

American Real Estate

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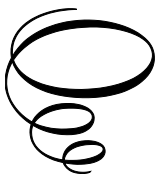
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American Real Estate

By

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CHAPTER 1

REAL ESTATE OWNERSHIP RIGHTS:

WHAT DO I OWN?

QUESTIONS TO BE ANSWERED

1. What is real estate?
2. What is the nature of the real estate business?
3. What is the relationship among its participants?
4. What do the participants have to offer a potential buyer? or seller?

OBJECTIVES

When a reader finishes the chapter, he or she should be able to:

1. Explain the nature of real estate by analyzing its physical and ownership components.
2. Identify the economic characteristics of real estate.
3. Describe the various services an agent can offer to a client.
4. Explain the differences among an agent, a REALTOR, a REALTOR-ASSOCIATE, and an agent who holds a designation in a specialty.
5. Explain the differences among the Real Estate Commission, the National Association of REALTORS, the State Association of REALTORS, and the local board.
6. Identify the other professionals who contribute to the real estate business and explain the services that each offers to a prospective buyer or seller.
7. Identify the future characteristics of the real estate business.

IMPORTANT TERMS AND PHRASES

air rights	life estate
appraiser	local board
environment	mineral rights
estate for years	National Association of
estate from year to year	REALTORS
estate in expectancy	property manager
estate in possession	real estate
estate <i>pur autre vie</i>	real estate agent
fee simple	real estate business
fixture	real estate commissioner
freehold estate	real estate developer
freehold estate of inheritance	real estate lender
freehold estate not-of-	real property
inheritance	REALTOR
general agent	REALTOR-ASSOCIATE
general contractor	rights of ownership
improvement	situs
improvements-on-the-land	special agent
improvements-to-the-land	tenancy at will
joint tenancy	tenancy by sufferance
land	tenancy in common
leasehold	title company
less-than-freehold estate	waste

WHAT IS THE NATURE AND PURPOSE OF THE TEXT?

Most real estate texts are topic-oriented. Typically, each chapter covers one topic in detail without much discussion of the reasons for studying one topic before or after another. For example, why are deeds examined before the settlement statements? Why are property taxes examined after a discussion of estimating the market value of a parcel? Why are license laws examined in the first chapter of the book?

This text presents topics on a need-to-know basis; that is, topics are presented and discussed in the order in which a typical normal consumer would encounter the need to use this information in a real estate transaction. In addition, information is presented in a decision-making framework that the reader can use to make decisions. Thus, the purpose of the text is to present the topics in a need-to-know framework, so that a typical consumer

can use the information to understand a typical real estate transaction and to make intelligent decisions.

The consumer may be a buyer, seller, interested citizen, potential agent, or actual agent. The typical transaction is the same for all. The same questions arise and must be answered in approximately the same order. Exceptions may exist in the order of the topics encountered for a particular transaction, but the steps remain essentially the same for the majority of the transactions.

What are Typical Steps in the Real Estate Transaction?

A summarization of the typical steps in a normal real estate transaction appears in the contents as Parts I through VI. These steps are repeated and expanded upon in the following paragraphs.

I. The Decision to Acquire Knowledge About the Real Estate Business

The consumer must understand the nature of real estate by first examining both the definition and meaning of real estate as a commodity. What characteristics does it have? What restrictions are placed upon its use? In addition, the consumer must decide whether there are any benefits to be gained from asking for help from one or several of the many individuals and firms that provide services. What services are provided? Who provides them? What are the advantages and disadvantages of asking for help, and should I? What is the role of the government in land-use development, and what are the tools commonly used? How do land-use controls influence business development and metropolitan growth?

II. The Decision to Estimate Market Value

A question that the typical consumer asks very early is, What is my property worth? Immediately he or she is expected to interpret local housing trends and understand the mechanics and concepts of income-property appraisal and residential appraisal. If this take is too time-consuming, the consumer may use the services of an appraiser.

III. The Decision to Finance the Transaction

All of the earlier decisions assume the buyer can raise the necessary cash to pay the negotiated purchase price. Later material covers the residential and commercial loan application process and presents the types of information that the consumer will need to know to evaluate the loan application process and the contracts used in residential financing.

IV. *The Decision to Invest*

A typical consumer will inquire early about the chance of receiving a capital gain and will ask whether the property is a good buy. In addition, a typical consumer may be interested in investment real estate to receive a tax shelter or a capital gain from either price appreciation or mortgage reduction.

V. *The Decision to Buy, Sell, or Manage*

If an agent is involved, the typical buyer or seller needs to know the economic motivations behind the agent's actions to evaluate the circumstances.

VI. *The Decision to Transfer the Title*

One chapter covers the preparation for the closing when the title is transferred. Every part should be able to verify the accuracy of the settlement statements.

