

# Property Rights Symposium Discussion Paper

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December 21, 2017

## 1 Introduction

2 The Appraisal Institute held a Property Rights Symposium at its headquarters office in September 2017.  
3 The event was attended by approximately fifty valuers, attorneys, and other interested parties with prior  
4 involvement relating to the specific questions posed, along with Appraisal Institute officers, committee  
5 chairs, and staff. It was facilitated by Dr. Lowell “Duke” Kuehn, a professional facilitator and strategic  
6 planner.  
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8 The purpose of the symposium was to consider differences of opinion relating to the valuation of fee  
9 simple estates. This Discussion Paper summarizes the issues discussed at the symposium, describes  
10 the proceedings at the symposium, sets forth ideas emanating from symposium attendees, explores  
11 some possible implications of these ideas and identifies a number of questions for individuals reading the  
12 Discussion Paper.  
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14 The purpose of the Discussion Paper is to stimulate broader discussion, thought and feedback. The  
15 ideas, views and opinions expressed in the Discussion Paper are not endorsed or approved by the  
16 Appraisal Institute. The Appraisal Institute has not taken a position on the matters discussed, made any  
17 revisions to *The Dictionary of Real Estate Appraisal*, 6<sup>th</sup> edition or *The Appraisal of Real Estate*, 14<sup>th</sup>  
18 edition, or even made a proposal to do so. Numerous steps would need to occur to get to that point. The  
19 Appraisal Institute hopes that the Discussion Paper results in constructive dialogue around important  
20 issues to help advance the appraisal profession and public trust.  
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22 To these ends, the Appraisal Institute Board of Directors directed exposure of the Discussion Paper to  
23 Appraisal Institute Professionals and other appropriate parties. The Board of Directors and the Body of  
24 Knowledge Committee will review the feedback and consider what, if any additional steps, to recommend  
25 or take.  
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27 If you have any comments on the Discussion Paper, please send your comments via e-mail to  
28 [comments@appraisalinstitute.org](mailto:comments@appraisalinstitute.org) within sixty (60) days of the date of this Discussion Paper. Comments  
29 sent to this e-mail address will be compiled for distribution to the Body of Knowledge Committee and  
30 Appraisal Institute Board of Directors.  
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## 32 The Issue

33 Long-standing valuation theory has held that the interests or rights in real estate are valued rather than  
34 the physical land and buildings themselves. Valuation standards require that the interests or rights be  
35 identified and reported in the valuation report. Valuers have traditionally accomplished this task using  
36 terms such as *fee simple*, *leased fee*, or *leasehold*. When a property is leased and the value of a lease  
37 interest is sought, the valuation process will reflect the lease and account for any loss or benefit due to  
38 the rent being above or below market or loss due to the time and cost to lease vacant space. But when  
39 the assignment is to value the fee simple estate in property that is typically leased and sold as leased, the  
40 question arises as to whether it should be valued as though occupied or as though vacant.

41 This question is critical in eminent domain and property taxation where law or regulation generally  
42 requires the valuation of the fee simple estate, even if a lease exists. It is also an important question in  
43 mortgage lending when lease income is needed to repay the loan but there is risk of unexpected vacancy.  
44 In recent years, there have been numerous property tax appeal cases where the appropriate  
45 methodology for valuing the fee simple estate has been at issue; several states have adopted or  
46 proposed legislation that dictates methodology for assessment purposes. One property type involved is

big-box retail—buildings designed for a single user, either (a) subject to sale-leaseback or bondable lease arrangements or (b) owner-occupied. Other property types have been involved also.

Related questions include the following:

- Does *fee simple* mean vacant and available for lease or occupancy? If so, should deductions be taken for lease-up time and cost? Does *fee simple* imply a “go dark” scenario?
- The definition of *market value* presumes a sale. *The Appraisal of Real Estate*, 14th edition, states that the best comparables will have the same highest and best use as the subject property. What are the considerations for market analysis and highest and best use analysis? To what level must the appraiser investigate effective demand, physical adaptability of the real estate, the typical buyer, and timing of use?
- What are the considerations for the selection of comparable sales and the derivation of capitalization rates? Are sales of fee simple estates involving vacant properties the best comparable sales? Is it appropriate to derive capitalization rates from sale-leasebacks?

