

Illinois Real Estate Letter

Torrens vs. Title Insurance: An Economic Analysis of Land Title Systems Thomas J. Miceli and C.F. Sirmans

To operate efficiently, our real estate markets require a system for establishing and protecting ownership interests. Since Colonial times, the predominant system for achieving this end in the US has been the "recording system," which relies on the maintenance of a public record containing the history of all transactions for all privately owned land. The would-be buyer of a parcel can consult this record to gather *evidence* that the seller has good title and there are no competing claims. However, because there is a possibility that unrecorded claims exist, that there are errors in the public record, or that the opinion of an attorney conducting a *title search* will be found incorrect, the buyer does not obtain *proof* that the seller holds good title. A buyer thus faces some risk of losing his interest if an unknown party later asserts a claim. This risk leads most buyers to purchase private *title insurance*, which provides financial indemnification in the event of a loss. It is also typical for a mortgage lender to require a real estate buyer to purchase title insurance for at least the amount of the mortgage loan. Although the "plants," or "factories," of profit-seeking title insurance companies are generally more efficiently organized and accurate than the public records, the possibility of a successful claim remains.

The Torrens Approach

In 1858, Sir Robert Torrens developed an alternative system for assuring title to land, modelled after a method for recording ownership interests in ships that Torrens had encountered in his work as an Australian customs administrator. The Torrens system ultimately spread to many English-speaking countries, including England, which adopted a version of the system in 1925 as part of sweeping land reform legislation. Since the late 1800s, as many as twenty-one states in the US have enacted Torrens legislation, though the system was used extensively in only a few jurisdictions, including Illinois, primarily in Cook County.¹ (The state repealed its Torrens Act in 1992.)

The Torrens system differs from the traditional recording system in that it establishes a legal procedure whereby the state *guarantees* the owner's title. The process begins with a court proceeding that involves an examination of the history of title to the real estate in question, in an effort to identify potential claimants. The court ultimately issues a certificate to the owner that establishes legal ownership against any claims that remain undeclared or unrecorded at the time of registration. (Any claim that is known or discovered, such as a current

Property Rights Legislation

The November 1997 issue of *The Insider*, published by the Washington, DC-based Heritage Foundation, reports that Congress may be poised to enact property rights legislation after many years of lost opportunities. Among reasons for optimism is the bipartisan support seemingly enjoyed by both the House and Senate bills. These bills, if enacted into law, would permit easier access to the federal courts by a party whose land is the subject of a regulatory takings dispute. According to current law, as interpreted under a Supreme Court ruling, a property owner who suffers financial harm through land use regulation must pursue all possible remedies through state courts (with their contradictory rulings) and various administrative agencies — a process that can drag on for years — before seeking remedies in the federal court system.

The proposed legislation would permit a plaintiff to seek relief through the federal judiciary after one failed attempt to obtain relief (in the form of injunction against the regulation or compensation for the rights taken) through the appropriate administrative agency. Perhaps the greatest benefit such a law would confer on the land owner is that she would no longer face endless, financially devastating battles to have her case heard in an impartial forum. *The Illinois Real Estate Letter* has, in the past, warned of the danger of a system in which private property owners can go bankrupt battling deep-pocketed public agencies (see "How Far Should Fair Housing Laws Go?" Winter 1997).

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mortgage, is recorded on the certificate.) Once the property is registered in the system, subsequent transfers do not require such an extensive procedure; a purchaser need only examine the certificate to verify ownership and learn of any valid claims. Ease of transfer following the registration represents an important benefit of Torrens; under the recording system a full title search must be done in connection with each transfer.

The key difference between the Torrens system and the recording system, therefore, is that under the latter, a good-faith purchaser bears the risk of losing his interest in the land if a claimant later appears, whereas under the former the owner's certificate defeats any competing claims not declared at the initial proceeding. Undeclared claimants, however, can seek monetary compensation from a public Torrens indemnity fund financed by registration fees. Because a certificate holder possesses a claim that is (with some exceptions) incontestable, he has no need (in theory) to purchase private title insurance, though in practice holders of Torrens certificates often do buy such coverage, for reasons noted below.