In sum, every chapter contains the information the authors think the typical buyers, sellers, or agents need to know about that step of a real estate transaction. In addition, the steps follow a central theme of *need-to-know* that presents information to the consumer as he or she would encounter it. When the text is finished, the topics and presentation should allow the consumer to make decisions about the particular set of circumstances in a particular transaction.

WHAT IS THE REAL ESTATE COMMODITY?

Real estate is a commodity in the same sense that an automobile and a television set are commodities. Each of these items is useful to an individual and each one is bought and sold in its specialized market. Moreover, each product is complex. Automobiles can be classified by their different external characteristics such as luxury versus compact, new versus used four-door sedan versus a sports car, domestic versus foreign, red versus blue. Less obvious, but also important, are such components as an eight-cylinder versus a four-cylinder engine, automatic versus standard transmission, and disc versus drum brakes. An analysis of television sets would reveal that they also could be categorized by external characteristics and based on major components.

To understand the nature of a complex commodity, the consumer must identify and closely examine its components. Before buying an automobile,

the consumer must know about the engine, the transmission, the brake system, and so on. These components are just as important as the external features of the commodity. The greater the consumer's knowledge about the parts, the greater will be his or her understanding of nature and the functions of the product.

This section presents a discussion of the commodity known as **real estate**. The real estate commodity has two major physical components (the land and the improvements) and a legal dimension consisting of a bundle of legal rights. The consumer must analyze each of the components and the legal aspects in detail to understand the nature and function of the commodity as a whole.

What are the Components of Real Estate?

Legal Concept of Land. When the term **land** is used, it typically refers to thoughts of the solid surface of the earth. It is the ground upon which individuals live and build things. It is the dirt in which vegetation grows. An examination of any dictionary definition of the term reveals that this concept underlies the major part of the meaning of the word land in the sense of its being a physical entity or commodity.

The legal concept of **land**, however, includes more than just the visible solid surface of the earth. The legal definition of land contains two additional, less visible components. When the consumer buys a parcel of land, that person legally buys whatever is below ground, the mineral rights, whatever is above ground, and the air rights. The term **rights** is used in this sense to identify the claim or the interest to which the owner is justly entitled under law or custom. The term **mineral rights** is the owner's claim of land to the minerals under the surface. The term **air rights** is the owner's claim in the space above the surface area of the property.

Mineral rights apply to a legally specified, three-dimensional, subterranean space. The surface area of the parcel forms the base of the three-dimensional figure. For simplicity, assume that the land area is a square. In this case, the three-dimensional figure is an inverted pyramid with a square base and a depth that is the distance from the surface to the center of the earth that is roughly 4,000 miles.

Under the legal concept of land, the owner has an automatic claim to all minerals enclosed within the geometric shape formed by the surface area and the center of the earth. The minerals belong to the owner unless the owner and the seller agreed that mineral rights did not transfer when the

property was sold. Even though the legal extent of the mineral rights reaches the center of the earth, the current state of technology establishes a practical limit to the extent of these mineral rights. Mine shafts and oil wells can go down to a depth of several miles; they do not descend for tens or hundreds of miles. The technology of the extractive industry determines the feasible quantity of mineral rights, and the law defines the full extent of these rights within the American system of laws and customs.

Air rights also apply to a legally defined, three-dimensional space. In this case, the surface area or shape of the parcel defines the air space. If the three-dimensional figure used to define the mineral rights were to be extended above the surface of the land parcel, the base and the sides of the air-rights space could be outlined. The height of this space, or the upward extent of the air rights, must still be defined. Typically, the height dimension is expressed as extending “to the sky” or “to the heavens.”

These statements could lead to an esoteric debate about the exact location of the sky and whether celestial bodies belong to the owners of land parcels. However, two considerations eliminate the need for such discussion: (1) The state of construction technology limits the feasible height of the landowner’s air rights. Currently, the height of most commercial structures does not exceed 1,400 feet above the surface. The tallest buildings are only slightly higher than 1,400 feet. (2) The federal government limits the height of air rights by establishing the airways above a stated height as public property for use by aircraft. Local governments also limit the upward extent of air rights by enacting building-height restrictions.

Due to the technological and governmental restrictions, the space in which a person has air and mineral rights, for all practical purposes, extends no more than 50,000 feet below the ground and no more than 1,500 feet above the ground, and the boundaries are established by the size and the shape of the land parcel.

Exhibit 1.1 shows the legal concept of land. Notice the distinction between legal dimensions and feasible/permmissible range. (*see Exhibit 1.1*)

Improvement and Fixtures. The second obvious component of real estate is any building or structure on the land. The term **improvement** is used to denote these buildings and structures, as well as other man-made additions such as fences, driveways, and retaining walls. The general term used to represent all types of permanently erected man-made structures is **improvement-on-the-land**. (*see Exhibit 1.2.*)

Another kind of improvement, called **improvements-to-the-land**, denotes such changes to the land as improving drainage, grading, and filling; providing utilities in the form of water and sewage laterals to the water and sewer mains, natural gas lines, electricity and telephone lines, and construction of access roads to main arterial streets and highways. These changes make the land suitable for some form of economic or public use, such as homes, stores, industries, schools, and parks.

