The Real Estate Appraiser & The Law

by

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DON'T GET CAUGHT LEGALLY UNAWARE

THE REAL ESTATE APPRAISER AND THE LAW is Howard Jackson's 5th book which is designed to guide appraisers, real estate brokers and lawyers through significant and complicated real estate and legal issues.

It is a must read for all appraisers, lawyers and real estate professionals.

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INTRODUCTION

There once was a time when appraising was ***"just my opinion."*** Many appraisers felt and still feel today safe from complaints, objections, or incrimination simply because it is ***"just an opinion."***

This monogram will explore why this is not true. Today the extent of appraiser liability (under current law) can be far reaching. In fact, how far reaching the appraisers' liabilities extend, will probably be a big surprise to many.

In order to understand the relationship between the appraiser and the law, the following areas will be examined and discussed:

1. Historical Perspective
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It should be noted that this work is not legal advice, as legal advice may only be given by an attorney. Rather, it is a presentation of facts by an appraiser who has had experience not only as an appraiser/author but one who has become involved with various legal cases and who has often appeared as an expert appraisal witness.

In addition, while written primarily for appraisers, this monogram is also intended for attorneys who must gain insight in order to either defend clients, assess damages or handle some related legal function.

One thing to remember about an appraisal or any other report is that as a document, the content of the report speaks for itself. Here is a quote from Blacks Law Dictionary which covers this legal term..

> **Res ispa loquitur.** "The thing speaks for itself." Rebuttable presumption or inference that defendant was negligent, which arises upon proof that instrumentality causing injury was in defendant's exclusive control, and that the accident was one which ordinarily does not happen in absence of negligence. Res ipsa loquitur is rule of evidence whereby negligence of alleged wrongdoer may be inferred from mere fact that accident happened provided character of accident and

> circumstances attending it lead reasonably to belief that in absence of negligence it would not have occurred and that thing which caused injury is shown to have been under management and control of alleged wrongdoer. Hillen v. Hooker Const. Co., Tex. Civ. App., 484 S.W.2d 113,115. Under doctrine of "res ipsa loquitur" the happening of an injury permits an inference of negligence where plaintiff produces substantial evidence that injury was caused by an agency or instrumentality under exclusive control and management of defendant, and that the occurrence was such that in the ordinary course of things would not happen if reasonable care had been used." Unless there are appropriate disclaimers in the report, this doctrine carries a lot of weight. Therefore, the actual work product becomes the initial focal point in any type of legal proceeding.

There are some distinct parallels between the accounting profession and the appraisal profession. Both are responsible for independently investigating a financial entity, preparing an analysis and a conclusion, and issuing a report that is relied upon by others. Thus, it is important for appraisers to be aware of recent legal developments in the accounting area that could have substantial, harmful side effects on the real estate appraisal profession.

When we talk about the law there is another doctrine called "stare decisis." This states once a case is settled by one court, it may be used as a basis for deciding other cases in the future. This doctrine also applies to related professions.

Recent newspaper articles have placed the blame for bad real estate loans on appraisers. In an article, for example, by Kenneth R. Harney, "Abuse Abounds In Appraisals", Nations Building News, Volume II, Number 15, he states according to a house subcommittee report released September 24th, 1989 "Inflated appraisals of homes and commercial properties have helped push hundreds of financial institutions into insolvency in recent years". This author does not agree with this statement. This report further states "the impact of this national appraisal scandal is so pervasive," that up to 40% of the bad loans involved faulty appraisals. While the faults were not specified, there have been many other reports blaming bad loans solely on the appraiser. Borrowers, however, default on real estate loans for a variety of reasons, such as poor underwriting decisions, construction cost overruns, overly optimistic cash flow projections, unfavorable tax law changes, lease terminations, market aberrations or fluctuations, interest rate changes, or sudden changes in energy prices and resultant economic disaster. Real estate appraisers are rarely responsible for these situations. Yet, due to the nature of the reports, appraisers do have fiduciary responsibilities. The problem is to whom do appraisers owe this responsibility? Only the client or every reader of the appraisal report? What happens in the case of misuse, such as a poor underwriting decision? Is the appraiser still responsible?

In the following chapters we will investigate and answer these questions (and others) in order that we might provide greater insight to the appraiser and the law.

HISTORICAL PERSPECTIVE

To begin our discussion of the appraiser and the law, a brief synopsis of law is in order. Early in this century, there had been in effect a long standing federal legal precedent concerning liability. It is paraphrased as follows: If a manufacturer was negligent in the production of a product and that product caused injury to an innocent buyer, the manufacturer was generally held liable for the buyer's injury. Liability was based on a legal theory known as "privity of contract": to those who "contracted" to purchase a product, the manufacturer owed a duty to use reasonable care in the manufacture of that product; however, that duty did not extend to third parties. In 1931, in deciding a lawsuit involving an accountant, the legendary Judge Benjamin Cardozo invoked this theory in holding that in the preparation of financial statements, accountants were liable only to those parties with whom they had contracted, i.e., their direct clients. Many states soon adopted a similar position.

