

# WRONG

## Property Rights? Part 1

The importance of identifying the rights to be appraised

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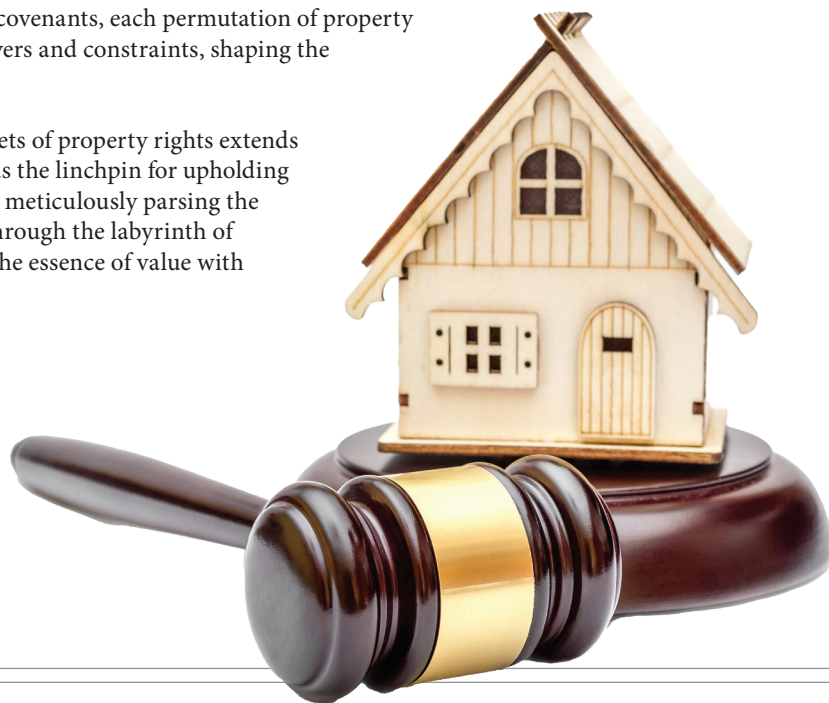
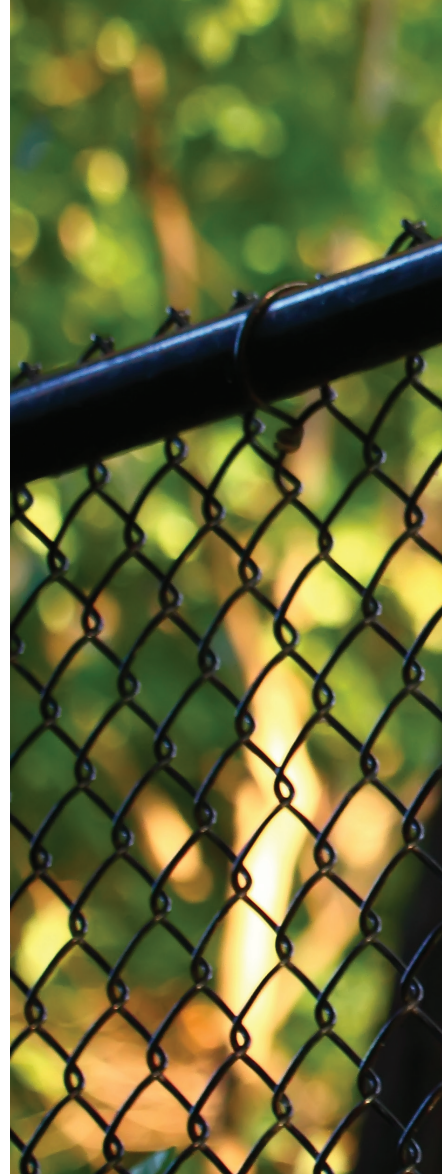
In the world of real estate appraisal, where critical decisions are made, one fundamental principle stands paramount — the understanding of property rights. Thus, the valuation of property may be considered the foundation for all real estate activity. As guardians of value, real estate appraisers wield a unique lens through which we scrutinize and decipher the intricate tapestry of property rights, recognizing them as the cornerstone upon which the edifice of real estate value is erected.

Property rights, often misconstrued as mere legal constructs, hold profound significance in shaping the dynamics of the real estate market. They delineate the bundle of entitlements conferred upon property owners, encompassing the rights to possess, use, hypothecate, transfer and exclude others from the property. Yet, beyond their legal delineation, property rights symbolize the essence of ownership and embody the nexus between individuals and the tangible manifestations of the benefits stemming from an owner's rights in property.

