

# 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.<sup>1</sup>

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

<sup>1</sup> 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.

of public record keeping, whereby ownership of all realty within a political jurisdiction could be catalogued. 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.<sup>2</sup> 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**.<sup>3</sup>

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

<sup>2</sup> 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.

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

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 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 which 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. The two most important types of future estates are the reversion and the remainder.

### ***Reversion***

A **reversion** exists when the holder of an estate in land (the grantor) conveys to another person (a grantee) a present estate in the property that has fewer ownership rights than the grantor's own estate and retains for the grantor or the grantor's heirs the right to take back, at some time in the future, the full estate that the grantor enjoyed before the conveyance. In this case, the grantor is said to have a reversionary fee interest in the property held by the grantee. A reversionary interest can be sold or mortgaged because it is an actual interest in the property.

### ***Remainder***

A **remainder** exists when the grantor of a present estate with fewer ownership rights than the grantor's own estate conveys to a third person the reversionary interest the grantor or the grantor's heirs would otherwise have in the property upon termination of the grantee's estate. A remainder is the future estate for the third person. Like a reversion, a remainder is a mortgageable interest in property.

## **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.<sup>4</sup> Leasehold estates are classified on the basis of the manner in which they are created and terminated.

<sup>4</sup> *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**

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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.<sup>5</sup> 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.”<sup>6</sup> 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.

<sup>5</sup> 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.

<sup>6</sup> 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 <i>and</i> to provide a warranty or guarantee.
(a) General warranty deed ↓	When the seller conveys a <i>general warranty deed</i> , 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 <i>possibility</i> 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.<sup>7</sup>

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).”<sup>8</sup>

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.

<sup>7</sup> 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.

<sup>8</sup> *Black's Law Dictionary*, 7th ed. (St. Paul, MN: West Publishing, 1999).

### ***General Warranty Deed***

It is important to understand that any deed, no matter how complete the warranties contained therein, can only convey the quality of title that the grantor actually has to the property. This is why most buyers of real estate usually obtain independent assurance of the validity and marketability of the title from a third party. A **general warranty deed** is the most commonly used deed in real estate transactions and the most desirable type of deed from the buyer's perspective. It offers the most comprehensive warranties about the quality of the title. Essentially, the grantor warrants that the title he or she conveys to the property is free and clear of all encumbrances other than those specifically listed in the deed. As pointed out above, encumbrances listed in a deed could include easements and leases. Generally, the most significant covenants contained in such a deed are the following: (1) a covenant that the grantor has good (legally valid) title to the property, (2) a covenant that the grantor has the right to convey the property, (3) a covenant to compensate the grantee for loss of property or eviction suffered by the grantee as a result of someone else having a superior claim to the property, and (4) a covenant against encumbrances on the property other than those specifically stated in the deed. In a general warranty deed, these covenants cover all conveyances of the property from the time of the original source of title to the present.

### ***Special Warranty Deed***

A **special warranty deed** makes the same warranties as a general warranty deed except that it limits their application to defects and encumbrances that occurred only while the grantor held title to the property. Unlike the warranties in a general warranty deed, those in a special warranty deed do not apply to title problems caused or created by previous owners.

### ***Bargain and Sale Deed***

A **bargain and sale deed** conveys property without seller warranties. This is sometimes referred to as an "as is" deed. The buyer of property takes title with no assurances from the seller and must take the initiative to determine whether any imperfections exist and, if desired, how to cure such defects.

### ***Sheriff's Deed-Trustee's Deed***

A **sheriff's deed-trustee's deed** is a type of bargain and sale deed received by a buyer from a foreclosure or other forced sale because the sheriff or trustee is acting in a representative capacity. No warranties are added.

### ***Quitclaim Deed***

A **quitclaim deed** offers the grantee the least protection. Such a deed simply conveys to the grantee whatever rights, interests, and title that the grantor may have in the property. No warranties are made about the nature of these rights and interests or of the quality of the grantor's title to the property. The quitclaim deed simply says that the grantor "quits" whatever "claim" he or she has in the property (which may well be none) in favor of the grantee.<sup>9</sup>

<sup>9</sup> Quitclaim deeds are appropriately and frequently used to clear up technical defects or "clouds" on the title to a property. Where the record indicates a person may have any potential claim to the property, obtaining a quitclaim deed from him will eliminate the risk that such a claim will be made in the future.