More recently however, the doctrine of privity of contract (being responsible only to purchaser or client) began to erode. Some state courts held that accountants were liable to third parties who relied on the accountants' reports, if the accountant actually knew of that reliance. By 1982-83, other courts had gone further, holding accountants liable to parties whose reliance, while perhaps not known specifically, was "reasonably foreseeable."

Then in the summer of 1985, the privity of contract concept was again under examination in the case of Credit Alliance Corp. v. Arthur Andersen & Co. Credit Alliance's business was making specialty loans. In making such a loan to a borrower that later went bankrupt, Credit Alliance had relied on financial statements prepared by Arthur Andersen for the borrower that allegedly misrepresented the borrower's true financial position. Credit Alliance sued Arthur Andersen for negligence when the loan went sour.

In a decision the American Bar Association called "the most significant common law decision in the commercial law area in the generation," the New York Court of Appeals, unanimously rejected Credit Alliance's claim. The court held that Credit Alliance had "failed to demonstrate the existence of a relationship (between it and Arthur Andersen) sufficiently approaching privity." Drawing from Cardozo's decision almost 35 years earlier, the court noted that to rule otherwise would potentially make accountants liable to "any number of an indeterminate class of creditors, present and prospective, known and unknown."

The court did, however, set forth a three-part test under which accountants could be held liable to third parties:

> *The accountants must have been aware that (1) their reports would be used for a particular purpose, and (2) relied upon by a known party; and (3) there must have been some kinds of conduct on the part of the accountants which would link them to the "injured" third party.*

In most instances, this test would not have opened the door to extensive additional liability, since third party reliance generally occurs long after the reports have been prepared and therefore, by conduct, the accountant cannot be linked to the third party. What is happening now, however, is that before making a loan, banks are requiring accountants to acknowledge that the bank may rely upon the financial statements the accountants prepared for the borrower. This often takes the form of a formally executed statement to that effect thus linking the accountant to the third party. Such a statement would appear to relieve lenders of some or all of their own responsibility for thorough underwriting.

Someone is going to have to pay for accountants' increased exposure. Ultimately, that someone is going to be all consumers of accounting services. In the future there is bound to be new Federal and State case law which will continue to redefine and shape this concept. In the meantime, the appraisal industry may see similar problems arise where appraisers will-be asked to acknowledge the use of their reports by parties other than their direct client. Hence, the need to document and support every conclusion, and not rely on the old concept that appraising is not " *just an opinion."*

TO WHOM ARE APPRAISERS RESPONSIBLE?

Only the client or every reader of the appraisal report?

The concept of "reliance" is what links responsibility to the accountants and appraisers. Like accountants, appraisers are in the business of analyzing a property at a single point in time; and then, producing reports upon which people rely. Also like accountants, a significant portion of the appraisal business is directly related to financial institutions. Should banks (for example) start requiring appraisers to sign "privity documents" linking appraisers to third parties, it will make it very easy for the bank or any other interested third parties to sue appraisers. Since the "privity documents" are designed to link all third parties to the appraiser, potential liability may be very large. For example, appraisers might be required to sign a document indicating their knowledge that an appraisal report might be used as part of a sales offering memorandum. This naturally would expose the appraiser to lawsuits from any investor for a substantial period of time.

Currently, in a lawsuit of this kind, without a privity document acknowledged by the appraiser, the plaintiffs attorney might spend up to 30% of the case time attempting to establish "reliance," for without it there would be no case. However, if the appraiser has signed an acknowledgement, a great part of the case has been established. It is clear that the legal precedent (case law) of the Arthur Anderson case sets the legal stage for its use against the appraiser. This could be standard operating procedure on the part of financial institutions when engaging appraisers in the near future. In the section "Who Can Sue the Appraiser", this will be elaborated upon.

The Society of Appraisers commissioned a law firm Laxalt, Washington, Pente and Dubuc in 1989 to discuss appraiser/client relationship. They concluded that each state law would take precedent and the appraisers could be liable to foreseen third parties.

An article by John F. Shampton, April 1991, Appraisal

Malpractice: Sources of Liability and Damages, Appraisal Institute also makes a similar conclusion.

These issues will be examined in more detail in this section.

MALPRACTICE, NEGLIGENCE AND FRAUD

We will leave the legal aspects for now and focus the discussion on what is malpractice, negligence and fraud.

In our world of appraising, malpractice, negligence, and fraud are words that are being heard in a more increasing frequency. This section will explore from a real estate appraiser's viewpoint, the nature of malpractice and negligence with particular attention given to legal definitions and descriptions. As part of this exploration other relevant topics will be examined. These include:

1. How is malpractice/negligence/fraud gauged and measured?

2. Who can bring a malpractice/negligence/fraud action?

3 . What are the mechanics of a malpractice lawsuit?