In the context of appraisal, comprehending the nuances of property rights is akin to deciphering a cryptic code that unlocks the latent value embedded within real estate assets. Whether it be fee simple, leased fee, leasehold, easements or restrictive covenants, each permutation of property rights engenders a distinct configuration of value drivers and constraints, shaping the asset's marketability, utility and investment potential.

Moreover, the appraisal profession's fidelity to the tenets of property rights extends beyond mere academic exercise. In essence, it serves as the linchpin for upholding the integrity and reliability of valuation outcomes. By meticulously parsing the complexities of property rights, appraisers navigate through the labyrinth of market intricacies, wielding their expertise to distill the essence of value with precision and impartiality.

Appropriately understanding and analyzing property rights is so fundamental to our profession that a significant revision was made to a segment of our Body of Knowledge (BOK), which underscores the critical importance of comprehending and analyzing property rights within our profession. The most recent edition of "The Appraisal of Real Estate, 15th Edition" (TARE) directed significant attention toward the meticulous description of property





rights as integral to ensuring the credibility of valuations, which ties directly into our professional standard requirements of identifying the subject and its relevant characteristics.

Indeed, the ramifications of neglecting property rights reverberate far beyond the confines of appraisal reports. In a world where real estate transactions serve as the bedrock of economic activity, misapprehensions or oversights regarding property rights can catalyze a cascade of adverse consequences, ranging from contentious legal disputes to suboptimal investment decisions.

Hence, as stewards of value, real estate appraisers are duty-bound to embrace the imperative of understanding property rights with unwavering diligence and acumen. By doing so, appraisers not only safeguard the integrity of the profession but also fulfill their mandate to illuminate the path towards informed decision-making in the dynamic landscape of real estate.

In this two-part article, we will embark upon a journey to unravel the complex tapestry of property rights, delving into their intricacies, implications, and imperatives within the realm of real estate appraisal. As we navigate through this terrain, let us remain steadfast in our commitment to uphold the sanctity of public trust and the appropriate identification of property rights, for therein lies the essence of our profession's *raison d'être*.

### **Appraisers Value Property Rights, Not Property**

Precisely what does a real estate appraiser value? In simplest terms, real property rights are valued, not the real estate itself. In real estate appraisal, an important distinction is made between the term's *real estate* and *real property*. Although some laws and court decisions treat the terms synonymously for legal purposes, in appraisal practice the terms *real estate* and *real property* are distinct concepts.



*Real estate* is the physical land and appurtenances affixed to the land (e.g., structures, minerals, timber, site improvements), while *real property* is comprised of the interests, benefits, and rights inherent in the ownership of physical real estate. While many market participants, including brokers, attorneys, courts and others, routinely use the term “real estate” as an overly broad characterization of what appraisers value or synonymously with the term “real property,” it is important to maintain the distinction between the concepts as it directly impacts how one understands an appraiser’s valuation.

While these tangible, immobile and physical components are ostensibly what give rise to value, as the “estate” reflects what is owned, it is actually how the “interests” generate a benefit to the estate that value is created. For instance, a property might have mineral deposits, but no viable means can be employed to extract these deposits. While the minerals physically exist, the inability to make use of them beyond the possibility of creating an attractive landscape, or view amenity, substantially impacts their contribution to value relative to a viable mining operation. Thus, it becomes clear that the benefit generated to the ownership is what influences and generates value, not the physical components of the property.

The terms *estate* and *interest* may be used differently depending on the jurisdiction or the discipline (see the “Dictionary of Real Estate Appraisal, 7th Edition,” pages 65 and 98). However, in valuation practice, *interest* is another term for property rights, while *estate* references the magnitude, or extent of the interests held in a property.

While these terms continue to be used interchangeably, there is an opportunity to foster greater conceptual consistency by better defining terminology in the future. Perhaps a more refined definition of “real estate” would better relate it to the concept of “estate” as defined in the “Dictionary of Real Estate Appraisal, 7th Edition,” rather than the physical property. However, such a change may not be possible given the usage of the terms in other professions or for historical reasons.

Therefore, at present, appraisers must resign themselves to being vigilant and consistent in their use of terminology to avoid confusion.

Given the above difficulties with understanding existing terminology, being able to categorize interests is helpful when identifying what

is to be appraised, with developing an appropriate scope of work, and in communicating with clients about their valuation needs. Property interests can be sorted into four broad categories: economic, legal, physical and financial. Let us briefly discuss each category before turning to more involved matters.

## Categories of Property Interests

**Economic property interests** refer to those interests created by a lease agreement. Examples include leasehold interests, leased fee interests and subleasehold/sandwich lease interests. This category of property rights is generally associated with a property owner transferring the right to use and occupy a property to another in exchange for a specified rent, thus granting this property right to a third party for a specified period of time. When approaching this category of property rights, it is therefore essential to comprehensively review the applicable lease agreements to ascertain the degree to which who controls use, for what duration, and under what terms.

