage document provides the lender with evidence of a **secured interest.** Obviously, this right has value to the lender and reduces the quantity of rights possessed by the owner.

It should be clear that some understanding of the legal characteristics of real estate is essential to analyzing the relative benefits that accrue to the various parties who have some rights in a particular property. In most real estate financing and investment transactions, we generally think in terms of investing, selling, or borrowing based on one owner possessing all property rights in the real estate. However, as we have discussed, all or a portion of these rights may be restricted or transferred to others. For example, a property owner may lease a property and pledge it as security for a mortgage loan. Remarkably, these parties generally enjoy their respective rights in relative harmony. However, conflicts arise occasionally concerning the relative rights and priorities among holders of these interests. The potential for such conflicts may also affect rents that individuals may be willing to pay or the ability to obtain financing from lenders and, ultimately, the value of property.

Definition of Estate

The term **estate** means "all that a person owns." The term *real estate* means all realty owned as a part of an individual's estate. The term *estates in real property* is used to describe the extent to which rights and interests in real estate are owned. A system of *modifiers* has evolved, based on English property law, that describes the nature or collection of rights and interests being described as a part of a transaction. For example, a *fee simple estate* represents the most complete form of ownership of real estate, whereas a *leasehold estate* usually describes rights and interests obtained by tenants when leasing or renting a property. The latter is also a possessory interest and involves the general right to occupy and use the property during the period of possession.

Two General Classifications of Estates

(1) Based on Rights: Estates in Possession versus Estates Not in Possession (Future Possession)

Two broad categories of estates can be distinguished on the basis of the *nature of rights accompanying the ownership of such estates.* An estate in possession (a present estate in land) entitles its owner to immediate enjoyment of the rights to that estate. An estate not in possession (a future estate in land), on the other hand, does not convey the rights of the estate until some time in the future, if at all. An estate not in possession, in other words, represents a *future* possessory interest in property. Generally, it does not convert to an estate in possession until the occurrence of a particular event. Estates in possession are by far the more common. When most people think of estates, they ordinarily have in mind estates in possession. Obviously, lenders and investors are very interested in the nature of the estate possessed by the owner when considering the purchase or financing of a particular estate in property.

(2) Based on Possession and Use: Freehold versus Leasehold Estates

Estates in possession are of two general types: freehold estates and leasehold estates. These types of estates are technically distinguished on the basis of the definiteness or certainty of their duration. A **freehold estate** lasts for an indefinite period of time; that is, there is no definitely ascertainable date on which the estate ends. A **leasehold estate,** on the other hand, expires on a definite date. Aside from this technical distinction, a freehold estate connotes ownership of the property by the estate holder, whereas a leasehold estate implies only the right to *possess* and *use* the property owned by another for a period of time.

Examples of Freehold Estates

It is beyond the scope of this chapter to review all the possible types of freehold estates. We will discuss two of the most common examples, however, to convey the importance of knowing the type of estate that is associated with a particular transaction.

Fee Simple Estate

A **fee simple estate,** also known as a *fee simple absolute estate,* is the freehold estate that represents the most complete form of ownership of real estate. A holder of a fee simple estate is free to divide up the fee into lesser estates and sell, lease, or borrow against them as he or she wishes, subject to the laws of the state in which the property is located. Apart from government restrictions, no special conditions, limitations, or restrictions are placed on the right of a holder of a fee simple estate to enjoy the property, lease it to others, sell it, or even give it away. It is this estate in property that investors and lenders encounter in most investment and lending transactions.

Life Estates

It is possible to have a freehold estate that has fewer ownership rights than a fee simple estate. One example is a **life estate,** which is a freehold estate that lasts only as long as the life of the owner of the estate or the life of some other person. Upon the death of that person, the property reverts back to the original grantor (transferor of property), his or her heirs, or any other designated person. Most life estates result from the terms of the conveyance of the property. For example, a grantor may wish to make a gift of his or her property prior to death, yet wish to retain the use and enjoyment of the property until that time. This can be accomplished by making a conveyance of the property subject to a reserved life estate. A life estate can be leased, mortgaged, or sold. However, parties concerned with this estate should be aware that the estate will end with the death of the holder of the life estate (or that of the person whose life determines the duration of the estate). Because of the uncertainty surrounding the duration of the life estate, its marketability and value as collateral are severely limited.

