# Fee Simple and Partial Interests


According to the bundle of rights theory, complete real property ownership, or title in fee, consists of a group of distinct rights. Each of these rights can be separated from the bundle and conveyed by the fee owner to other parties in perpetuity or for a limited time period. When a right is separated from the bundle and transferred or mortgaged, a partial, or fractional, property interest is created.

Property interests may be examined from many perspectives because the ownership, legal, economic, and financial aspects of real estate overlap.

From an ownership perspective, property interests can be divided in various ways. For example, several parties may have undivided partial ownership rights in a specific property through joint tenancies, tenancies in common, or tenancies by the entirety. A land trust is a vehicle for partial property interests in which a group of property owners continues to operate and manage a property, but the legal title is conveyed to a trustee. Other legal arrangements and title-holding entities that divide property rights among groups of owners include corporations, partnerships, cooperative corporations, condominiums, and interval ownerships or timeshares. In these arrangements, property rights or interests are divided among several parties, and an appropriate legal entity is chosen to hold the property title.

The leasing of real estate is one practical and familiar application of the bundle of rights theory. An owner of a complete bundle of rights (the lessor) may convey to a tenant (the lessee) rights to use and occupy a property for a fixed period of time. In return, the tenant agrees to pay periodic rent.

In valuing the economic and legal interests created by leases, appraisers must consider two basic factors: the relationship between contract rent and market rent and the credit rating of the tenant. Both of these factors strongly influence the selection of discount rates and have a lesser effect on the forecast of future benefits.

The financial aspects of property interests have a major impact on real estate investment practices. The analysis of mortgage and equity components is of particular importance. Mortgage funds are secured debt positions, while equity is venture capital. Mortgage and equity components may be subdivided into fee simple, leased fee, and leasehold interests. They may also be broken down according to the proportions of land and building in the overall property. Other possible financial arrangements include senior and subordinated debt, sale-leaseback finance, and equity syndications.

The ownership, legal, economic, and financial perspectives from which lease interests and other fractional property interests can be described illustrate the complexity and usefulness of the bundle of rights. A thorough understanding of the property rights to be valued in an appraisal assignment is needed not only to define the problem but also to produce an appropriate solution.

## Leases

### Lease Terms

A lease is both a contract and a conveyance. It is a conveyance by which the landlord gives the tenant the right to occupy the property for the terms specified in the lease. It imposes a contractual obligation on the tenant to pay rent to the landlord, and it may contain other promises and agreements between the landlord and the tenant. The legal interest of the tenant, the leasehold estate, is considered personal property.[1]

[1] *Robert Kratovil and Raymond J. Werner,* Real Estate Law, *8th ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983), p. 579.*

Leases that cover a period of 1 year or more must be in writing. In some states, leases for shorter periods may be verbal. A lease should describe the rented property with certainty, specifying the geographic location, street address, and condition of the premises. The signatures of the lessor and the lessee effectively establish the legal power of a lease. The tenant's possession generally provides notice that the rights of the leasehold estate are being exercised. Long-term leases are usually recorded documents.

Most leases contain clauses pertaining to the duration of tenancy, rent, security deposits, insurance, payment of public utilities, right of entry, assignment and subleasing arrangements, maintenance and repair arrangements, fixtures, taxes, eminent domain, default, and renewal options. Other contractual clauses may address purchase options, rent escalations, alterations, and use restrictions.

Lease clauses can influence property value. Therefore, it is imperative that appraisers read and understand all leases that affect the property interests being appraised. In some instances it may be advisable or necessary for an appraiser to consult an attorney for assistance in interpreting lease provisions.

By leasing real estate, a lessor receives some advantages, including the receipt of a certain income or annuity, favorable income tax considerations, and the benefit of tenant-built improvements. These can, and frequently do, enhance property value and provide the owner with a hedge against inflation. The potential advantages for a lessee include a minimum equity investment in property, an alternative to costly financing, favorable tax considerations, and reduced management responsibility.

### Tenancy

When the bundle of rights is divided into property interests, tenancy is created. In real estate *tenancy* has two meanings: *(1) the holding of property by any form of title, and (2) the right to use and occupy property as conveyed in a lease.* The first definition usually refers to co-ownership of real estate; the second definition concerns the nature of the relationship between a landlord and a tenant.

Co-ownership may be described as joint tenancy, tenancy by the entirety, or tenancy in common. *Joint tenancy is joint ownership by two or more persons with right of survivorship.* Under this arrangement,