Improvement-on-the-land and improvements-to-the-land, taken together, are referred to as **on-site improvements**. Thus, the second major physical component of the commodity known as real estate is the entire complex of man-made additions known as on-site improvements.

A **fixture** is a personal property that is legally considered real estate because it is attached to the land or to an improvement, which is itself permanently attached to the land. Attachment is only one criterion used to identify a fixture. Other factors that must be considered are the method of attachment, the intention of the party making the attachment, and the purpose for which the personal property is to be used. In terms of the method of attachment, if the item of personal property is firmly attached so that its removal would injure the property, the item is considered to be a fixture.

The intention of the person making the attachment is another criterion. When an owner builds an appliance into the counter, the courts view the appliance as a fixture because, by building it in, the owner has expressed an intent to make the appliance a fixture. In another situation, the owner of a parcel of residential real estate may offer to sell the house with a fully equipped kitchen.

Finally, the purpose for which the property is used also is important. If the item is used to promote the purpose for which the real estate is owned, the presumption is that the owner intended the item to be a fixture regardless of the manner of the attachment. An example of this situation is the sale of a retail store as a clothes store to a buyer who expresses an intention to use the property in the same way.

The question of whether an item of personal property is a fixture arises only if the property to which the item is attached changes owners, or if the property has been rented to a tenant and is subsequently returned to the owner, or if the property is used as security for a loan. If the object does not change hands or if it is not used as collateral for a loan, the character of the

item as personal property or a fixture is immaterial because it belongs to the owner in any event (*see Exhibit 1.2*).

What Are the Legal Dimensions of Real Estate?

The legal dimensions of the commodity known as real estate are a package called **rights of ownership**. These rights include the right to use the commodity, the right to possess the commodity, the right to exclude others from using it, and the right to dispose of the commodity by selling it or by giving it away as a gift. These rights are intangible factors that exist in law and pertain to the physical or tangible aspects of real estate -- land and on-site improvements.

When the ownership dimension is added to the two physical components, a change occurs in the term designating the commodity. Real estate becomes **real property** when the rights of ownership are considered. However, in the generally accepted use of the term **real estate**, most people imply these intangible rights of ownership. In popular usage, the term **real estate**, which denotes only the physical aspect of the commodity, and the term **real property**, which denotes the physical entity and the ownership rights in the commodity, are used as synonyms. The term **realty** is also used by many people. **Realty** typically refers to the physical components of the property and is thereby a synonym for real estate.

Any classification of ownership must be based on the degree to which the rights of use, possession, exclusion, and disposition are held by the owner of the real estate. In other words, the owner of real estate can use the property, but only within limits established by the government. The owner can have the property in his or her possession. The owner can exclude others from the property, and, finally, the owner can choose the means of disposing of the property -- i.e., by sale or gift. The material in this section will be presented by analyzing these four rights. However, these same rights can be presented as a classification system of more than four items. For example, the right to dispose of the property could be subdivided into the rights to sell, the right to give away, and the right to lease. The discussion in this section will focus on the four rights identified. Of these four rights, the two most significant in real estate law are the right of disposition and the right of possession. These two rights are closely intertwined in the body of real estate law (*see Exhibit 1.3*).

The Freehold and Less-than-freehold Estates. Ownership can be broken down into freehold and less-than-freehold (leasehold) estates. The **freehold**

estate is a package of the rights of ownership possessed by the owner for the duration of a lifetime, a period that must be recognized as indefinite because it can last from a day to many decades. The **less-than-freehold estate** is a package of the rights of ownership obtained by a tenant from an owner; it can last for either a definite period or an indefinite period, depending on the expressed wishes of the landlord and the tenant.

The owner of a freehold estate may or may not have the right of disposition along with the right of possession. A **freehold estate of inheritance** is the situation in which the owner has all four rights of ownership -- to use the land, to possess the land, to exclude others from that land, and to dispose of the land according to his or her wishes. This is the highest form of ownership and is often called a **fee simple estate**.

A **freehold estate not-of-inheritance** is an estate in which the owner has the rights of use, possession, and exclusion, but does not have the right of disposition. The most common form of this type of estate is the **life estate**. The rights of ownership are limited to a lifetime, in this case, the lifetime of the owner. As an example of this form of estate, consider the following case.

Your parents retire to Hawaii and give you the family home for as long as you live, an estate based on the duration of your lifetime. Upon your death, the home goes to your younger sister. Your parents owned the home as a freehold estate of inheritance; they have the right to dispose of it. The fact that they gave it to you as a life estate allows you to use, possess, and exclude others from the property for as long as you are alive. However, they did not give you the right of disposition. Regardless of your wishes, your younger sister will receive that property upon your death.