**Legal property interests** are those created by agreements that place restrictions on use. Interests falling into this category can rapidly become nuanced and complex as agreements can take many forms and include just about any conditions imaginable. As an example, properties encumbered by declarations, special assessments, deed restrictions, covenants or easements (utility, conservation, subsurface, etc.), limit the potential uses to which a property can be put, as defined within the corresponding deed language, document or agreement.

In some instances, this results in a change of highest and best use while in other instances there is limited immediate impact given the prevailing economic climate, patterns of development and location of restriction within a property. Another example includes affordable housing restrictions, wherein units can only be leased to qualifying households that fall within the specified household income levels. This type of restriction on use can significantly alter the income generation of a property and can impact financial feasibility of proposed development (and thus highest and best use).

The third category, or **physical property interests**, pertains to those interests dealing with physical aspects of the real property. Examples include water rights, air rights, mineral rights, timber, etc. These rights can be vertical or horizontal in nature and often times are severed from the primary ownership of the real property. Examples includes mineral rights retained by the seller, or water rights transferred to a distant property not contiguous to the natural water flow (where legally permitted).

Finally, **financial property interests** deal with equity and mortgage interests. While a mortgage interest requires the collateralization of the real property, the equity interest exists without this process occurring. These rights become important especially in instances where mortgage-backed securities are involved or when dealing with fractional/minority interests.



**LEASE AGREEMENT**



As intimated earlier, part of the appraiser's task is to identify not only the estate but also the limitations on the interests associated with the estate. Part of identifying a property's relevant characteristics involves identifying the source and definition of market value. Available through numerous laws and regulations, textbooks, codes, professional standards, and many other resources, there are an assortment of differing market value definitions. The definition from the "Dictionary of Real Estate Appraisal, 7th Edition" provided below embodies the concepts that are most commonly accepted and represents the concept of value in exchange:

### Market Value

*The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the **specified property rights** should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.*

As noted above, USPAP requires that an appraiser cite and source their definition of market value and as a result, many appraisers use the exact definition above or a precise definition available through one of the many resources previously noted. However, some will also augment these definitions to include language that will enable the intended user(s) to appropriately understand how the appraiser's opinions and conclusions were developed.

The same logic is used in another component of identifying a property's relevant characteristics — property rights. As previously noted, a real property appraiser is not only responsible for valuing and identifying a property's estate (fee simple, leased fee, leasehold, etc.) but also the impacts of any associated interests such as the previously described known easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, private or public restrictions, etc., as dictated by professional standards.

Furthermore, as indicated in "The Appraisal of Real Estate, 15th Edition," "[I]n valuation practice, it is not necessary to label estates and interests in a prescriptive manner as long as all relevant property rights are identified in a manner that the intended users can understand." In identifying the property rights to be valued, there is no requirement for an appraiser to use a specific definition; however, if a specific definition is helpful for the intended user(s) to properly understand the developed opinions and conclusion, then a definition of the rights or interests should be included, but as demonstrated in the "market value" example above, the appraisers can and should augment the definition, as to be clear and not misleading.

As a result, these attributes, along with the defined value and intended use of the appraisal, which form the context for which credibility is determined, guide the selection of data and analyses required for the scope of work. Therefore, the foundational

steps to proper identification or problem solving that are sequenced in Step 1 of the valuation process necessitate that the appraiser start their decision-making process early in the development of an assignment and specifically, for property rights and things that impact property rights (i.e., intangibles, easements, encumbrances, restrictions, etc.), as required in Standards Rule 1-2(e). Thus, placing the burden of proof for conclusions about which property characteristics (physical, economic and legal attributes that affect the property's value), on the appraiser.

### Closing Thoughts

As has hopefully become illuminated in the above discussion, the identification of property rights is foundational to the role of appraisers and valuation practitioners. This is tied not only to mandates from standards of practice but also to clarity and consistent use of terminology in limiting confusion. Part two of this article (to be printed in the subsequent edition of this publication) will build on this foundation to discuss some practical situations wherein the importance of identifying property rights can significantly impact a valuation analysis. This will include a brief discussion of the difference between partial and fractional interests, why condominiums represent an ownership type rather than a property right, and a discussion of fee simple versus leased fee valuation scenarios. ✪

<sup>1</sup>The Dictionary of Real Estate Appraisal, 7th Edition, page 154 (real estate) and page 155 (real property)

<sup>2</sup>The Appraisal of Real Estate, 15th Edition; pages 59-74



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