In late 2016, the issue and related questions were brought to the attention of the Appraisal Institute’s Body of Knowledge Committee, which proposed a symposium to the Board of Directors to help explore the issue and advance the profession towards generally agreed-upon theory and practice relating to the matter.

## Proceedings and Issues Addressed

After President and acting CEO Jim Amorin, MAI, SRA, AI-GRS, gave opening remarks, Dr. Kuehn introduced the process to be followed for the two-day session. Three brief presentations were then delivered on why the issue is critical to the valuation profession. For the remainder of the first day, four panels, each with three to four valuers working in different areas of practice, presented concerns and questions about how the issue affects condemnation, property taxation, and lending. After each of these panels’ presentations, symposium participants were divided into four work groups, and each of these groups convened to brainstorm ideas and identify possible resolutions. After each discussion, the entire group of symposium participants reconvened as a whole to share their findings.

The four work groups raised and deliberated over many issues, including the following:

### Theory issues:

Value definitions: Do the definitions of *market value* and *value in use* need to be revisited? Do the definitions contribute to the issue?

Possible deficiencies in market analysis and highest and best use analysis: Do these types of deficiencies exist and if so, can they lead to value opinions that are not credible?

Data verification: Are valuers obtaining adequate information about what interests are included in a sale transaction?

### Ethics issues:

Are there instances where valuers take positions that are not reasonably supported but that advocate the cause of their clients? If so, how pervasive is this problem?

Has the profession lost the confidence of some whom it serves (public trust) because of a perception that valuers can provide differing values on the fee simple estate in the same property, and, if so, what can be done about it?

Are valuers making assumptions relating to occupancy and vacancy that aren't appropriate for the intended use or aren't properly disclosed in the valuation report? If so, what can be done to resolve these problems?

Client relations issues:

Many clients may not understand what estates/interests are and which needs to be valued when. This can make it difficult for the valuer to frame the assignment properly. What can be done to ameliorate this?

Valuers need to learn to help clients "get the question right." What kind of assistance can be provided to valuers to help them achieve this?

Other issues:

There is a need for the valuation profession to take the lead in establishing valuation theory and practice, rather than the courts, regulators, or others. How can we ensure this happens?

There is a need to expand on valuation education, especially if a change is made to established definitions or theory. How can we ensure this happens?

The valuation profession's terminology relating to "fee simple" may be out of sync with others in the real estate world. Is this a real concern, and, if so, how do we resolve it?

By the second day of the symposium, there was a common thread running through all the discussions related to the definition of *fee simple estate*. Many participants thought that the definition currently used by the valuation profession should be re-examined and probably revised.

Twelve individuals were nominated to a work group to draft a potential new definition of *fee simple estate*. While this Fee Simple Definition Work Group met, the remaining participants split into smaller groups to discuss methodology issues relating to the "fee simple" question.

## Proposal

After deliberating, the Fee Simple Definition Work Group presented a proposed new definition, as follows:

*Fee simple estate. The highest estate allowed by law. An inheritable ownership interest of indefinite duration.*

In addition, it was suggested that the valuation profession discontinue use of the terms *leased fee* and *leased fee estate*.

The group as a whole debated these proposals for the remainder of the second day in conjunction with the issues deliberated by the Methodology Work Groups. By the end of the symposium, there was general agreement that the proposed new definition should be exposed for comment in a Discussion Paper that provides an explanation of the rationale for the proposed change and its potential implications.

### **Rationale for Proposed New Definition of *Fee Simple Estate***

The definition of fee simple estate currently used by the valuation profession and published by the Appraisal Institute in *The Dictionary of Real Estate Appraisal*, 6th edition, is

Fee simple estate. Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.