An interesting sidelight of this example is that the creation of the life estate by your parents created two ownership packages. You received an **estate in possession**. Your younger sister received an **estate in expectancy**. You have the right of possession; your sister has an ownership interest that is expected to materialize in the indefinite future. Each of you has a clearly defined package of rights. You can live in the house or rent it out; your sister can sell the property with a delivery date to the new owner that occurs upon or slightly after your death. In this example, you are known as the owner, and your sister's estate is legally referred to as a **remainder** while you are alive.

Alternatively, your parents may have arranged to give you the family home for as long as you live and to have it returned to them upon your death. Such an arrangement might be used if your life expectancy, due to illness, is shorter than theirs. In this case, your parents' interest in the property is known legally as the **reversion**.

The second form of freehold estate not-of-inheritance is an **estate pur autre vie**. A loose translation of this phrase is "an estate for another's life." An example of this estate is the case in which your parents give you the family home for as long as your younger sister's husband is alive. Upon his death, the home goes to your sister. You have an estate of possession; your sister has a remainder. Both estates are based on your brother-in-law's lifetime.

The person in possession of a freehold estate not-of-inheritance has certain obligations to the owner of a remainder or the reversion. The owner of a life estate cannot commit **waste**. The legal term *waste* refers to an act that does permanent injury to the real estate that is owned as a life estate. Examples of waste are the destruction of a building without agreement by the owner of the remainder, failure to make ordinary repairs and to provide necessary maintenance, and failure to pay all of the property taxes and other charges imposed by the local government upon the property.

In addition to the life estate and the **estate pur autre vie**, some states maintain legal life estates known as **dower** and **curtesy**. Dower, in common law, is the wife's life estate in the real property of her deceased husband. The common-law provision generally held that the wife was given a life estate equal to one-third of all of the real estate that the husband owned at the time of his death. Curtesy is the reciprocal of dower; it is the legal life estate created, in common law, for the husband out of the wife's property at her death.

The less-than-freehold estates are a specified package of the rights of ownership that last for less than a lifetime and do not include the right of disposition. In other words, the owner of a less-than-freehold estate possesses it for a prescribed period and has no right to sell or give away the property. This form of estate is more commonly known as a **leasehold**.

Stated in positive terms, the rights of the holder of a leasehold are the rights to possess and use the property; the right to exclude others from the property, except that the owner has the right of entry in certain situations; and the right to transfer the use and possession of the property to others through the process of subletting with the consent of the owner.

The body of real estate law defines four categories of leasehold estates. An **estate for years** is a leasehold that continues for a definite period. The duration of the leasehold can be for one year (as in a residential lease), for more than a year (as in the case of a commercial or industrial lease), or for a definite time that is less than a year.

The second type of leasehold is an **estate from year to year**; it is often referred to as an **estate from period to period**. This estate comes into effect when a tenant maintains possession of the property after an estate for years expires and the owner agrees to the tenant's continued possession of the property by accepting a payment of rent. In this case, the terms of the original expired lease are reestablished for a maximum period of one year if the original lease was for one year or more. If the original lease was for less than one year, the same shorter time is reestablished.

The third type of leasehold is the **tenancy at will**. Under the provisions of this leasehold, the duration is not specified. The agreement between the owner and the tenant exists for as long as both are in agreement. If either party chooses to negate the agreement, the lease arrangement is terminated. The only limitation imposed on the owner and the tenant is that they must give legal notice of their intent. As a general rule, the notice is in the order of magnitude of thirty or sixty days. Finally, the death of either party terminates the lease under the tenancy at-will agreement.

The last type of leasehold is the **tenancy by sufferance**. This form of leasehold comes into existence when a tenant's right under one of the other leaseholds expires and the tenant retains possession against the owner's wishes. In common usage, the tenant at sufferance is called a **holdover tenant**. This situation generally culminates in the eviction of the tenant by the owner of the property. The property owner's right to eviction varies from state to state. At times, the holdover tenant pays the rent, which is accepted by the landlord. In this instance, the tenancy at sufferance usually becomes a tenancy from period to period (*see Exhibit 1.4*).

Co-ownership. The rights of ownership to a parcel of real estate can be held by one person or organization or can be owned by more than one entity. When the rights are held by more than one entity, the persons or organizations are known as *co-owners* of the property. The principal forms of co-ownership are joint tenancy, tenancy in common, tenancy by the entirety, and community property. They differ in terms of the right of disposition.

The first form of co-ownership, **joint tenancy**, requires the existence of four unities in some states-- the unities of title, time, possession, and interest. The **unity of title** implies that individual owners in the joint-tenancy arrangement do not have the right of disposition of the entire property. It can only be sold when the co-owners all agree to the sale. Furthermore, upon the death of one of the co-owners, the total number of owners is reduced by one and the deceased person's ownership rights revert to the surviving owners. When all the other co-owners have died, the last surviving member of the joint tenancy owns the property completely.