Torrens vs. Recording in Practice

The initial experimentation with Torrens in the US was based on several features on which Torrens is purported to offer advantages over the recording system.² The principal advantage of land registration is that it clears clouded titles, thereby promoting land's marketability and development. Thus, much of the early motivation for Torrens registration in the US was to promote land development during periods of rapid urbanization. Registration also facilitated redevelopment following idiosyncratic events like the Great Chicago Fire of 1871, in which the public land records were destroyed. In addition to clearing title for development reasons, land registration has been used to clarify boundaries when early property lines have become blurred or historical surveying techniques were found unreliable,³ and to protect absentee owners against loss of their land to "squatters" under adverse possession statutes.⁴ It can be argued, in fact, that registration's prevention of involuntary transfer of title by adverse possession is efficiency-enhancing.

Yet despite its advantages, Torrens has been put to fairly limited use in our country. This lack of success suggests that the system's disadvantages outweigh its advantages in most jurisdictions. The principal disadvantage is the initial cost of registering a parcel, an outlay high enough to deter switching by all but those owners whose land is unmarketable due to title flaws. Potentially offsetting this high up-front cost is a supposed savings in the transaction costs for subsequent transfers of the property; recall that the title history of a registered parcel need not be searched anew with each sale, and that an unrecorded claimant can not seek an interest in the land (he can pursue only compensation from the indemnity fund).

Another potential savings under the Torrens system is that property owners would seem not to have to buy private title insurance; the government, in effect, insures their title. In practice, however, researchers Blair Shick and Irving Plotkin found that in jurisdictions where Torrens and recording coexisted, land owners bought title insurance with about the same frequency under the two systems. The authors further determined that the cost of insuring was the same for registered and unregistered land. Owners of registered land buy private insurance (and lenders often require it) because certification of ownership under Torrens admits several exceptions that continue to pose threats of loss. Examples include tax and mechanics' liens, claims from bankruptcy proceedings, and claims from Native American tribes. In addition, the public indemnity funds, which potentially compensate victims of these losses, can go bankrupt as a result of underfunding.

A final reason for Torrens's failure in the US, unrelated to its merits, has been resistance by parties, especially lawyers and private title insurers, with vested interests in the recording system. Thus history, politics, and the voluntary nature of the system have contributed to the failure of Torrens to thrive in the US, despite a legal expert's view that someone without knowledge of traditional practices would identify registration as the best system. Our successful implementation of land registration would likely require its mandatory imposition, as was done in England with "remarkable success."⁵

Market Analysis

Conflicting Results

Attempts to measure supposed transaction cost savings under Torrens in jurisdictions where it has coexisted with the recording system have shown conflicting results. This lack of consistent findings is illustrated in Figure 1, which summarizes the results of two comparisons, both from Cook County. In the first, Joseph Janczyk used data from 1938 – 1967 to calculate the one-time cost of registering a parcel under Torrens, and to estimate the average cost of transferring a property under the two systems.⁶ His results are shown in the first column of Figure 1, where we inflate the estimates to 1976 dollars using the CPI. Janczyk found a substantial savings in the costs of transfer under the Torrens system (\$335.29 – \$173.54 = \$161.75) which, he argued, justified the one-time registration cost of \$442.54. Indeed, he estimated that if all property in Cook County were transferred to the Torrens system, the present value of net savings would be \$76 million in 1976 prices (if discounted at a rate of 4%, representing society's required rate of return on the initial investment).

Shick and Plotkin, however, arrived at a conclusion somewhat less favorable in its evaluation of Torrens. First, they estimated a 1976 registration cost in the \$574 to \$774 range (depending on legal fees), compared to Janczyk's estimate of \$442.54. Second, they found the Torrens system to offer little, if any, savings in average transfer costs. Specifically, while

their \$332 estimate of the cost of transfer under the recording system (including title insurance) was essentially the same as Janczyk's \$335.29, their measure of the corresponding cost under Torrens was substantially higher (a \$269 to \$332 range, compared to Janczyk's \$173.54).