## Web App

The American Land Title Association ([www.alta.org](http://www.alta.org)), founded in 1907, is the national trade association for the title insurance industry. ALTA members search, review, and insure land titles to protect home buyers and mortgage lenders who invest in real estate. ALTA is

headquartered in Washington, DC. There is a “Consumer Information” link on this site that includes a discussion of common title problems. Outline the types of problems that can be encountered due to a problem with the title for a property.

Very few buyers of real estate rely solely on the guarantees of title provided in deeds of conveyance by the seller. The two methods that buyers employ most often to obtain assurance of title independently of the guarantees provided by the seller are an attorney’s opinion of title and title insurance.

### Abstract and Opinion Method

Obtaining a lawyer’s opinion of title used to be the most common method of title assurance before the widespread availability of title insurance. Essentially, the abstract and opinion method is a two-step process. First, there is a search of the title record, which involves locating and examining all of the instruments in the public records that have affected the title of the property in question.<sup>10</sup> Second, when the title search is completed, a lawyer studies the relevant public records and other facts and proceedings affecting the title for the purpose of arriving at an expert opinion of the character of the title. Based upon this study of the abstract or the record, the lawyer will give his or her judgment whether the title is good and marketable. If the title is found to be “clouded,” the opinion should state what defects or encumbrances were uncovered by an examination of the records, and it should also state what the lawyer thinks can and should be done to “cure” the defects uncovered.

Because a lawyer’s responsibility is limited to what appears in the records, the lawyer cannot be held liable for any defect in the title not disclosed therein. Any liability borne by the lawyer is based upon proof of his or her negligence or lack of professional skill in the examination of the records. Rather than relying on the lawyer’s opinion, the title insurance industry has evolved. Many lenders and investors now prefer title insurance, which reduces this risk.

### The Title Insurance Method

Title insurance was developed to cure the inadequacies of title validation accomplished through an abstract and legal opinion. Title insurance does all that a carefully drawn abstract and a well-considered opinion by a competent lawyer are expected to do. In addition, it adds the principle of insurance to spread the risk of *unseen hazards* among many property owners.

Elimination of risk arising from unseen hazards in the public record has caused many investors and lenders to prefer this method of title assurance. In fact, title insurance is required for any mortgage that is traded in the secondary mortgage market. The title insurance process

<sup>10</sup> Most of the instruments that affect title to real estate are recorded, in accordance with the recording acts of the various states, at what is typically called the county recorder’s office. But some instruments that affect title may be recorded in other places. The nature of these other places where records are filed varies from state to state.

starts with a careful analysis of the records. The information available to the commercial title insurance company may be even more complete than that found in the public records. Skilled technicians at title insurance companies examine all available evidence of the title to determine its character. If their conclusions warrant, the title company will insure the title to a property and assume risks that are not even disclosed in the public records or in its own files. In short, title insurance ensures that the title is good and marketable.

What title insurance is supposed to add to the abstract system and the opinion of skilled lawyers may be summarized as follows: (1) definite contract liability to the premium payer, (2) reserves sufficient to meet insured losses, (3) supervision by an agency of the state in which the title insurance company operates, and (4) protection to the policyholder against financial losses that may show up at any future time because of any kind of title defect, disclosed or hidden. Despite these advantages, the abstract and opinion method may still be used because of its lower cost. In general, one method, but not both, is used when purchasing property, to avoid the duplication of effort and cost.

### ***Kinds of Title Insurance Policies***

There are two kinds of title insurance policies. The **owner's policy** insures the interests of a new property owner. The **lender's (or mortgagee) policy** insures the interests of the mortgagee. The owner's policy is payable to the owner (or to the heirs of the owner); the lender's policy is payable to the mortgagee.

Both policies are paid for with a one-time premium. In many states, premiums are regulated by a state insurance commission, as are financial requirements to incorporate and continue to do business. The one-time premium for the owner's policy insures the owner for the entire period of time that she owns the property. The insurance premium may be paid by either the seller or the buyer, depending on the terms of the purchase contract, which are influenced by local custom and market conditions. It is almost universal practice for the borrower to pay the cost of the mortgagee's policy which will insure the lender for the term of the loan. In cases where properties are *refinanced* by the same owner, a title search may be required by a new lender. In these cases it may be possible to obtain a new title insurance policy from the same company at a *reduced cost*.