Related to the unity of title discussed in the preceding paragraph is the **unity of time**; the joint tenants must receive title to the property at the same point in time. Moreover, the joint tenants take possession of the property as though they were a single individual. This is the fact implied by the **unity of possession**. Finally, the joint tenants have a **unity of interest**. They hold an undivided interest in the property; no separate components are identified as the portions of the property owned and possessed by any one of the co-owners. They own equal shares in the entire property, their shares cannot be divided, and they all have the same right of possession.

In terms of each individual's right of disposition, the joint tenancy can be viewed as a freehold estate not-of-inheritance that is owned by two or more people. The individual cannot sell the property, give it away, or leave it as an inheritance for his or her heirs and have this new owner incorporated into the joint tenancy. However, each joint tenant can sell his or her undivided interest. The new owner does not become a member of the joint tenancy but becomes a tenant in common. (The concept of tenancy in common is the next form of co-ownership to be discussed.)

A **joint tenancy** can be dissolved by specific actions of the tenants. Each joint tenant has the right to destroy the agreement. The specific conditions and actions are not discussed here.

In the second form of co-ownership, **tenancy in common**, the individual owners do have the right of disposition within the form of co-ownership and do have separate, identifiable interests, which need not be equal. Each tenant in common owns an explicit percentage of the undivided total interest. The tenants in common can pass their respective interests on to their heirs or can sell their interests. In other words, tenancy in common is a freehold estate of inheritance among several persons or organizations.

The tenancy in common also differs from the joint tenancy in the way the property passes from a deceased tenant in common. Under a joint tenancy arrangement, the surviving tenant(s) receives the deceased member's interest. Under a tenancy in common, the surviving tenant(s) in common does not automatically receive the interest held by the deceased member. In a tenancy in common, each member can dispose of his or her undivided share by will -- i.e., leave the property interest to an heir.

The other two forms of co-ownership are ways in which property is owned under the institution of marriage. The form known as **tenancy by the entirety** is a joint estate between married people. It is thereby a freehold estate not-of-inheritance; it is an estate in which the marriage partners do not have individual rights of disposition. They can only dispose of the property jointly. Neither the husband nor the wife can dispose of the property or any part of it without the consent of the other person.

The other marriage-oriented form of co-ownership is **community property** that is a property jointly acquired and owned by a husband and wife. Each individual may own property separately, but this property is typically property acquired before the marriage.

Nonpossessory Rights. The freehold estates and the leaseholds discussed in the preceding sections are all estates of possession. The only exceptions are the remainder and the reversion interests, which are estates in expectancy, and even these estates in expectancy are estates of future possession. In contrast to such estates of ownership, which include the rights of use, possession, exclusion, and disposition, certain nonpossessory rights of use and exclusion can be held by one person in real estate owned by another person. The two types of nonpossessory rights in real estate are **easements** and **liens**, which are discussed in a later chapter.

What is Bundle-of-Rights Theory?

In the discussion of the components of real estate, several rights are identified. Some rights are related to the physical commodity (e.g., surface rights, mineral rights, and air rights). Other rights are the intangible rights of ownership such as the several ownership interests based on the right of disposition (e.g., freehold estates of inheritance, freehold estates not-of-inheritance, and leasehold estates). These various rights can be held as either possession or expectancy. If the right of disposition is defined, the separate estates in possession can be disposed of by several methods such as a sale, gift, or lease.

The usually accepted analogy is that these various rights in real estate are like a bundle of sticks, each stick representing an identifiable right. Each stick can be disposed of as a separate entity. If an individual holds a freehold estate of inheritance, that individual owns the whole bundle of rights. The owner can dispose of these rights in a variety of ways. The use of the surface and the mineral rights can be leased to one person and the air rights can be leased to someone else. At the same time, an easement or several easements can be created and sold to third parties. Then, even while these leasehold and easements are in force, the entire estate could be sold in expectancy with a delivery date ten, fifteen, or twenty years in the future.

WHAT ARE THE CHARACTERISTICS OF REAL ESTATE?

The characteristics of the real estate commodity are of two types: physical and economic. The physical characteristics are related to the land itself and to the on-site improvements. The economic characteristics are different in certain respects from those of other commodities.

What are the Physical Characteristics?

The physical characteristics of land are its **immobility**, **indestructibility**, and **nonhomogeneity**. Once the size and shape of a parcel of land are established, the legal nature of the land is also established for mineral and air rights. Knowledge of the legal concept of land is important for analyzing its physical characteristics. The land is considered legally fixed at its current location. The property owner can spend years moving the earth on the surface, as in the case of a strip mine, but such activity does not move the rights to the minerals in the deeper strata or move the rights to the air above the newly created surface. This point can be reemphasized by saying that the location of the mineral rights and the air rights cannot be moved even if the surface is moved.

