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Limiting an Appraisal Firm's Liability and Exposure

Changes in the regulation of the appraisal industry are transforming the profession. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and other regulatory standards have led appraisers to be more concerned about quality than ever before. This article addresses methods a firm can use to minimize liability and exposure so it can continue to be profitable and successful through these changing times.

Regulatory forces are reshaping the appraisal industry. State licensing, legislation, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), requirements from lending institutions, and other factors are forcing appraisal firms to adapt to new rules and regulations. Appraisers are more vulnerable to legal action than ever before as a result of the liability requirements of the *Uniform Standards of Professional Appraisal Practice* (USPAP). The result of these regulations is increased liability and exposure for both appraisers and their firms.

Given the increased demand for quality and the added responsibilities placed on the appraiser, how can one limit exposure? There are three primary areas that can be addressed: competence, quality control, and business methods.

COMPETENCE

The best defense against potential liability problems is to have adequate training to perform appraisals competently. Competence is not acquired just by working toward professional designation; it involves continuous training, whether in the classroom or on the job.

Staff training

Staff training can help minimize errors that may result in a claim against the company. This training should include both academic and on-the-job education. Field inspection and market analysis techniques should be emphasized for new appraisers to help them develop good research habits. Demanding assignments

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should be made only after the appraiser is well trained in these techniques.

On-the-job training also helps to blend the theoretical framework presented in the classroom with practical, hands-on material obtained from field work. By integrating the two, the appraiser will learn more in a shorter period of time. This can reduce the potential for error and likewise reduce exposure.

Specialization

Specializing can be a double-edged sword for any appraiser. It can result in more assignments, but if market conditions change and the volume of work decreases it can be hard to redefine skills or shift focus. However, having at least one specialty can help to limit exposure and liability. With a specialty, an appraiser will have added insight into the valuation of a particular property and can provide a more solid report, thereby reducing liability and exposure.

Specialization is defined not only by types of appraisals done but also by the geographic area an appraiser covers. Focusing work in certain states or counties allows an appraiser to gain more insight into various market demands. Economies of scale result from data collection. The most important reward, however, is developing a feel for values and an understanding of trends in the marketplace. These insights increase an appraiser's comfort level and ability to defend a valuation, again reducing exposure.

Use of outside experts

If an appraiser does not have the competence to handle a certain facet of a report he or she should hire someone that does. This allows an appraiser to limit his or her exposure to the interpretation of the results stemming from an expert's conclusions. This situation is analogous to a bank that hires an independent appraiser for his or her appraising skills; the bank does not want the liability that comes from doing the job in-house. By hiring outside experts, an appraiser can benefit in many ways. For example, if a property has problems related to wetlands and the appraiser does not hire an expert or recognize the degree to which the wetlands may affect the marketability and value of a parcel, the appraised value may be overstated.

Some may argue that hiring experts from various fields is cost prohibitive. An appraiser may be forced to either raise fees to pay the expert (reducing profitability), or simply not do the report. But these initial costs should not be an appraiser's primary concern; instead he or she should consider the liability invited by not securing expert opinions.

QUALITY CONTROL AND REVIEW

Quality control and review are essential for limiting exposure and liability. A firm should establish a good quality control program and not deviate from its implementation. In addition to correcting minor errors that may occur, quality control can provide additional viewpoints to help establish a more credible valuation.

Appraisal review is a key ingredient in a quality control program. By signing a report, the lead appraiser admits full liability for its contents and puts his or her reputation on the line. A careful review by one or more experienced appraisers can provide a world of insight and strengthen the valuation conclusions contained in the report. Some larger appraisal companies have round-table reviews and discussions about appraisals, which help establish a high comfort level with the reports. Although small appraisal firms may not have the resources to conduct reviews with such frequency or magnitude, almost any additional input about an appraisal report can help identify problem areas in the valuation.

Another way to implement quality control is by scheduling a second or third review before the field appraiser submits the report. The first review can address grammar, math, punctuation, or other basic errors in the report. By putting the report aside for two or three days and then reading it a second time the appraiser may find new insights into the report. An appraiser can be more objective about a report during the second reading because he or she may have new analyses or data to add. This is a good quality control technique for smaller firms that may not have large numbers of appraisers to review each report.

Inspections by lead appraisers

Most letters of engagement require that the lead appraiser inspect the property.

