Real Estate Appraisal Malpractice: Liability and Damages

by Peter J. Mastaglio

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Peter J. Mastaglio *practices law in Garden City, New York. He received his B.A. degree from Manhattan College and his J.D. degree from New York University School of Law. A member of the New York Bar, he specializes in litigation. This article is reprinted by permission of the* **New York State Bar Journal,** *official publication of the New York State Bar Association.*

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Traditionally, most professionals strive to produce accurate results, such as legal opinions or medical diagnoses, measurable by accepted objective standards. Assuming equal diligence and expertise, the results of similar efforts by two professionals in the same field should be consistent. On the other hand, consistency among (real estate) appraisals usually is not one of the attributes claimed for the appraisal profession . . . . For example, one of the principal reasons the accounting profession has refused to adopt current market value as the basis for financial accounting is the inability of appraisers to produce consistent value conclusions.[1] It is this belief in the inexactness of their science that has until recently virtually insulated real estate appraisers from liability for the negligent preparation of an appraisal report—in short, from liability for malpractice.

The scarcity of reported decisions in this area is changing due to forces generated by an increasing public tendency to hold all professionals responsible for negligence services and by the movement within the appraisal community to attain public recognition of its professional stature and the education, training and experience required of its members.[2] With the growing acceptance of the professional stature of real estate appraisers, their clients may be less inclined to accept the commonly-held belief that two real estate appraisers with equal training, experience and effort, may, when evaluating the same property at the same time, reach widely disparate opinions of value rather than substantially similar ones. When there is great disparity between valuations, the party relying to his detriment on one of these appraisals has the right to know why.

Standing

Since the incidence of malpractice in the real estate appraisal profession is probably as prevalent as in other professions, the number of aggrieved parties with valid but unasserted claims is necessarily substantial. The transformation of such claimants into litigants will depend upon the extent of the damages suffered and an appreciation of the reality that appraisers can be made to account for lack of professionalism.

The two most likely groups of potential plaintiffs are prospective purchasers of real estate seeking advice as to market value and lending institutions retaining an "outside appraiser" for the same purpose prior to the issuance of a mortgage commitment. To be added to these groups are persons, with no direct contractual relationship to the appraiser, whom the appraiser knows will rely on the appraisal.[3] While a purchaser may not ordinarily rely on statements of value made by his seller,[4] he may rely on the opinion of an appraiser retained by the seller when it is known to the appraiser that the appraisal would be relied on by the purchaser.[5] The same is true as to a lender relying on an appraisal furnished to the borrower.[6]

Decisions

Litigation in the professional malpractice field has been expanding rapidly from its early concentration on the medical profession into virtually every other area of expertise. There are reported decisions involving malpractice claims against engineers,[7] surveyors,[8] and even attorneys acting as title examiners.[9] Although there are relatively few reported decisions involving real estate appraisers, what may be the first reported decision dates back more than ninety years to Victorian England. In *Cann v. Willson*[10] mortgagees, relying on an appraisal, successfully sued the appraiser when it developed that the property was worth far less than its appraised value. That decision, discussed more fully below, was overruled by the Queen's Bench in *Le Lievre v. Gould*[11] on the narrow issue of privity, the appraisal having been ordered by the prospective mortgagor, but having been delivered to the mortgagee's solicitors. In another English case, *Baxter v. Gapp,*[12] an appraiser was held liable to the mortgagee for negligently appraising at 1800 pounds property which was eventually held to be worth not more than 1200 pounds.

Closer to home and of much more recent vintage are the March, 1980 and November, 1979 decisions of the First Department and the Supreme Court, Queens County, in *Chemical Bank v. National Union Fire Insurance Company of Pittsburgh,*[13] and *Fusco v. Brennan.*[14] In *Chemical Bank* the surety guaranteed payment of an obligation relying on an appraisal issued to the property owner-obligor. The First Department over a dissent affirmed the denial of the appraiser's motion for summary judgment, holding that the rule of *White v. Guarante*[15] governing an accountant's liability to third persons should be applied rather than the rule referred to above concerning a false statement by a vendor to a vendee as to the value of real property. In *Fusco* the appraiser issued his appraisal based on an understanding that it would be used for the purposes of a stockholder agreement. It was subsequently used by the owner of the property to obtain a loan from the plaintiff Welfare Fund. Trial Term found that the relationship between the plaintiff and the defendant appraiser was so tenuous that it failed to support causes of action based on negligence and breach of contract. The Court went on, however, to find that the appraiser's failure to independently verify the data supplied to him was so negligent that it warranted an inference of fraud and that the appraiser owed a duty to "all possible investors . . . to prepare the appraisal without fraud". The Court found that the appraiser "acted with negligence sufficiently gross as to warrant the inference of fraud".[16]

