



LIMIT YOUR LIABILITY

A contractual clause can help appraisers minimize their exposure

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In a recent case on the West Coast, a certified general appraiser was sued for professional negligence by a commercial lender. The lender had made a high-interest, short-term loan to an investor/developer for the purchase of a large parcel of land that the borrower planned to subdivide and sell as mini-ranches.

The property was appraised for approximately \$5 million in 2007, and the lender had loaned \$3.2 million. Within months after closing, the borrower's project began sputtering because of the financial crisis, and by early 2009, the borrower was in default. The property sold at foreclosure for \$1.8 million in 2010, leaving the lender with a deficiency of more than \$1.5 million in unpaid principal and interest.

In its lawsuit, the lender contended that the appraiser made a serious error by incorrectly determining zoning in reporting the land to have sub-dividable agricultural zoning when it allegedly had agricultural/preservation zoning that prevented subdivision. The lender contended that the zoning difference made the property worth millions less than appraised and was the reason for the large deficiency. Moreover, the lender contended it would not originally have made the loan if the appraiser had accurately reported the zoning. The lender's \$1.5 million damages demand significantly exceeded the appraiser's Error & Omissions insurance limit.

The defendant appraiser faced a serious situation. If found liable for the lender's entire damages demand, the appraiser would be exposed to a judgment exhausting not only his insurance but also his personal assets. Fortunately, litigation of the case did not go as the lender had hoped, and the parties settled for a very small percentage of the \$1.5 million first demanded.

How was the catastrophic loss avoided? The appraiser had an engagement agreement with a limitation of liability clause that specified the appraiser's maximum liability would be no more than the appraisal fee received for the

assignment—in this case \$7,500. While the case didn't settle for such a small amount, the liability cap proved to be enough of a defense that the lender was forced to settle for much less than its earlier demand.

Limitation of Liability Clauses

In general, limitation of liability clauses are contractual provisions used to cap the liability of a party to a contract or transaction. The clause might cap just one party's liability or be mutual. Although the largest commercial appraisal firms and many smaller ones use limitation of liability clauses in their terms of engagement, they are more common in other types of professional contracts—particularly architecture, based on long-standing contractual guidance from the American Institute of Architects.

As to appraisers' use of such clauses, some don't see the need while others object to them, believing them to be unprofessional. I've heard appraisers ask, "Why should an appraiser cap his liability? Everyone should be accountable for their mistakes." That position is easier to take when you haven't been a defendant to a frivolous professional negligence claim or even a not-so-frivolous claim where an honest mistake may expose

you to millions of dollars in personal liability. In any event, the law generally favors that people be legally accountable for their wrongdoing—which is why limitation of liability clauses in professional agreements are strictly construed by courts or sometimes even unenforceable.

Using a Liability Cap

On the other hand, aside from an appraiser's desire to save his or her own hide in the event of a lawsuit, there are legitimate policy considerations for appraisers seeking to cap their liability. Is it fair for an appraiser to act as a financial backstop on multimillion-dollar transactions? The fees charged by appraisers are generally modest in comparison to the value of the properties and transactions. Moreover, it is the client that stands to gain the most economically from a transaction, be it a loan on which the lender collects fees and interest, or a transaction such as the donation of a conservation easement for which the owner seeks a multimillion-dollar tax deduction. And appraisers' clients—whether lending or non-lending—usually are in a better position than the appraiser to gauge the overall risk of a particular transaction. For example, the lender knows the borrower's credit standing and ability to pay, and sets the loan terms and interest rate accordingly. The lender is also able to spread its risk among hundreds or thousands of loan transactions. The appraisal fee, on the other hand, probably is not adjusted for the risk of a transaction and almost certainly is not based on anticipation that an appraiser may be demanded to act as a financial guarantor for an opinion of value.

Choosing to use liability caps is nevertheless an individual business decision made in light of an appraiser's own practice and whether their clients will object. When I advise my legal clients, I generally consider the commonly held notion that limitations of liability are not enforceable to be irrelevant. For most states, that is not true. When liability caps are well drafted in consideration of individual state intricacies, there is a good chance they will be enforced.

Even when not wholly enforceable, limited liability clauses can still lower the probability of an actual lawsuit or, at least, reduce the severity of lawsuits actually filed. Some lawsuits are avoided because parties will read the terms of engagement and decide against

taking legal action after seeing a liability cap. In other situations, when a lawsuit has been filed, the liability cap will have to be litigated and may cause the plaintiff to resolve the case for less than might otherwise be recovered. Thus, my general advice to clients is usually to include a limitation of liability in agreements unless doing so would hurt a client relationship at the outset.

liability to the client but also the client's liability to the appraiser. This is not considered as a weakness for most appraisal firms because the only common harm clients can inflict is failing to pay the appraiser. The clause also sets a liability cap that is meaningful and higher than the appraisal fee (unless the fee exceeds \$25,000) to overcome legal arguments that the cap is unreasonably

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A Sample Clause

Consider using a limitation of liability clause such as the one below, but only after discussing it with your own counsel:

Mutual limitation of liability. Appraiser and Client agree that the following mutual limitation of liability is agreed to in consideration of the fees to be charged and the nature of Appraiser's services under this Agreement. Appraiser and Client agree that to the fullest extent permitted by applicable law, each party's and its Personnel's maximum aggregate and joint liability to the other party for claims and causes of action relating to this Agreement or to appraisals or other services under this Agreement shall be limited to the higher of [\$25,000] or the total fees and costs charged by Appraiser for the services that are the subject of the claim(s) or cause(s) of action. This limitation of liability extends to all types of claims or causes of action, whether in breach of contract or tort, including without limitation claims/causes of action for negligence, professional negligence or negligent misrepresentation on the part of either party or its Personnel, but excluding claims/causes of action for intentionally fraudulent conduct, criminal conduct or intentionally caused injury. The Personnel of each party are intended third-party beneficiaries of this limitation of liability. "Personnel," as used in this paragraph, means the respective party's staff, employees, contractors, members, partners and shareholders. Appraiser and Client agree that they each have been free to negotiate different terms than stated above or contract with other parties.

This clause is responsive to several issues that often impede enforcement. It is mutual, limiting not only the appraiser's

low or that the appraiser has no liability risk for their negligence. The sample clause also clearly extends the cap to the appraiser's negligence, which is a matter that must be spelled out under certain state laws. Finally, the clause seeks to extend protection of the cap to each party's "personnel," because, yes, there have been cases where courts found that a liability cap only applied to the firm itself and not the individual professionals within the firm who were not parties to the agreement or specifically mentioned. ✪

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