## **Recording Acts**

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All states have enacted statutes known as **recording acts**. Although the recording acts are not uniform among the states, these acts in general provide a publicly accessible system for assessing and establishing claims or interests in real estate as against all other parties. These statutes also provide a set of authoritative rules for resolving priority disputes among competing claimants to interests in real estate. As part of this system, procedures have been established for placing documents affecting claims to real estate interests on the public record and for maintaining these records to make information available concerning almost all interests in real estate. Once an instrument creating a claim on an interest in real estate has been duly recorded, the recording is deemed to give constructive notice of this interest "to the world." Constructive notice means that the recording acts deem a person to have whatever information is contained in the public records—information that could be obtained by a reasonably diligent investigation of the records whether or not the investigator actually has knowledge of the information recorded. Instruments affecting virtually all interests in real estate, including deeds, mortgages, assignments of mortgages, liens on real estate, land contracts, long-term leases, easements, restrictive covenants, and options to buy, are covered by recording acts.

Most recording acts say that in order to establish and preserve a claim to an interest in real estate that will take precedence in law against future claimants, the instrument creating

that claim must be recorded in accordance with state law. These acts were designed in part to protect an innocent person who purchased an interest in real estate in good faith unaware that the interest had already been acquired by another. For example, if A conveyed to B, who did not record the instrument establishing his claim, and later A conveyed the same interest to C, who did record, C's claim would be superior to B's if C was unaware of the prior conveyance and paid valuable consideration to A. B's only claim would be to file a suit against A for fraud.

### ***Mechanics' Liens***

One cloud on the title which may not be disclosed by the public records is a **mechanics' lien**. In general, mechanics' liens give unpaid contractors, workers, and material suppliers the right to attach a lien on the real estate to which they added their labor or materials. To obtain the payment owed them, they may foreclose such liens by forcing a judicial sale of the encumbered property. They are then paid from the proceeds of the sale. Use of mechanics' liens exists in every state, although the nature of the statutes varies.

Mechanics' liens are permitted to be recorded "after the fact." In other words, state laws generally give contractors, laborers, or suppliers of materials a certain period of time following the completion of work or delivery of materials during which to file their lien. When the lien is filed, it "relates back" and takes priority over all liens filed after the time when materials were first delivered or work was first performed on the real estate. As a result, until the end of the time allowed for filing (generally 60 days), a purchaser of an interest in newly constructed or improved real estate cannot be sure that the interest will be unencumbered or that the interest will have the priority bargained for. As a precaution, lenders and purchasers of such real estate should require the seller to provide an *affidavit* stating that at closing, all moneys due to contractors and subcontractors have been fully paid. In the event that liens are filed after the closing, a breach of the seller's covenants in the affidavit can easily be proven, and the seller can be held liable for the discharge of those liens. In practice, owners of properties that are newly constructed or renovated should require contractors, workers, and material suppliers to sign a *lien waiver*. This is an acknowledgment that they have been compensated and that they agree to waive all lien rights. In many situations, if a lender is advancing funds for such work and material, a signed waiver will be required at each stage of construction before additional funds are released.

## **Limitations on Property Rights**

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### ***Government Restrictions***

Throughout this chapter, we have stressed the importance of property rights in real estate. We should also point out that although our form of government protects the rights of individuals to own real estate and to enjoy real property rights, these rights are not unrestricted. Government restrictions on private property rights do exist. Land use regulations are most prominent at the state and local level. The right to regulate emanates from the "police powers of the state," which are based on the protection of the health, safety, and general welfare of its citizens (societal considerations). As the population in an area grows, it may apply to the state to become incorporated as a city, township, or municipality. At this point, the state usually delegates some areas of land use regulation. Incorporated areas then may modify and expand land use controls and develop restrictions on land use. These items are usually enumerated in zoning ordinances and building codes. Common restrictions used to implement controls include zoning ordinances, allowable uses, height

restrictions, parking requirements, and building codes, permits, and inspections. The state usually retains control over water or riparian rights, mineral rights, eminent domain, and the like, while the federal government regulates housing and loan discrimination, interstate land sales and securities, and environmental restrictions (pollution of water and air, and endangered species, as well as effects of property use and development on wet lands).

