The Price is Right--Considerations for Avoiding E&O Claims from Property Valuations

Recommendations for navigating the role of real estate appraiser for customers and lenders.

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At the heart of America's longest-running game show, "The Price is Right®," is an age old and deceptively simple question: "What's it worth?" Deceptive, indeed. If the answer was easy, the show would not have lasted 41 years. For more than 7,800 episodes contestants have been venturing their best guesses about the cost of everyday items. And, time after time, most of those guesses have been wrong.

A similar, but far less entertaining contest rages among a very different set of contestants over the valuation of real estate, both residential and commercial. Carriers want covered properties insured to full replacement cost, with premiums to match. Property owners, on the other hand, want low premiums – but "full coverage" in the event of a complete or partial loss. Lenders just want their loans secured, but increasingly, they are reluctant to offer appraisals that others might rely upon to their detriment.

Their collective unease is understandable. In recent years this difficult task has become more so as the cost of new construction moved in anything but a straight line. In the face of this storm, to whom do our contestants turn for valuation advice? The humble – insurance agent.

That is a role agents should decline. Dabbling by insurance agents in unfamiliar lines of business has always been ill-advised. Dabbling in other professions entirely – *like real estate appraisal* -- can be downright perilous.

Commercially available 'replacement cost estimator' programs may be used to fill the 'expertise gap,' but those programs, too, have their limitations. They cannot bring order, logic ***and*** predictability to the roller coaster U.S. real estate and construction markets.

Yes, they are better – ***much better*** – than merely guessing (or ignoring the issue altogether), but if you take a look at the disclaimers attached to those programs you will see just how sure their creators are of their digital crystal ball's accuracy. They understand better than anyone how many variables affect the outcome and how many alternate scenarios may play out, especially over time.

To make matters worse, third parties such as lenders are now attempting to offload their own appraisal burdens onto agents. They are not customers. They pay no fee or commission. Yet they boldly request copies of the broker's replacement cost estimates with a simple endgame in mind: if it turns out to be wrong such that there is a shortfall in coverage, blame the agent and force him to pay the difference. The simple answer to those requests: just say no.

What does the busy insurance agent know about a property's value that a mortgage lender does not? Because of the business they are in, lenders are in a far better position, in terms of both volume and resources, to ascertain whether a particular property is adequately insured – at least when it comes to limits. Their reluctance to do so is instructive, to say the least. They have learned a hard lesson over time: they do not know whether 'the price is right,' and cannot afford to be wrong. Can you?

Agency procedural considerations:

Here are some recommendations that agents should consider when assessing their own operation and current procedures involving the determination of property values for replacement cost purposes:

- Do not agree to become an appraiser in the first place. Instead, urge customers – *in writing* -- to have their property (re)appraised by a licensed professional on a regular basis to ensure that the limits in place are, and remain, adequate.

- Make sure the customer understands the definition/concept of ‘replacement cost’. Explain that the 'replacement cost' of a building will likely exceed both the 'actual cash value' and 'purchase price' of a building, often by a significant margin.
- Explain what a *'coinsurance penalty'* is, and how a loss may not be fully covered even if it is within policy limits. Consider highlighting the provision in the policy.
- Offer some examples of resources you might suggest to find a ***licensed*** appraiser include:
  - www.appraisalinstitute.org
  - www.appraisers.org
  - State/provincial licensing boards, e.g., www.myfloridalicense.com/dbpr/re/freab.html
  - Other alternatives: reconstruction cost estimates by licensed general contractors, architects or engineers.
- Document your recommendation that a licensed professional be consulted, as well as the customer's refusal to do so.
- Make clear to the customer the ***substantial*** limitations on your training and experience as an appraiser – particularly with respect to determining the "replacement cost" of a commercial or residential building – and document those warnings, too.
- If you use one of several commercial 'replacement cost estimator' programs on the market to arrive at a number, provide a copy of the program's disclaimer (it's sure to have one) to the customer, indicating that your estimate is subject to the same limitations. Offer the figure to your customer as evidence that the current number is too low and that a professional valuation is needed.
- Replacement cost estimators are affected by a number of variables, e.g., location, square footage, usage, materials and design. Document the information used in arriving at an estimate and the source of that information.
- Be explicit: construction costs go up every year by varying amounts, depending on market conditions. So should policy limits. A yearly 'inflationary increase' likely will not keep pace with the cost of construction, which brings you back to the subject of periodic appraisals.
- Request that the carrier confirm that the property is insured to replacement cost such that no coinsurance penalty will apply.

Above all, place the final decision firmly in your customer's lap.