4. Other subjects of a peripheral and supporting nature.

MALPRACTICE DEFINED

Malpractice is defined by one court:

"Professional misconduct or unreasonable lack of skill. Failure of one rendering professional services to exercise that degree of skill and learning commonly applied under all circumstances in the community by the average prudent reputable member of the profession with the result of injury, loss or damage to the recipient of those services or to those entitled to rely upon them. It is any professional misconduct, unreasonable lack of skill or fidelity in professional or fiduciary duties, evil practice, or illegal or immoral conduct." Matthews v. Walker 34 Ohio App. 2d, 128, 296, N.E. 2 569, 571, 63, 0.0. 2d 208. (1)

Bear in mind that this definition and many others in state and federal law evolve from case decisions. Other definitions are:

"Malpractice" is "treatment in manner contrary to accepted rules and with injurious results; hence any professional misconduct or unreasonable lack of skill or fidelity in performance of professional or fiduciary duties; wrong doing, etc.," Sales v. Tauber - 27 Ohio N.P., N.S. 371 (2)

"Malpractice" means "any professional misconduct, unreasonable lack of skill or fidelity in professional or fiduciary duties, evil practice or illegal or immoral conduct." Gregory v. McInnis 134 S.E.527, 529, 140, S.C. 52 (3)

From these definitions, we can see that appraisers must be very careful to exercise diligence, skill, fidelity and professional conduct.

DUE DILIGENCE/DILIGENCE DEFINED

Diligence. Taken from Black's Law Dictionary, *"Vigilant activity; attentiveness; or care, of which there are infinite shades, from the slightest momentary thought to the most vigilant anxiety. Attentive and persistent in doing a thing; steadily applied; active; sedulous; laborious; unremitting; untiring. National Steel & Shipbuilding Co. v. U. S., 190 Ct.Cl. 247, 419 F.2d 863, 875.*

The civil law is in perfect conformity with the common law. It lays down three degrees of diligence,--ordinary (diligentia); extraordinary (exactissima diligentia); slight (levissima diligentia).

There may be a high degree of diligence, a common degree of diligence, and a slight degree of diligence, with their corresponding degrees of negligence. Common or ordinary diligence is that degree of diligence which people in general exercise in respect to their own concerns; high or great diligence is, of course, extraordinary diligence, or that which very prudent persons take of their own concerns; and low or slight diligence is that which persons of less than common prudence, or indeed of any prudence at all, take of their own concerns."

Due diligence. *"Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case."*

NEGLIGENCE DEFINED

Again, by looking at what the courts have said about negligence, we can establish a good understanding of negligence. "Negligence" is a departure from the normal or what should be the normal, and is a failure to conform to standard of what a reasonably prudent man would ordinarily have done under the circumstances, or is doing what such man would not have done under the circumstances. Moran v. Pittsburgh - Des Moines Steel Co., D.C. Pa. 86 F. Supp. 255, 266. (4)

"Negligence" being failure to do that which an ordinarily prudent man would do or doing of that which such a man would not do under same circumstances, an ordinary custom, while relevant and admissible in evidence of negligence, is not conclusive thereof, especially where it is clearly a careless or dangerous custom. Title v. Omaha Coliseum Corp., 12 N.W. 2d, 90, 94, 144, Neb. 22, 149, A.L.R. 1164 (5)

Whether or not an act or omission constitutes "negligence" seems to be determined by what under like circumstances would men of ordinary prudence have done. Cleveland C., C., & St. L.R. Co. v. Irvins, Ohio 12, O.C.D. 570 (6)

"Negligence: means simply the want of ordinary care under the circumstances surrounding that particular case and the transaction in question, and "negligently" simply means doing an act in such a manner that it lacks the care which men of ordinary prudence and foresight use in the everyday affairs of life under the same or similar circumstances. Smillie v. Cleveland Ry., Ohio 31 O.C.D. 323, 325, 20, Cir. Ct. R.N.S. 302 (7)

"Negligence" is the failure to do what a reasonable and prudent man would ordinarily have done under circumstances of situation or doing what such a person, under existing circumstances, would not have done. Judt v. Reinhardt Transfer Co. 17 Ohio Supp. 105, 197, 32, 0.0. 161. (8)

Reasonable Man Doctrine or Standard. These are taken from Black's Law Dictionary: "The standard which one must observe to avoid liability for negligence is the standard of the reasonable man under all the circumstances, including the foreseeability of harm to one such as the plaintiff."

Reasonable Care. "That degree of care which a person of ordinary prudence would exercise in the same or similar circumstances. Pampas v. Cambridge Mut. Fire Ins. Co. La. App. 169, So. 2d, 200, 201; Pierce v. Hovrath, 142, Ind. App. 278, 233, N.E.2d 811, 815. Due care under all the circumstances." Failure to exercise such care is ordinary negligence. (13)