An explanation for this difference may be that there are scale economies in property transfer activities, and that a declining use of Torrens between 1967 (the last year of Janczyk's data) and 1976 (the year of Shick and Plotkin's analysis) thereby caused average costs to rise. One source of scale economies is high *fixed* costs, and Shick and Plotkin found that the successful operation of a registration system did, in fact, require higher quality administration (in terms of more, and

Transfer & Development Incentives

The principal economic difference between Torrens and recording, as noted above, is how they assign property rights to the land when a claim is asserted. Simply stated, under Torrens the possessor keeps the land and the claimant receives monetary compensation, whereas under the recording system (with title insurance) the claimant gets the land and the possessor is compensated. (For simplicity, we consider only claims of full ownership, though the analysis would be the same for partial claims.) From an economic perspective, the question (aside from transaction costs) is which system is better at promoting *efficient* land use.

Achieving efficiency involves two components: encouraging land's transfer

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better qualified, personnel) than did the recording system. In view of their findings, the authors concluded that, for the typical land owner, the one-time registration cost incurred under Torrens was not justified by the modest savings (at best) in transfer costs, especially in light of the time delays that were likely to result from inadequate administration.

to the highest-valuing user (*exchange* efficiency), and creating incentives for efficient land development (*investment*, or *production*, efficiency). First, consider incentives for efficient transfer. Suppose that the possessor of a parcel values it at \$70,000 (the minimum sum he would accept to surrender it voluntarily), but that its market value is only \$50,000. The \$20,000 difference represents the *subjective value* that the possessor assigns to the land, an amount that presumably increases with the length of occupancy, especially for residential users.⁷

Now suppose that someone unknown to the possessor asserts a claim to the land. In the typical case of this nature the claimant has never occupied the land, and therefore has no subjective interest in the property, so we might assume that the claimant values the land at its \$50,000 market value. (In any case, the claimant likely values the land less than does the possessor; otherwise he would negotiate its purchase.) An implication is that the claimant would be indifferent between receiving the land and obtaining compensation equal to its market value. In contrast, the possessor, for whom the value is

Figure 1

<i>Cost Comparison of the Torrens and Recording Systems (1976 \$):</i>		
	Janczyk ^a	Shick and Plotkin
Registration cost	\$442.54	\$574 – \$774 ^b
Average cost of transfer		
Torrens system		
Registrar fees		\$76 – \$128
Closing costs		\$193 – \$204
Total	\$173.54	\$269 – \$332
Recording system		
Registrar fees		\$30
Closing costs		\$302
Total	\$335.29	\$332

^a Results are based on a statistical analysis of data from 1938-1967.
 The estimates were inflated to 1976 dollars with the Consumer Price Index.
^b Differentials are due to a range for lawyers' fees and/or variation in practices.

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\$50,000 plus a subjective amount, would obviously be better off if he were allowed to retain the land rather than being forced to surrender it at its market value.

The example, as outlined so far, might seem to suggest that Torrens is superior to the recording system in terms of maximizing the value of the land, in that Torrens assigns the land to the highest valuer, in this case the possessor. This conclusion is not necessarily true, however. To see why not, consider that if a court awards the land to the claimant, this assignment is not likely to represent the final ownership situation. After all, the displaced possessor (with \$50,000 in title insurance proceeds) will pay up to \$70,000 to recoup the land, whereas the claimant will accept any amount in

The fact that possessors are better off distributionally than successful claimants under Torrens suggests that, *politically*, the Torrens system should be able to replace the recording system, especially since land possessors vastly outnumber would-be claimants. From an *economic* perspective, however, we know that a large but apathetic majority (the risk of a claim on any parcel is minuscule) will often fail against an active minority.

The preceding discussion is based on an assumption that transaction costs in connection with a resale would be low. If these costs were high, the Torrens system would be preferable at a societal level, because it assigns the land initially to the highest-valuing user (recall that we expect a current possessor to realize

though they may lose the land itself, just as we insure expensive consumer goods. (Of course, this conclusion is based on an assumption that a developer is primarily interested in land as an investment, and that he attaches little or no uncompensable subjective value to it.) Both systems therefore have the potential to provide the same level of protection to investors.

A Graphical Analysis

We can use a simple graphical analysis in explaining the economics of land transfer under the two systems.⁹ Figure 2 shows potential spending choices for the current possessor of a particular parcel of land. This person has financial resources, or a *budget*, that he can spend entirely on land (a commodity designated L), hold entirely in an alternative wealth form (a mix of cash and other assets that we call W), or devote to some combination of land and other wealth. He would like to spend unlimited amounts on both land and other assets (choices that would be represented by locations farther to the "northeast" in the figure), but must, like all of us, make constrained choices. Specifically, his resources are limited, and thus he can hold no more of land or other wealth than the amounts shown by points along line BB' : B' units of land, B units of other wealth, or combinations involving lesser sums of both on the BB' budget constraint.