### ***Private Deed Restrictions***

In some cases, property owners may choose to incorporate certain **deed restrictions** that limit the use of property by all subsequent owners of that property. Property owners may use such restrictions to achieve personal or business objectives. One example of a personal objective would be to add a deed restriction explicitly prohibiting the sale or consumption of alcoholic beverages on the property forever. In the event that this restriction is violated, the restriction may stipulate that the title will revert to the owner who incorporated the restriction, or to his heirs. An example of a business objective that is commonly achieved through deed restrictions may involve subdivision of a large tract of land into smaller individual tracts to be sold to builders and developers. In order to assure the initial buyers of the subdivided tracts that subsequent buyers will build improvements that conform in quality and use, the owner of the initial larger tract may deed restrict each of the subdivided tracts. Such restrictions may require a minimum and/or maximum building size, minimum quality building materials, landscaping, and the like, thereby providing all owners with some assurance of conformity and general standards in design and building quality. However, resolution of any future violations of deed restrictions may prove to be problematic, particularly after a long period of time. In the first example, the original property owner or all of his heirs would have to bring an action against the current owner to regain title to the property if the deed restriction prohibiting the sale of alcohol were to be violated. In the case of the subdivision, usually a property owners association representing owners of the subdivided properties would have to bring legal action against the property owner who is in violation. In this instance, the court may require the owner in violation to cure the problem or pay the owners association for any loss in property value as opposed to forcing the sale of the property.

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## **Conclusion**

This chapter discussed legal considerations important in creating and defining various rights to real property. This is important in the study of real estate finance since it is these rights that are purchased, sold, and mortgaged. Thus, an understanding of the various rights associated with real estate is necessary to properly evaluate a real estate financial decision. Legal considerations affect the risk of receiving the economic benefit associated with one's property rights. For example, we have discussed the importance of having a marketable title. Any defects in the title may result in a loss of benefits to the owner and jeopardize the collateral value of the real estate for the mortgage lender. To some extent, this risk is controlled and minimized by the use of title assurance methods, including title insurance and the use of general warranty deeds.

Knowing the various ways of partitioning property rights may also result in maximizing the value of a particular property, since it allows parties with different needs (e.g., users, equity investors, and lenders) to have claims on the property rights that best meet those needs. Thus, the total value of all the rights associated with a property could exceed the total value of the property itself if there are no leases or other ways to separate rights.

## Key Terms

abstract of title, 9	leasehold estate, 4	quitclaim deed, 10
bargain and sale deed, 10	lender's (or mortgagee) policy, 12	real estate, 2
deed, 9	lessee, 3	real property, 2
deed restrictions, 14	lessor, 9	recording acts, 12
easement, 7	life estate, 5	remainder, 5
estate, 4	mechanics' lien, 13	reversion, 5
estate for years, 6	nonpossessory interest, 7	secured interest, 3
estate from year to year, 6	owner's policy, 12	sheriff's deed-trustee's deed, 10
fee simple estate, 4	ownership rights, 2	special warranty deed, 10
freehold estate, 4	personal property, 2	title, 7
future estates, 5	property rights, 2	title assurance, 7
general warranty deed, 10		

## Useful Web Sites

**www.alta.org**—The American Land Title Association—Provides information related to title insurance.

**www.ired.com**—International Real Estate Digest—Provides information for most real estate professionals as well as real estate software and tools.

**www.reals.com**—This is a real estate directory for such subjects as commercial real estate, international real estate, and professional services.

**www.findlaw.com**—A good source of legal information, including real estate.

**www.investorwords.com**—InvestorWords.com provides all of the necessary keys for decoding what can often seem like an encrypted language, regardless of your investing experience. InvestorWords.com provides definitions for over 6,000 financial terms and includes 20,000 links between related terms. The glossary is completely free to use. It also provides a list of great investing and personal finance Web sites, but most of them assume you already have a certain level of experience, or even a certain vocabulary.

**www.fiabci.com**—This site is a good source for a comparison between legislation, professional standards, taxation, and licensing among different countries. It also gives a comparative snapshot of various requirements for commercial leases in several countries.

**www.china-window.com/china\_market/china\_real\_estate/index.shtml**—This Web site gives information about the real estate market in China. It also gives useful information about the laws and regulations concerning real estate, different Web sites related to real estate in China, and contact information for different government agencies.

**www.epra.com**—This site is hosted by The European Public Real Estate Association (EPRA), which is a not-for-profit body established under Dutch law. This Web site gives quarterly review reports of developments in the European Real Estate Sector. It also provides different research reports published related to real estate.

## Questions

1. What is the difference between real property and personal property?
2. What is meant by an estate?
3. How can a leased fee estate have a value that could be transferred to another party?
4. What is an abstract of title?
5. Name the three general methods of title assurance and briefly describe each. Which would you recommend to a friend purchasing a home? Why?
6. Would it be legal for you to give a quitclaim deed for the Statue of Liberty to your friend?