Estates Not Yet in Possession (Future Estates)

The preceding discussion concerned estates in possession, which entitled the owner to immediate enjoyment of the estate. Here, we discuss estates not in possession, or **future estates,** which do not convey the right to enjoy the property until some time in the future. Two very important types of future estates are the reversion and the remainder.

Reversion

A reversion exists when the owner of a property wants to create and convey an estate to another party, but only for a specified period of time or the life of that party. When the end of the time period is reached, the estate is re-conveyed to the owner. Reversions are used in many cases when the owner wants to allow another party the right to occupy and use a property for a time but does not want to give up ownership. The owner intends to re-occupy the property at a future date and perhaps use it again or sell at that time. A reversionary interest can be sold or mortgaged because it is an actual interest in the property.

Remainder

A remainder exists when an owner wishes for another party to occupy and use a property for a specified number of years or for his life, then upon expiration of that time or upon his death, the estate is conveyed to a third party. In other words, an owner allows one party to occupy and use, then ownership eventually goes to a third party.

The above two cases are examples of many scenarios that are possible when a property owner wants to achieve certain results in the future as opposed to the present. Attendant issues that also must be resolved in these cases include responsibility for maintenance, insurance, property taxes, and so on, before the reversion or remainder occurs.

Examples of Leasehold Estates

There are two major types of leasehold estates: estates for years and estates from year to year. There are two other types, but they are not common.[4] Leasehold estates are classified on the basis of the manner in which they are created and terminated.

[4] *Estate at Will:* An estate at will is created when a landlord consents to the possession of the property by another person but without any agreement as to the payment of rent or the term of the tenancy. Such estates are of indefinite duration. *Estate at Sufferance:* An estate at sufferance occurs when the tenant holds possession of the property without consent or knowledge of the landlord after the termination of one of the other three estates.

Estate for Years: Tenancy for Terms

An **estate for years** is the type of leasehold estate investors and lenders are most likely to encounter. It is created by a lease that specifies an exact duration for the tenancy. The period of tenancy may be less than one year and still be an estate for years as long as the lease agreement specifies the termination date. The lease, as well as all contracts involving transactions in real estate, is usually written. Indeed, a lease is generally required by the statute of frauds to be in writing when it covers a term longer than one year. The rights and duties of the landlord and tenant and other provisions related to the tenancy are normally stated in the lease agreement.

An estate for years can be as long as 99 years (by custom, leases seldom exceed 99 years in duration), giving the lessee the right to use and control the property for that time in exchange for rental payments. To the extent that the specified rental payments fall below the market rental rate of the property during the life of the lease, the lease has value (leasehold value) to the lessee. The value of this interest in the property can be borrowed against or even sold. For example, if the lessee has the right to occupy the property for $1,000 per year when its fair market value is $2,000 per year, the $1,000 excess represents value to the lessee, which may be borrowed against or sold (assuming no lease covenants prevent it).

While a property is leased, the original fee owner is considered to have a *leased fee* estate. This means that he or she has given up some property rights to the lessee (the leasehold estate). The value of the leased fee estate will now depend on the amount of the lease payments expected during the term of the lease plus the value of the property when the lease terminates and the original owner receives the reversionary interest. Hence, a leased fee estate may be used as security for a loan or may be sold.

Estate from Year to Year

An **estate from year to year** (also known as an estate from period to period, or simply as a periodic tenancy) continues for successive periods until either party gives proper notice of its intent to terminate at the end of one or more subsequent periods. A "period" usually corresponds to the rent-paying period. Thus, such a tenancy commonly runs from month to month, although it can run for any period up to one year. Such estates can be created by explicit agreement between the parties, although a definite termination date is not specified. Since these estates are generally short term (a year or less), the agreement can be, and frequently is, oral. This type of estate can also be created without the express consent of the landlord. A common example is seen when the tenant "holds over" or continues to occupy an estate for years beyond the expiration date, and the landlord accepts payment of rent or gives some other evidence of tacit consent.

If present tenants are to remain in possession after the transfer or sale of property, the grantee should agree to take title subject to existing leases. The agreement should provide for prorating of rents and the transfer of deposits to the grantee. Buyers of property encumbered by leases should always reserve the right to examine and approve leases to ensure that they are in force, are not in default, and are free from undesirable provisions.