The typical individual likes to consume a combination of goods or services, rather than devoting all of his budget to purchasing large quantities of a single item. Our land possessor's preferences for trading off land against other wealth are represented by curves U_2 and U_1 . They are called *indifference curves*, because the land holder would be equally content (have equal well-being, or *utility*) at any point along such a curve – holding little land and much other wealth, moderate amounts of both, or much land and little other wealth. There are two important points to note with regard to these curves. First, curve U_1 (farther to the "northeast") represents larger combinations of land and other wealth than those shown on curve U_2 , so our land holder is happier to be situated on U_1 than on U_2 . Second, an indifference curve involving two *goods* (land, wealth) is *convex*, or *c-shaped*; at an extreme position the consumer would

Simply stated, under Torrens the possessor retains the land and the claimant receives monetary compensation. Under the recording system (with title insurance), the claimant gets the land and the possessor is compensated.

excess of \$50,000. Thus, unless there are significant transaction costs, the land still ends up in the hands of the highest valuer (the original owner), who repurchases it for a price between \$50,000 and \$70,000, perhaps \$60,000. (The exact price in such a negotiation depends on the bargaining abilities of the parties involved.)

The preceding example shows that title will likely end up with the highest-valuing user regardless of how it is initially assigned, a result suggesting that the title system does *not* affect the final allocation of rights to the land.⁸ The initial assignment of rights will likely matter, however, for the distribution of income. Specifically, suppose that financial compensation under both systems is equal to the land's market value. In this situation, the initial possessor would prefer Torrens, under which he retains the land rather than having to repurchase it for a \$60,000 figure that exceeds his \$50,000 title insurance settlement. The claimant, by contrast, prefers recording, under which he gets title and then sells the land back to the first possessor for \$60,000 rather than receiving \$50,000 from the Torrens indemnity fund.

a subjective value that a claimant would lack). In contrast, another costly transaction would be required under the recording system, and if the transaction costs exceeded the difference between the possessor's value and the claimant's (\$20,000 in our example), this transfer might not occur at all; the result would be an inefficient assignment of rights.

The title system also affects incentives for land *development* when possessors face the risk of claims. Indeed, recall that an important argument for experiments with Torrens in the US was its ability to stimulate land development. The supposed advantage of Torrens in this respect is that developers need not fear the loss of their land, so they can invest as if there were no risk of a claim (just as we might buy more expensive consumer goods if we did not have to fear theft). It is not necessarily true, however, that the recording system provides inferior incentives to invest in land. As long as developers purchase sufficient title insurance to cover the value of the land and improvements, they are able to invest without fear of losing their financial interests in their properties, even

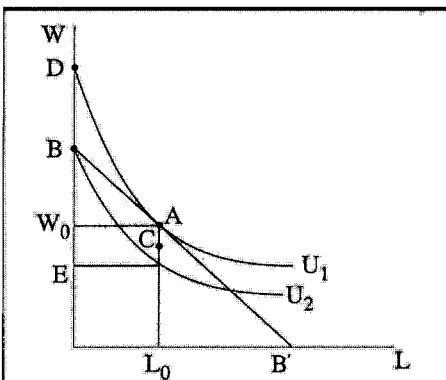
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happily give up much of the abundant commodity to gain a small amount of the scarcer one. This convexity indicates that the possessor does not view land and wealth as perfect substitutes for each other. As a result, the amount of money that the possessor would have to receive in return for the land, in order to remain at a given level of utility, could be substantial, possibly even exceeding the land's market value.

As the figure shows, the combination actually selected consists of a tract of land L_0 units in size and W_0 units of other wealth; this portfolio, shown by point A, is optimal in that it maximizes the possessor's utility subject to the budget constraint (it is on the highest utility curve, U_1 , that can be afforded with budget BB'). The slope of BB' is the negative of the unit price of land, p . Thus, the parcel's market value is given by the distance BW_0 on the vertical axis (if B represents 100 units of wealth, and if $W_0 = 60$ units of wealth are held in non-land form, then $BW_0 = 40$ units of wealth must have been spent on the land). That is, $p = BW_0/L_0$ by definition, implying that $pL_0 = BW_0$.