In *United States v. Neustadt,*[17] purchasers of residential property claimed that they were misled by a statement reporting the results of a negligently inaccurate inspection and appraisal made by an FHA appraiser. Although the lower Federal courts held that the United States was liable for the negligent misrepresentation, the Supreme Court reversed on the ground that the claims were not actionable under the Federal Tort Claims Act. In *Breckinridge Hotels Corp. v. Real Estate Research,*[18] hotel developers claimed that an appraiser twice mistakenly calculated a tax preference item. The appraiser was held liable for damages attributable to a three-month delay caused by its error. In *Stotler v. Hester*[19] an appraiser erroneously calculated the square footage of the property. The New Mexico court held that a purchaser of the property who relied on the appraisal was entitled to recover from the appraiser, even though the purchaser was not in privity of contract with the appraiser, based on the theory of negligent misrepresentation, and on a third party beneficiary theory.

Quality of Proof

In any malpractice case, the plaintiff must prove not only negligence, but also the existence and extent of the resulting damages. In an appraisal malpractice case, reliance on the appraisal report is an additional necessary element.[20]

It is not sufficient to show that the defendant was negligent in preparing the appraisal report, since it is possible that, despite the negligence, the valuation may still substantially reflect the property's true market value. If this were the case, plaintiff would be unable to prove that he was damaged as a result of the appraiser's negligence. Therefore, to succeed plaintiff must introduce evidence of the true market value of the property as well as evidence of the defendant's negligence, i.e. how the defendant deviated from accepted practice in the profession.[21] In *Baxter v. Gapp,* one of the Court of Appeals judges in a concurring opinion seemed to imply a shifting of the burden of going forward with evidence of negligence once the plaintiff introduces evidence of gross overvaluation.

Gross overvaluation, unless explained may be strong evidence either of negligence or incompetence. I have no doubt that there was in this case gross overvaluation, and one looks to see whether or not there is any explanation of it, and whether or not it can be seen that the defendant has failed to take any steps which he ought to have taken, or to pay regard to matters to which he ought to have paid regard.[22]

Although distinction in the complaint as to causes of action for negligence and breach of contract may have some limited significance in a given case, e.g. the applicable statute of limitations and the effect of contributory negligence in a jurisdiction where such negligence is a total defense, the proof required to establish the plaintiff's case under either cause of action should be the same.

If the real estate appraisal profession is unique, it is probably due in part to the high percentage of subjective considerations that influence the end result. For example, the valuations reached through the cost, market data and income approaches are dependent to a great extent on the depreciation formula to be applied in evaluating a building (cost), the comparability of sales and rentals (market data and income) and the capitalization rate (income). If the result in a given case is dependent on proving that the appraiser failed to use a particular comparable sale or rental or used a capitalization rate that was too low or too high, the chances of proving that the defendant was negligent are slim. However, if the deviation from accepted practice is obvious or if, without adequate explanation by the defendant, it can be shown that in all of his prior appraisals the appraiser never used such a low or high capitalization rate, then perhaps the burden of proof will be met.

To avoid the roadblock presented by the aura of subjectivity which seems to insulate real estate appraisers from malpractice liability,

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the plaintiff's attorney should concentrate most of his efforts on the appraisal report's bank of objective data against which the subjective formulae are applied. He should show, for example, that, even using defendant's comparables or capitalization rate, but applying the correct annual rental or square footage, the end result will be a value substantially different from defendant's appraisal. In short, plaintiff must isolate the point or points where defendant made his mistakes and demonstrate that, were it not for those errors, defendant and plaintiff's experts would be in substantial agreement as to value.