The land is **indestructible** in the sense that movement of the surface does not destroy the full package of rights. Moreover, other deliberate human acts, as well as the acts of nature, are not capable of destroying the land in its legal sense. Fire can char the land. Wind and rain can erode the surface. Earthquakes can rearrange the sub-surface strata and cause the surface to rise or fall. Nuclear bombs can dissipate part of the surface. However, in none of these instances is the land destroyed in the legal sense. The land cannot be destroyed because its location cannot be destroyed.

The land is **nonhomogeneous**. Each parcel of land can be distinguished from all other parcels of land on the basis of several physical characteristics.

The size and shape can differ. The geological features of elevation, slope, drainage capacity, mineral composition, soil fertility, and bedrock characteristics can be different. However, even if all of these characteristics are perfectly identical, each parcel of land is unique because of its location. No two parcels of land occupy the same space on the earth's surface. The physical feature of the location is a very important issue because it is a dominant physical attribute of any property.

What are the Economic Characteristics?

The economic features or characteristics of the real estate commodity are somewhat different from those of other commodities. Real estate is the only commodity that the typical consumer buys that is measured in multiples of that individual's or household's income. The home is usually valued at two or three times the household's yearly income, whereas all other commodities -- even the automobile -- are measured in fractions of the household's yearly income. Because of this first economic characteristic of real estate, its **high price**, the purchase of real estate is generally undertaken with **borrowed funds**. This second characteristic of real estate is shared with many other commodities that the consumer buys.

The third economic characteristic of real estate arises from its physical characteristics of immobility, nonhomogeneity, and location. The **search costs**, or **information-gathering costs**, associated with comparison shopping are greater for real estate than for any other product. Each parcel is unique in its location and cannot be moved. Consequently, unless the properties are adjacent, a side-by-side comparison is not possible. The purchaser must expend money and time to examine the many different units that are being considered for possible purchase or rental.

The fourth economic characteristic of real estate is **scarcity**. Real estate in both its components of land and improvements is not available in sufficient quantities to meet the desires that all individuals have for them. At any point in time, the total amount of land available is limited. For example, if a local geographic area is defined, within that area there is only a limited amount of available land. Moreover, within that same geographic area, there are a limited number of structures.

A fifth economic characteristic is the concept of **situs**, which represents the economic location of a parcel of real estate. Each parcel is immobile -- a physical characteristic. Therefore, each parcel is affected by changes in economic and demographic factors in the surrounding area.

A sixth economic characteristic is an influence that the quantity and the quality of **surrounding structures** and other off-site improvements-to-the-land have on the property in question. As the quantity of desirable improvements increases, or, as their physical quality improves, there is a favorable impact on the value of the subject property. The reverse situation can and does happen if the physical surroundings deteriorate. Many refer to this sixth economic characteristic as “modification” on value caused by adjacent parcels of property.

Finally, the concept of **fixity** is often introduced as an economic characteristic. As land is improved by the addition of on-site improvements (buildings, driveways, water lines, etc.) the investment is fixed. It cannot be moved or easily altered, and it has a long physical and economic life.

WHAT IS THE REAL ESTATE BUSINESS?

The purpose of this section is to explore the nature of the **real estate business**. The participants are identified, their relationships to each other are explained, and the services that each offers to a potential buyer, seller, and the public, in general, are described. This information is important to the potential consumer (buyer or seller) for the following reasons:

It can eliminate any misconceptions about the real estate business

It can assist either the buyer or seller in deciding whether to handle certain steps of a transaction by using personal knowledge or training or to seek assistance from a real estate specialist

It identifies the specialists from whom the consumer can solicit assistance

It helps to illustrate that a real estate transaction can be a very detailed process and could require the services of several individuals within the real estate business to ensure that the needs of all parties are satisfied and protected

The real estate business encompasses all individuals and organizations who receive compensation for providing a service. It includes the carpenter who frames a new structure as well as a life insurance company that loans several million dollars for the construction of a new shopping center. It encompasses the real estate agent, the financial lender, the attorney, the title company, the appraiser, the counselor, the insurance agent, the developer, the contractor, and the property manager. Each plays a special role by

providing a service to and satisfying a need of, the buyer, seller, or the public in a real estate transaction.

What is the Real Estate Agent?

A **real estate agent** is licensed by the state to enter into a contractual relationship with a client to assist in a real estate transaction with the expectation of receiving compensation. State law will define the type of real estate transactions involved such as finding a buyer for a seller, locating a tenant for an owner of rental property, or locating a specific property for a buyer. Compensation may be paid as a negotiated fee or a commission which is a percent of the transaction price.

The “**agent**” is typically the “**agency**,” and refers to the firm which is operated by a broker who possesses a **broker’s license** given by the state. **Sales agents** are licensed by the state, also, and work for the agency. The broker is responsible for the actions of all sales agents employed by the firm. This means that the business is self-regulating as the broker can be held responsible for the actions of all employed agents.