Symposium participants identified the phrase “unencumbered by any other interest or estate” to be a source of potential confusion in the profession because some practitioners have interpreted that language to mean that the property is to be valued as though vacant and available to be leased or occupied while others have interpreted the phrase differently. Another potential source of confusion arises because the definition of *fee simple estate* may differ with how the term is defined in *Black’s Law Dictionary* and often used in other areas of real estate. For example, real estate agents typically list a property to be sold with a lease (or leases) in place as “fee simple,” not “leased fee.”

The term *fee simple* has its roots in feudal England, when title to all of the land in the kingdom ultimately resided in the king. At first, only the king had a permanent ownership interest in land. Over time, individuals secured the right to acquire and pass on title without limitation. The name of this estate, unrestricted in terms of duration, disposition, and inheritance, was “fee simple.” The terms *fee*, *fee simple*, and *fee simple absolute* had to do solely with whether the estate was perpetual and freely inheritable. They did not have anything to do with which “sticks in the bundle of rights” were being conveyed or whether there were other claims encumbering the estate.

Other estates—leasehold, life estate, fee tail—had finite durations and restrictions on disposition. The land reverted to the sovereign (lessor) at the end of the lease in the case of a leasehold, the end of the person’s life in the case of a life estate, or after all specified descendants passed on without issue in the case of a fee tail. Only the fee simple estate was, in essence, infinite in duration.

*Black’s Law Dictionary* defines *fee simple* as “An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs, esp. a fee simple absolute. Often shortened to fee.”<sup>1</sup> This definition contains two key concepts:

1. the concept that fee simple includes a possessory interest in the land (it is the “broadest” form of ownership)
2. the concept of inheritability (i.e., permanence)

Both of these concepts reflect the term’s feudal origins.

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<sup>1</sup> *Black’s Law Dictionary*, 10th ed. (Thomson Reuters, St. Paul, MN, 2014), 733-734.

In valuation literature, earlier versions of the definitions of *fee simple* and *fee simple estate* were more consistent with the definition in *Black's Law Dictionary*, and those earlier versions referenced inheritability. But over time the valuation profession began to define the terms with respect to the *types of interests* associated with the estate, not the character of the estate itself. *Real Estate Appraisal Terminology*, jointly published in 1981 by the American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers, included this definition:

*Fee simple. An absolute fee; a fee without limitations to any particular class of heirs or restrictions, but subject to the limitations of eminent domain, escheat, police power, and taxation. An inheritable estate.*<sup>2</sup>

The first edition of *The Dictionary of Real Estate Appraisal*, published by the American Institute of Real Estate Appraisers in 1984, included this definition:

*Fee simple estate. Absolute ownership unencumbered by any other interest or estate; subject only to the limitations of eminent domain, escheat, police power, and taxation.*<sup>3</sup>

The earlier *Real Estate Appraisal Terminology* focused on the issue of inheritability, whereas the definition in *The Dictionary of Real Estate Appraisal* introduced the phrase “unencumbered by any other interest or estate.” This phrase has remained in all subsequent editions of *The Dictionary of Real Estate Appraisal* published by the American Institute of Real Estate Appraisers and then by the Appraisal Institute. Yet considering the *Black's Law Dictionary* definition, the notion that the fee simple interest implies a lack of encumbrances apparently is not used in the legal profession.

Once the definition became focused on encumbrances (or absence of encumbrances) rather than on duration, some may have perceived potential ambiguity with regard to *what* was being valued—the property as though occupied, as though leased at market rents, or as though vacant and available to be leased or occupied. If the interpretation were the latter—that when valued in fee simple the property would be valued as though vacant, or “dark”—then a deduction would be required to reflect any loss in income over the lease-up period. Further, an occupied, performing property would need to be compared to supposedly “comparable” sales of vacant, potentially functionally obsolete properties because those would be the only sales in the market without leases in place. If this stance is taken, the resultant value opinion could be significantly lower than if the interpretation were that fee simple did not mean “vacant.”