In preparing for trial one of the most important factors for attorneys to keep in mind (especially those with experience in the condemnation and tax certiorari fields) is the trier of fact's relative lack of appraisal sophistication. Since the action seeks a money judgment, either party is entitled to a jury trial.[23] Even in a non-jury trial the judge will most likely be assigned from the ranks of the Trial Term judges and will probably not be the judge sitting in the condemnation and tax certiorari part. While the Court and counsel in condemnation and tax certiorari proceedings tend to focus on cross-examination of the various experts with few, if any, objections being raised on direct examination, qualification of the expert in an appraisal malpractice action may well prove impossible if the expert witness is not well prepared. An isolated example in a recent jury trial[24] involved objections raised by defense counsel to the use by plaintiff's expert of "comparable sales" in reaching an opinion of the value of the subject property as of the date of the questioned appraisal made six years before the trial. In support of his objections counsel argued that the expert was not able to compare the physical characteristics of comparables and the subject property when he had never inspected them until approximately six months before the trial. The expert eventually correctly stated that his testimony and ultimate opinion as to comparability were based on assumptions as to the condition of each building. As to the condition of the subject property, he had the benefit of the defendant's appraisal report and, as to the condition of the "comparables" (industrial buildings), he noted that the important features were the four walls, the roof and the other basic components and that the presence or absence of cosmetic improvements in particular buildings had little bearing on their value. If the expert had not been able to bridge that time gap, the trial judge might not have permitted him to give further opinion testimony.

Contributory Negligence

In keeping with the adage about a good defense, a fertile ground for any counterattack by the defendant may be the underlying transaction necessitating the appraisal request. An examination of the circumstances attending the plaintiff-purchaser's purchase of the property or the plaintiff-lender's making of the mortgage loan could very well lead to revelations as to plaintiff's poor business practices. Whether that conduct can be elevated to the status of a defense necessarily depends on whether the expert's failure to exercise due care, in whole or in part, caused the damage.[25]

The lender, as an example, may seek an appraiser's opinion as to the value of property in order to assure himself that, in the event of default, he will have adequate security. The lender first looks to normal sources of repayment, and, only after default, does he turn to the security. The need for security of a value sufficient to cover the indebtedness and provide a margin of safety, as required by statute[26] and sound lending practice, presupposes that the borrower may default. In short, the security is the lender's insurance against a mistaken credit decision respecting the ability of the borrower to repay the loan.

In determining the causal effect of the lender's negligence in making the loan, a calculation must first be made of the loss that the lender suffered as a result of the appraiser's negligence. At first glance, it would appear that the balance due on the loan would meet the definition of loss and, if so, did not the lender's negligence contribute to that loss? On the other hand, it can be argued that the loss arises from the fact that the lender found himself in a situation where, when faced with a defaulted loan, he had to look to security that was substantially less in value than had been contemplated. This latter approach was adopted by two courts applying New York law in *National Surety Corp. v. Lybrand*[27] and *Shapiro v. Glekel*.[28] Both cases deal with claims against accounting firms for failure to detect defalcations or inaccuracies in financial records. In both cases the courts rejected on similar grounds the defense of contributory negligence, with the *Lybrand* Court holding that:

Accountants, as we know, are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible. Accordingly, we see no reason to hold that the accountant is not liable to his employer in such cases. Negligence of the employer is a defense only when it has contributed to the accountant's failure to perform his contract and report the truth.[29]

The distinction drawn in the last quoted sentence is an important one. If the plaintiff through negligence prevented the appraiser from doing a professional job or so misled him on some particular as to influence the end result of the appraisal, the defense should apply. But, where plaintiff's negligence relates solely to the making of the loan (in the case of a lender) or the purchase of property (in the case of a purchaser), the defense should not apply.

Damages

As long as the value of the appraised property has not depreciated prior to trial and the plaintiff has not expended any monies above his purchase price or the amount of his mortgage, he should be satisfied, assuming that he can show a loss,[30] with a judgment covering either the difference between the value as appraised and the actual value or the difference between the mortgage loan actually made and that which would have been made but for the negligent appraisal. However, when the property with which plaintiff is left, either as owner or mortgagee lienor, has depreciated in value or plaintiff's expenses in relation to the property have mounted, plaintiff, in order to be made whole, will require, because of the changed circumstances, more than *status quo ante* relief. The plaintiff should claim the full amount of his investment, i.e., the purchase price or the outstanding loan balance, and then be prepared to turn over to the defendant whatever interest he may have in the property.

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In *Baxter v. Gapp*, the plaintiff-lender was able to demonstrate that he would not have made the loan had he been aware of the true valuation. The English Court of Appeals held that his damages comprised his loss of interest and capital insofar as it had not been reduced as a result of the sale of the property. In short, plaintiff was held entitled to what he "...lost by being led into this disastrous investment."[31] However, if it appears that the loan would still have been made, but in a lesser amount, the measure of damages would be the difference between the mortgage loan and the lesser loan that would have been made.[32] The same distinction should apply to purchasers of real property who can show that they would not have purchased had they known the true value.