Typically, the agent must satisfy a series of prerequisites before receiving a license. Although these differ among states, they typically include requirements for education and/or experience, recommendations from property owners, references covering high morals and good character, and a passing score on an examination.

Real Estate Commission. In every state a **Real Estate Commission** or, in some cases, a Real Estate Commissioner is charged with the responsibility of enforcing the state license law. The commission issues licenses to real estate agents, schedules hearings on complaints, issues penalties such as suspensions and revocations against the license, and passes rules and regulations governing the operation of the real estate business.

All license laws contain a description of the activities that characterize a broker and a salesperson. Typically, there are two essential distinctions of a broker. A broker may (1) name the firm after himself or herself and advertise the firm in his or her name, and (2) employ salespeople as independent contractors or employees. The salesperson may not.

National, State, and Local Boards. The **National Association of REALTORS (NAR)** acts as a parent trade organization for the **State Association of REALTORS** and **local boards**. The purpose of these organizations is to promote the business, offer education, express the

members' views politically, and support a code of ethics. Any agent has the option of joining all three groups.

Several institutes affiliated with the NAR award several designations to members to indicate completion of a prescribed course of education and the presentation of satisfactory experience in specialized areas. For example, a member may become a Certified Residential Broker (CRB) to indicate a specialty in the brokerage of residential properties. A member may pursue a "CCIM" designation to indicate a specialty in commercial and industrial property brokerage and management. Other specialties are available through affiliate programs such as in appraising (Member of the Appraisal Institute) and in property management (Certified Property Manager) known respectively as MAI and CPM.

Typically, a client would have good reason to expect a high level of professionalism and performance from an agent who is a REALTOR and holds a designation in the appropriate specialty. For example, a person buying or selling a home would expect a high level of competence from an agent who is a REALTOR and a CRB.

What is a Real Estate Lender?

Real estate lenders provide **equity** and **debt** funds to investors and borrowers who do not have sufficient cash to pay the full purchase price of a property. These lenders serve a valuable function in the economy by competing with other markets for the investment dollar so that it can be used in real estate. Thus, they serve as a valuable conduit of money into the real estate market and provide loans to potential buyers who otherwise would be unable to purchase real estate.

Equity and Debt Funds. Typically, lenders loan either equity funds or debt funds for the purchase of real estate. **Equity funds** come from the assets of the potential buyer. If the buyer provides this money from his or her resources, it is expressed on that person's balance sheet as an asset. **Debt funds** are supplied from the assets of other people and are added to the equity funds to equal the purchase price of the property. This additional amount is usually in the form of a mortgage, which enters the buyer's balance sheet as a liability because it is a debt that he or she owes with interest. A buyer usually cannot borrow 100 percent of a property's purchase price. If the buyer does not have enough cash for the down payment (the difference between the purchase price and the mortgage amount), he or she can sometimes borrow the needed funds.

What is the Appraiser?

The job of the appraiser is to provide an independent estimate of the value of a property. The appraiser inspects the premises, gathers data on the local market and trends, and applies a professional approach to determining the property value.

The appraiser must be licensed by the state for the protection of the public. In addition, the appraiser may be designated by one of the professional appraisal organizations. For example, the appraiser may be a Residential Member (RM) or a Member of the Appraisal Institute (MAI), which means that he or she has successfully completed a course of instruction and satisfied an experience requirement prescribed by the Appraisal Institute.

What is the Title Company?

The **title company** prepares an abstract (chain of title) containing the complete history of a parcel of real estate. This history includes all title transfers and all encumbrances against the property, including mortgage releases and outstanding liens. The title company compiles this history by searching the public records to locate all recorded documents that pertain to the subject property.

The abstract is very valuable to the buyer in that it gives the buyer and his or her attorney the facts from which to determine whether the seller owns all of the property rights. Also, it informs the buyer of any outstanding encumbrances and shows whether any other parties have interests in the property. Therefore, the title company, by preparing the abstract, is allowing the buyer to determine whether a valid title can be acquired from the seller. The abstract is usually sent to the buyer's attorney for an opinion on the seller's ownership rights. It thus protects the buyer.

What is the Real Estate Attorney?

A **real estate attorney** can provide several services to the client. The attorney can write a contract of sale, give opinions about the validity of the present owner's rights of ownership and any outstanding encumbrances, and prepare the deed and any other necessary legal documents. Further, an attorney can perform numerous other services that consist of legal advice or service related to problems with the subject property.

What is a Property Manager?

A **property manager** is a specialist in the management of real estate. Typically, the property is income-producing, and the manager is needed to collect rents, negotiate leases, supervise maintenance, reduce expenses, and advise the investors. Property managers generally are not required to be licensed by the state, although resident managers living on the premises may be required to hold a real estate agent's license.