Interests, Encumbrances, and Easements

An *interest* in real estate can be thought of as a right or claim on real property, its revenues, or production. Interests are created by the owner and conveyed to another party, usually in exchange for other consideration. In real estate, an interest is usually thought to be less important than an estate. For example, an owner of real estate in fee simple may choose to *pledge* or *encumber* his property as a condition for obtaining a loan (mortgage loan). In this case, the lender receives only a *secured interest,* but not *possession, use, and so on,* of the property. The nature of the secured interest is usually documented in a mortgage which explains the actions that a lender may take in the event that the loan terms are not met by the property owner. In the interim, the property owner *retains possession and use* of the property. Another example of the creation of an interest in real property occurs when an owner encumbers a property by granting an easement, or the right to ingress or egress his property, to another party.

An **easement** is a **nonpossessory interest** in land. It is the right to use land that is owned or leased by someone else for some special purpose (e.g., as a right of way to and from one's property). An easement entails only a limited user privilege and not privileges associated with ownership.[5] Examples of easements would be the following: property owner A allows property owner B to use a driveway on A's land to provide owner B with better access to his property. In some retail developments, owners A and B may execute reciprocal easements to allow access across both properties, thereby enhancing customer traffic flow and shopping opportunities.

Assurance of Title

When making real estate investments, buyers of property typically want assurance that they will become the legal owner of the property and that the seller is lawfully possessed and has the right to convey title. Exhibit 1–2 contains a basic flow diagram that should help the reader understand concepts relating to real estate ownership.

When considering the purchase of real estate, buyers must be in a position to assess the quantity and quality of ownership rights that they are acquiring. **Title assurance** refers to the means by which buyers of real estate "(1) learn in advance whether their sellers have and can convey the quality of title they claim to possess and (2) receive compensation if the title, after transfer, turns out not to be as represented."[6] Lenders are also concerned about title assurance because the quality of title affects the collateral value of the property in which they may have a secured interest. Before we examine the mechanisms used for title assurance, we must briefly review the concepts of title and deed.

The Meaning of Title

Title is an abstract term frequently used to link an individual or entity who owns property to the property itself. When a person has "title," he is said to have all of the elements, including the documents, records, and acts, that prove ownership. Title establishes the quantity of rights in real estate being conveyed from seller to buyer. The previous section briefly examined some of the various types of ownership rights and possessory interests that can be involved in a parcel of real estate. We saw, for example, that one person may hold title in fee simple ownership, convey title to a life estate to someone else, and convey the right to reversion upon termination of the life estate to yet another person. Hence, there are many possible combinations of rights and interests.

[5] When a property owner provides another with an interest such as an easement, the property owner is said to have encumbered the property. This may be transferred as a part of subsequent sales to successive owners unless it is defeated, or the owner of the interest releases or recognizes the interest to the property owner.

[6] Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance and Development,* 2nd ed. (St. Paul, MN: West Publishing, 1981), p. 167.

EXHIBIT 1–2

Flowchart: Ownership of Real Property

Concept	**Discussion**
Ownership	When a person or other legal entity has lawful possession of realty and real property rights they are said to have "ownership."
Proof of ownership	Proof is usually accomplished with documents such as deeds, contracts, wills, grants, property records, and/or evidence of continuous possession and use, and so on.
Title	When a person or entity has legal evidence, or "proof," of ownership, they are said to have "title" to a property. This evidence links ownership by a person to a specific property.
Assurance of title	When investing in real estate, the investor must be able to evaluate the quality and/or completeness of title that they will receive. This is important in the event that the buyer wants to obtain financing and/or resell the property in the future. As part of the contract negotiations, the seller usually agrees to convey title *and* to provide a warranty or guarantee.
(a) General warranty deed	When the seller conveys a *general warranty deed*, she warrants (1) that she is in lawful possession of the property and all property rights, (2) that no other individuals or entities have an ownership interest in the property, and (3) that the title is unencumbered or free of imperfections (with any specific exceptions noted: e.g., easements, leases, or liens). In the event that a buyer who relies on the seller's warranty incurs a loss because of title imperfections, the seller may be liable.
(b) Qualified warranty deeds	In cases when the seller is unsure of the quality of title or is unwilling to provide a general warranty deed, the seller may qualify assurance of title by conveying a "special warranty deed," a "bargain and sale deed," or a "quit claim deed."
Evidence as to the nature and quality of title being conveyed	How can the investor in a property be assured that the seller legally possesses the property and that the record of ownership is clear, or that the title is unencumbered?
(a) Attorney's opinion	An attorney reviews public property records and other evidence to ascertain whether or not the "chain of title" is "clear." When a title is clear, this usually means that all individuals who may have had an ownership interest in the property have conveyed or relinquished such interests in previous conveyances of title. When the *possibility* exists that other parties may have an ownership or other interest, these may be referred to as title "imperfections or defects." If an investor wants clear title, action must be taken to "cure" such defects. This is usually done by an attorney who will contact relevant parties in the chain of title and negotiate a release or conveyance of their interest, possibly in exchange for some consideration.
(b) Title insurance	More commonly, an insurance policy indemnifying against a loss due to possible title imperfections is purchased (usually by the buyer). This may be done because the seller's warranty may be effectively limited. This could happen if the seller files for bankruptcy or does not have the financial capacity to reimburse the buyer for losses due to title imperfections. Title insurance also may be used in lieu of an attorney's opinion because the latter protects the buyer only to the extent that the title search was done negligently by the attorney or her abstractor. Title insurance companies usually conduct a review of the title chain before issuing a title insurance policy.