If the possessor were to lose title to the land (leaving him with only other wealth forms), he could remain on indifference curve U_1 (at point D) only if he received compensation represented by the distance DW_0 , which exceeds the market value BW_0 . Thus, if the possessor were to receive only market value for the land, he would be at point B instead of A or D, and at the lower utility realized along curve U_2 . Distance BD represents the subjective value the possessor assigns to the land. If this value grows over time, as we hypothesize, then the convexity of the possessor's indifference curve also increases, thus increasing distance BD .

Figure 2



In contrast to the land's possessor, the claimant (under our hypothesis that non-possessors do not acquire subjective preferences) values the land only at its market value. Thus, the claimant in effect has indifference curves that are straight lines, each with a slope equal to that of the budget line BB' .

Now consider the impact of the two title systems with regard to exchange efficiency. Under the Torrens system, the possessor would retain the land and remain at point A (remember that the registration fee was paid in the past and is sunk), while the claimant would receive monetary compensation equal to BW_0 . In contrast, under the recording system the claimant would receive the land, which he values at its market value BW_0 , and the displaced possessor would receive compensation of BW_0 , putting him at point B. Thus, the claimant enjoys the same wealth position under either of the two systems, but the possessor has lower utility under the recording system.

It is unlikely that this allocation of rights would represent the final outcome, however, since the displaced possessor, starting from point B, is willing to pay BE to reacquire the land (note that in paying BE , he can buy back the land and remain on indifference curve U_2). Since BE exceeds distance BW_0 that indicates market value, the claimant (who is happy to get anything above market value) will sell the land back to the initial owner (whose value includes a subjective component) for some amount between BW_0 and BE . The final point reached on the graph depends on the price arrived at in the parties' negotiations; if the transactors split the gains from trade evenly, the possessor will end up at a point such as C (on an indifference curve between U_1 and U_2). Thus, the dispossessed occupant still has less utility than under Torrens, while the claimant is better off by the difference between the repurchase price and the market value. Under either system, however, the land ends up with the highest valuer: the initial possessor. ■

Notes

1. Other states where Torrens was used extensively are Massachusetts and Minnesota. Currently, land can be registered in only a few states; as of 1991 these were Colorado, Georgia, Hawaii, Massachusetts, Minnesota, New York, North Carolina, Ohio, Virginia, and Washington.

2. See Blair Shick and Irving Plotkin, *Torrens in the United States*, Lexington, MA: Lexington Books, 1978.

3. These motivations were especially relevant in Massachusetts and Minnesota.

4. Adverse possession statutes exist in all 50 states, and though the definition of *adverse* can vary across jurisdictions, a typical requirement is that possession be open, continuous, exclusive, and with a claim of right. The usual economic justifications for adverse possession are that it clears title to land and prevents owners from leaving productive land idle. While Torrens does not address the second of these concerns, economists recognize that leaving land idle is not necessarily an inefficient use, in light of the option value of future development. See Thomas J. Miceli and C.F. Sirmans, "An Economic Theory of Adverse Possession," *International Review of Law & Economics* 15 (1995): 161 - 173.

5. See John E. Cribbett, *Principles of Law and Property*, 2nd, 1975: 316.

6. See Joseph Janczyk, "An Economic Analysis of the Land Title Systems for Transferring Real Estate," *Journal of Legal Studies* 6 (1977): 213 - 233.

7. Oliver Wendell Holmes once observed that "man, like a tree in the cleft of a rock, gradually shapes roots to its surroundings, and when the roots have grown to a certain size, can't be displaced without cutting at its life." We should also recognize, however, that the passage of time can bring about events, such as children's graduation from school or the home owner's retirement from work, that might reduce subjective values.

8. This situation illustrates the *Coase Theorem*; see Ronald Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3 (1960): 1 - 44.

9. This discussion is based on our article, "The Economics of Land Transfer and Title Insurance," *Journal of Real Estate Finance & Economics* 10 (1995): 81 - 88.

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