A property manager may be designated or nondesignated. He or she may be an Accredited Residential Manager (ARM) or a Certified Property Manager (CPM). To obtain either of these designations the candidate must complete a course of study and satisfy an experience requirement administered by the Institute of Real Estate Management

The property manager collects the rent, rents the vacant units, pays the mortgage payment for the investor, supervises the maintenance, and solves any problems about the property. A property manager provides the client with an income and expense statement periodically. The obvious advantage to an owner is that the property is managed by a professional. Also, the owner is not bothered by the problems of the tenants.

For additional information on real estate management, the Building Owners and Managers Association URL can be found at the website for this text at www.boma.org.

What is the Insurance Company?

Any improvements on the property that have value should be covered by insurance against loss from common hazards. If the improvements have been mortgaged, the lender will require an insurance policy protecting their interests. The insurance is purchased from a property and casualty insurance company through an agent who has been licensed by the State Insurance Department.

The service provided by an insurance company is giving protection to the lender and the buyer in the event of a financial loss to the property from a hazard. A typical homeowner's policy covers a home, home fixtures, and garages on the premises, as well as furniture, clothing, appliances, and most other personal property. The policy specifically identifies the hazards against which the property is insured; for example, fire, lightning, explosion, smoke, vandalism, riot damage, hail, windstorm, vehicle damage, and glass breakage. The policy also lists certain hazards to which the insurance does

not apply; for example, acts of war, rebellion, and revolution. No payment is made for damage caused by unlisted hazards.

Additional coverage can include protection against claims by other people for accidental injury or damage to their property on or off the insured's premises, protection against theft hazards not otherwise specified in the policy, and protection (in most states) for second homes such as seasonal dwellings located in or out of the insured's home state. Earthquake coverage can be provided as additional coverage, and flood insurance may be available through the National Flood Insurance Association.

Using insurance, the risk of any financial loss is transferred from the lender and the homeowner to the insurance company. The lender and the owner can be assured that they will not face the possibility of bankruptcy if damage occurs to a property that is covered by insurance.

What is the Real Estate Developer?

A **real estate developer** is any person or firm that transforms the property from one stage of use to another. Developers typically start with raw acreage. They have the property subdivided and plotted by an engineer. They solicit and receive the necessary permits from the city, county, state, and federal agencies to erect a structure on the site. The developer may be a real estate agent who is involved in marketing the properties. Thus, the property is transformed from raw acreage to a site ready for construction, to a potentially inhabitable structure, to an inhabited structure.

Anyone can develop a property that can bear the financial burden and knows. There are no licensing requirements unless the developer acts as a broker by employing other people to sell the property for a commission and thus becomes subject to the real estate license law.

What is the Escrow Agent?

An **escrow agent** is a neutral, independent third party who agrees to execute the escrow agreement. The agreement typically allows the deed to be given to the buyer and the funds to be paid to the seller once certain predetermined conditions of the sale are satisfied. The essential purpose of using the escrow agent is to assure that the terms negotiated within the contract of sale are satisfied.

The escrow agent provides a convenient method of assuring that the terms of the escrow agreement are fulfilled. Essentially, this means that the terms

negotiated within the contract of sale are satisfied. This can include providing an abstract and opinion of title, title insurance, warranty deed, paid utility receipts, evidence of liens that have been paid, completion of construction, predetermined repairs, recording of the deed, and so on. The agent serves as a depository that has the authority to transfer, dispose, and execute according to the predetermined escrow agreement.

What are the Unique Features of the Real Estate Transaction?

A typical real estate transaction involves several parties working together to ensure that the purchase (or sale) progresses smoothly and everyone's interests are protected. Thus, the transaction is not similar to that carried out by a consumer in purchasing a suit of clothes or a new automobile. In the latter cases, the consumer enters a retail outlet that carries the product, examines the item, and, if it meets his or her needs, pays for it and takes it home. In a real estate transaction, the buyer must find a seller who possesses the product that he or she desires or vice versa. A tremendous search cost may be incurred before the two parties find each other. An agent's services can be used to lower this search cost and to enable one or both parties to save time. Once the buyer finds a seller with an acceptable property, a considerable amount of negotiation may transpire before an acceptable selling price is reached. An agent can be asked to help with the negotiations or an attorney can be employed to review and/or write the contracts. Next, appropriate financing needs to be arranged and at this point the local lending institutions become involved. The lender may insist that an appraiser is hired to estimate the market value of the property and in addition, may require an abstract with an attorney's opinion or title insurance. A survey may be needed, and an attorney may be called upon to solve any legal problems. The agent can handle the closing or it can be conducted by the title company or the financial institution.

Thus, a typical real estate transaction involves several specialists who are asked by the buyer or seller to give their service or who are involved because one of the participants requires their service. It is different from a routine retail transaction because it requires a prolonged search, complex negotiations, the services of numerous specialists, and hence more time to complete successfully.

WHAT OTHER BUSINESSES SERVICE REAL ESTATE?

Numerous other individuals and firms support the real estate business, especially in the construction sector. For example, when a structure is built,