An **abstract of title** is a historical summary of the publicly recorded documents that affect a title. The quality of the title conveyed from seller to buyer depends upon the effect these documents have upon the seller's rightful possession of his or her property.

Essentially, title exists only for freehold estates. A leasehold estate, on the other hand, is typically created by a contract (called a lease) between a person who holds the title (the **lessor**) and another person (the lessee), whereby possession of the property is granted by the owner to the other person for a period of time. The existence of leases on a property will, however, affect the nature of the rights that can be conveyed to a new buyer because lease terms are binding on the new owner unless waived by the lessee or, in some jurisdictions, unless title is acquired at a foreclosure sale. Because investors and lenders are concerned about the nature and extent of the rights they are acquiring or financing, leases encumbering the property can have a profound impact on a property's value.

Deeds

Usually title is conveyed from one person (the grantor) to another (the grantee) by means of a written instrument called a **deed.** (We use the term *grantor* instead of *seller* because title may also be transferred by the owner [grantor] to an heir [grantee] by means of a will; hence the terms *grantor* and *grantee.*) To be a valid conveyance of ownership interests in real property, all deeds must be in writing and meet certain other legal requirements of the state in which the property is located.[7]

Generally, a purchaser wants the deed to convey a good *and* marketable title to the property. A good title is one that is valid in fact; that is, the grantor does lawfully have the title he or she claims to have to the property. However, a good title, because of the lack of sufficient documentation or encumbrances on the property, may be unmarketable. A marketable title is one that is not merely valid in fact but is also "free from reasonable doubt," one that is "reasonably free from litigation," and "one which readily can be sold or mortgaged to a reasonably prudent purchaser or mortgagee (mortgage lender)."[8]

Encumbrances on a title, such as easements, leases, and mortgages (secured interests), do not automatically make it unmarketable. A purchaser may be willing to take title to the property subject to encumbrances. But the deed should note all encumbrances on the title so that a potential purchaser can rationally decide whether to purchase the property and to arrive at the appropriate price given any risks, costs, or restrictions posed by the encumbrances.

Methods of Title Assurance

There are three general ways in which a buyer has assurance that a title is good and marketable. First, the seller may provide a warranty as part of the deed. Second, there may be a search of relevant recorded documents to determine whether there is reason to question the quality of the title. This is usually done by an attorney and is accompanied by a legal opinion. Third, title insurance may be purchased to cover unexpected problems with the title.

[7] A deed is not the only way by which ownership rights in real property are conveyed. Titles are also transferred by wills, court decrees, and grants of land from the government to private persons. In addition, lawful title to property can be acquired by means of adverse possession. It should also be pointed out that although we use the terms *buyers* and *sellers* in this book, the more general terms *grantor* and *grantee* are frequently used in contracts or other documents in real estate. **Grantors** include sellers but also include property owners who may be transferring title by gift (not sale), by will, and so on. **Grantees** include buyers in a transaction but also may include persons who receive title by gift, as an heir in a will, and so on.

[8] *Black's Law Dictionary,* 7th ed. (St. Paul, MN: West Publishing, 1999).