Conclusion

Although the public requires of the real estate appraisal profession considerably less conformity of opinion than it requires of the other professions, the public (and presumably a jury) will not stand still for an unprofessional effort when it involves the sloppy compilation of objective data, and especially when one or more experts prove to the public's satisfaction that the actual value of the property is "substantially" higher or lower than originally appraised. The public's reaction to this situation has in the past and should more frequently in the future be a stimulus for litigation.

[1]*Smith, Value Concepts as a Source of Disparity Among Appraisals, 45 Appr. J. 203 (1977).*

[2]*Cook, Toward Professionalism: Developing a Real Estate Discipline, 42 Appr. J. 222 (1974).*

[3]*Cf. Glanzer v. Shepard, 233 N.Y. 236, 235 N.E. 275, (1922).*

[4]*Sellers' statements of value are considered to be only opinions, not equivalent to factual assertions upon which a claim for misrepresentation may be founded. 24 N.Y. Jur., Fraud and Deceit, § 75 (1962).*

[5]*Cf. White v. Guarente, 43 N.Y. 2d 356, 361, 401 N.Y.S.2d 474, 372 N.E.2d 315 (1977).*

[6]*See 24 N.Y. Jur., Fraud and Deceit, §77 (1962); and see Chemical Bank v. National Union Fire Insurance Company of Pittsburgh, 74 A.D.2d 786, 425 N.Y.S.2d 818, (1st Dept.), leave to app. granted, 76 A.D.2d 823, N.Y.S.2d (1st Dept. 1980).*

[7]*St. Rita's Home Inc. v. Town of Amherst, 38 A.D.2d 109, 327 N.Y.S.2d 674 (4th Dept. 1972).*

[8]*R.H. Bowman Associates, Inc. v. Danskin, 72 Misc.2d 244, 338 N.Y.S.2d 224 (Sup. Ct. Schen. Cty. 1972).*

[9]*South Shore Brick Masons Inc. v. Steele, N.Y.L.J., June 23, 1976 at 14, col. 1 (Sup. Ct. Suff. Cty. 1976).*

[10]*39 Ch. D. 39 (1888).*

[11]*1 Q.B. 491 (1831).*

[12]*1 All E.R. 752 (C.A. 1939).*

[13]*supra, note 6.*

[14]*N.Y.L.J., July 30, 1979, at 13, col. 4 (Sup. Ct. Queens Cty. 1979).*

[15]*supra, note 5.*

[16]*supra, note 14, at 13, col. 5.*

[17]*366 U.S. 696, 6 L Ed.2d 614, 81 S.Ct. 1294 (1961).*

[18]*452 F.Supp. 529 (E.D.Mo. 1978).*

[19]*92 N.M. 26, 582 P.2d 403 (N.M. Ct. App.), cert. den. 92 N.M. 180, 585 P.2d 324 (N.M. Sup. Ct. 1978).*

[20]*Cf. Fed. Savings & Loan Insur. Corp. v. Cook, 419 F.2d 1296, 1297 (7th Cir. 1970).*

[21]*See, e.g., Goodman v. Emergency Hospital, 96 Misc.2d 1116, 410 N.Y.S.2d 511 (Sup. Ct. Erie Cty. 1978) (medical malpractice claims).*

[22]*Baxter v. Gapp, supra, note 12, at 758.*

[23]*N.Y. CPLR § 4101(1) (McKinney's 1971).*

[24]*Nassau Trust Company v. Sutton & Towne, Inc., Supreme Court, Nassau County (Index No. 19587/76).*

[25]*Cf. Spier v. Barker, 35 N.Y.2d 444, 451, 363 N.Y.S.2d 916, 323 N.E.2d 164 (1974).*

[26]*N.Y. Banking Law §§ 103(4), 235(8), 380(2), (McKinney's 1971).*

[27]*256 App.Div. 226, 9 N.Y.S.2d 554 (1st Dept. 1939).*

[28]*380 F.Supp. 1053 (S.D.N.Y. 1974).*

[29]*National Surety Corp. v. Lybrand, supra, note 26 at 235.*

[30]*The misled purchaser's loss is prima facie the difference between the actual and the appraised value. The lender, on the other hand, will presumably have to demonstrate through foreclosure or otherwise the inadequacy of his security.*

[31]*Baxter v. Gapp, supra, note 12, at 758.*

[32]*Singer and Friedlander, Ltd. v. John D. Wood & Co., 243 Est. Gazette L. Rep. 212 (Q.B. 1977).*