## Implications for Valuations

The proposed revision of the definition would make it more consistent with the definition in *Black's Law Dictionary* and with its general use in other areas of real estate practice. Under the proposed definition, *fee simple estate* would refer to the duration of a possessory right, not to which interests may or may not encumber that estate. The interests associated with the real estate are of course highly relevant to the appraisal assignment. But merely identifying the rights appraised as the “fee simple estate” does not settle the appraiser's question about whether any actual or hypothetical interests, such as leases or

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<sup>2</sup> Byrl N. Boyce, *Real Estate Appraisal Terminology* (American Institute of Real Estate Appraisers and Society of Real Estate Appraisers, Chicago, 1981), 102.

<sup>3</sup> *The Dictionary of Real Estate Appraisal* (American Institute of Real Estate Appraisers, Chicago, 1984), 123.



easements, are to be included. A significant implication of this proposed definition is that the valuer likely would need to identify not only the ownership estate (fee simple, leasehold, life estate) but also the interests associated with the property to be valued.

*Title* is ownership or evidence of ownership. An *estate* is what is owned; it carries with it the hallmark of ownership, which is the right of possession and the power to exclude others.<sup>4</sup> *Interests* are rights in real property; they can burden the land and affect the value of the estate. **What is valued is the estate subject to specified interests.**

In the overwhelming majority of valuation assignments, the estate to be valued will be the fee simple estate. Less frequently, the estate will be a leasehold, and on occasion a valuation assignment will involve a life estate.<sup>5</sup>

Interests that may be associated with the real estate include all of the claims on the real property by third parties, such as easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, or other items of a similar nature.<sup>6</sup>

Another potential implication of the proposed revision to the definition of *fee simple estate* is that the terms *leased fee* and *leased fee estate* would not be needed; in fact, such terms would be inappropriate and would not be used. A lease is simply an interest in property, albeit a possessory interest. When a property is leased, the lessor retains the fee simple estate, though the rights (interests) to use and occupy the property are transferred to the lessee. The lessee now has a leasehold estate, but it lasts only until the end of the lease, at which point the rights of use and occupancy revert to the lessor. “Leased fee” would be presented instead as a fee simple estate subject to a lease.

The first step in the valuation process, problem identification, includes identifying “what is to be valued”, or which estate subject to which interests. This information generally comes from the client; the valuer must consult with the client to ensure that the valuation will address the correct estate and interests.

From a practical standpoint, the valuer can usually identify the interests to be reflected in the valuation by referring to a title report that details the interests or rights associated with the real estate. The valuer should consult with the client to identify any specifically included or specifically excluded interests, as well

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<sup>4</sup> Possession is the power to exclude others, and it is what makes an estate different from a mere interest in property. Possession (the power to exclude) is not identical to occupancy (the actual physical use of the property), and more than one party may have possessory rights at any given time. For example, a landlord and a tenant both have possessory rights to exclude others; because each has a possessory right, each has an estate (landlord: fee simple; tenant: leasehold). By contrast, the holders of mere interests in a property (such as a mortgagee or the beneficiary of an easement) has no possessory right and hence no power to exclude others.

<sup>5</sup> Fractional interests in the fee simple estate may also be valued, such as mineral rights, development rights, and air rights.

<sup>6</sup> *Uniform Standards of Professional Appraisal Practice*, 2016-2017 ed. (The Appraisal Foundation, Washington D.C., 2016: Standards Rule 1-2(e)(iv)), 18. Certain claims may grant rights to use the property for a specific purpose, such as to harvest timber, graze livestock, farm, or hunt.

as any presumed conditions of the property as of the date of value.<sup>7</sup> For example, if the estate to be valued is the fee simple estate, it may be valued

- subject to an existing lease,
- subject to hypothesized leases at market rates and terms, or
- as though vacant and available to be occupied or leased at market rates and terms.