Policies designed to limit the exposure of a firm include rejecting assignments in areas an appraiser finds unfamiliar or uncomfortable, limiting the size of the firm, or qualifying the assignment.

But it is very easy to get bogged down with the day-to-day operations of running a company and overlook the inspections. This is not a sound practice, however, as an appraiser never knows when he or she will be called into court to testify about an appraisal. If the lead appraiser did not inspect the property but stated that he or she did, the legal exposure can be very high.

Inspecting the subject of a report is also an important step in the quality control process. Many lead appraisers have developed a feel for values and a personal inspection makes it easier for the lead appraiser to support his or her judgment. Inspections also provide a useful review of field appraisal skills. And if the lead appraiser is familiar with the comparables used in the report, inspections can provide a review of the judgment the field appraiser used to compare these sales to the subject.

Verification

Investing time and effort in verification can provide many benefits. This additional insight into the transaction provides more support for conditions of sale adjustments, a more professional presentation of material, and most important, more protection for the company against bad data or analyses.

Verification becomes even more important when the sales comparison approach is given primary weight in the reconciliation. If a client questions an appraiser about his or her sales, prior verification provides additional data that can be used to defend the analyses to the client or in court.

File memoranda

File memoranda provide the means by which an appraiser can re-create the thought processes that shaped his or her conclusions. On occasion, an appraisal report may be used in court years after it had been written. With a good file memoranda system, the appraiser can defend his or her valuation with relative ease.

File memoranda are also extremely important for defending against a claim. There can be problems at the state level for a licensed appraiser and additional problems with any organizations with which the appraiser has an association. Since the appraiser must conform to USPAP, not having a proper file memoranda system can increase the exposure of the firm.

BUSINESS METHODS

Limiting exposure may involve a strategic change in a firm's business methods. Policies designed to limit the exposure of a firm include rejecting assignments in areas an appraiser finds unfamiliar or uncomfortable, limiting the size of the firm, or qualifying the assignment.

Saying no to an assignment

No one likes to turn down additional work. Sometimes, however, an assignment involves an area in which an appraiser has little or no experience. Taking such an assignment can increase an appraiser's liability because his or her opinions will not be based on solid experience. If such an appraisal were to be challenged in court, the appraiser's defense of the valuation may be shaky. Appraisers should not feel compelled to take difficult assignments simply because of the additional fees.

Maintaining a small staff

Maintaining a small staff can help limit liability and exposure. A smaller staff can foster more professional interactions, better and faster training, and more hands-on control of the operation. Having too large a staff, especially if one or more members are not fully trained, can be a disaster. One large claim against a lead appraiser based on an error made by his or her associate can tarnish a firm's reputation for years, as well as result in a large financial loss for the company. Having a smaller, more interactive staff can increase the comfort level among appraisers. A small firm can be the best kind of firm, especially when it practices the strategies suggested throughout this article.

Qualifying the assignment

An appraiser can limit his or her liability for the information contained in a report by properly qualifying the assignment. By initially specifying to the client how various situations will be handled, ambiguity can be reduced. For example, if a firm is uncomfortable doing land valuations based on an "as approved" value when

no approvals exist, an appraiser should state this discomfort as part of the terms of employment. In this case, the firm might request that the as approved value be excluded from the appraisal, especially if it can take several years to get final approvals.

Selecting errors and omissions insurance

Errors and omissions insurance can help prevent a devastating loss that may result from a mistake made in a report. An appraiser should select an errors and omissions policy that will protect him or her for actions taken years after the date of valuation, not only problems that arise within one year, which is the case with the majority of errors and omissions policies.

As with specialization, possessing insurance can be a double-edged sword. The fact that an appraiser carries such insurance may make a client more likely to sue, but an appraiser who does not have it may be at risk. Deciding whether or not to obtain the insurance is a judgment call. Most companies have the insurance, believing that it is better to be safe than sorry.

CONCLUSION

Limiting a company's exposure and liability should be an important consideration for any appraisal firm owner. But just buying insurance is not enough. To keep small problems from becoming big ones, appraisers need to identify and correct potentially problematic situations. This may require changing a firm's quality control system, developing additional skills, or even changing the way a firm does business. It is management's responsibility to find the best balance between the risks and rewards of appraising. The suggestions presented here can provide guidelines for limiting a firm's exposure and securing long-term success.