Any presumed condition regarding occupancy must be clearly stated in the valuation report. The methodology applied to arrive at the value opinion must reflect the presumed condition. That is, if the assignment is to value the fee simple estate subject to the existing leases, the value will reflect any nonmarket leases as well as time and cost to lease up unleased space. Or, if the assignment is to value the fee simple estate as though subject to leases at market rates and terms, the value will reflect the property as if fully leased to stabilized occupancy at market rates and terms. Finally, if the assignment is to value the fee simple estate as though unencumbered by leases ("dark"), the value would reflect any lease-up costs and loss in income over the lease-up period, if appropriate.

## Examples of Possible Statements in Valuation Reports

As noted above, using the proposed revised definition of *fee simple estate* would require the valuer to determine and clearly state in the valuation report (1) the estate (fee simple, leasehold, or life estate) as well as (2) the interests associated with the real estate that are reflected in the valuation. The following are examples of language that might appear in valuation reports:

### Example 1

The purpose of this appraisal is to provide an opinion of the market value as of January 2, 2018 of the fee simple estate in 123 Main St., Anytown, USA, subject to the easements described in the title report provided by XYZ Title Company, dated mm/dd/yyyy. A copy of this title report is included in the addenda.

### Example 2

The purpose of this appraisal is to provide an opinion of the market value as of January 3, 2018 of the fee simple estate in 456 Main St., Anytown, USA, subject to a lease between ABC Investment Partners Ltd. and Goodpills Drug Store, dated mm/dd/yyyy. The lease terms and conditions are more fully described on p. xx of this appraisal report.

### Example 3

The purpose of this appraisal is to provide an opinion of the market value as of January 4, 2018 of the fee simple estate in 789 Main St., Anytown, USA. The value opinion is based on the premise that the property is leased at market rates and terms and is at stabilized occupancy on the date of value.

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<sup>7</sup> The definition of *market value* presumes a hypothetical sale of the property on the date of value. The question is, what rights or interests would affect the estate on the date of value?



298 Example 4

299 The purpose of this appraisal is to provide an opinion of the market value as of January 5, 2018  
300 of the fee simple estate in 1011 Main St., Anytown, USA. The value opinion is based on the  
301 premise that the subject is vacant and available for occupancy or lease on the date of value.  
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303 **Conclusions**

304 Based on discussions by participants in the symposium, this Discussion Paper explores the following  
305 proposals:  
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- 307 1. Whether the definition of fee simple estate currently in *The Dictionary of Real Estate Appraisal*,  
308 6th edition, and used throughout the Appraisal Institute's educational materials should be revised  
309 to delete reference to "encumbrances," and to be more consistent with the definition in *Black's*  
310 *Law Dictionary*, such as the following: *The highest estate allowed by law. An inheritable*  
311 *ownership interest of indefinite duration.*  
312  
313 2. Whether the terms *leased fee* and *leased fee estate* should no longer be used in valuation  
314 practice.  
315

316 Potential implications of these proposals are that valuers would need to determine, and valuation reports  
317 clearly state, the estate (fee simple, leasehold, or life estate) as well as the actual or assumed interests  
318 associated with the real estate that are reflected in the valuation. Depending on the question to be  
319 answered by the valuation (i.e., the problem to be solved) for a property that is leased, or would likely be  
320 leased, the valuation could be subject to the existing lease, subject to leases at market rates and terms,  
321 or as though vacant and available to be leased at market rates and terms. The valuer generally must  
322 consult with the client for the service to clarify which interests to value.  
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324 **QUESTIONS FOR DISCUSSION PAPER RECIPIENTS:**

- 325 1. Do you agree with the definition of *fee simple estate* proposed in the Discussion Paper? If not,  
326 why not?  
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328 2. If you agree with the proposed definition of *fee simple estate*, does the Discussion Paper  
329 adequately explain the definition and its implications so that valuers as well as users of valuation  
330 services can understand them?  
331  
332 3. What questions related to the issue remain outstanding? What is the best way for the Appraisal  
333 Institute to assist in ensuring that these questions are resolved?