THE VALUATION OF DISTRESSED PROPERTIES AND DEFINING THE VALUE

BY DAVID BABINEAU, AACI, P.APP, FELLOW
VOLUNTEER ON THE APPEAL SUB-COMMITTEE

"IF YOU ARE ASKED TO PREPARE AN APPRAISAL OF A PROPERTY WITH THE PURPOSE OF ESTIMATING A VALUE OTHER THAN MARKET VALUE, YOU MUST INCLUDE A RELEVANT DEFINITION OF THE VALUE YOU ARE ESTIMATING."

The purpose of this article is to provide some clarity in regard to a challenging appraisal problem – *the valuation of distressed property*, while the intent of the article is to prevent the appraiser from becoming more distressed than the property he or she is asked to value.

Let's start by trying to clarify what the term 'distressed property' means in the context of real estate appraisal. According to the *Business Dictionary* (*businessdictionary.com*), a definition of the term 'distressed property' is as follows:

> *Property that is under a foreclosure order or is advertised for sale by its mortgagee. Distressed property usually fetches a price that is much below its market value.*

The preceding definition provides a description of what may transpire in a forced sale situation in Canada – or does it?

In Canada, the 'power of sale' process is most often employed by lenders when a borrower defaults on their mortgage obligations. From an appraiser's perspective, this process differs from a 'foreclosure' in two important aspects. First, ownership of the property does not change hands until the property is sold in a power of sale proceeding, whereas the lender becomes the owner of the property as a result of foreclosure. Second, any extra money from the sale of the property goes to the homeowner in a power of sale situation, while the lender has the right to keep any extra money (proceeds in excess of the unpaid loan, arrears and expenses) in a foreclosure action. The distinction between the power of sale process and a foreclosure may have some important liability implications for appraisers, but more about that later.

Where a distressed property may fetch a price that is **below its market value** [emphasis added], then the appraisal of a distressed property calls for a valuation that is different from market value and it is critical the client and the intended user of the report understand that this is the case.

According to 2014 edition of the *Canadian Uniform Standards of Professional Appraisal Practice* (*CUSPAP*), an acceptable definition of 'market value' is as follows:

> *The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.*[1]

As most of us are aware, this definition may be expanded by adding the following:

> *Implicit in this definition are the consummation of a sale as of the specified date and the passing of title from seller to buyer under conditions whereby:*
>
> - *buyer and seller are typically motivated;*

FORECLOSURE

HOUSE FOR SALE

"THE DISTINCTION BETWEEN THE POWER OF SALE PROCESS AND A FORECLOSURE MAY HAVE SOME IMPORTANT LIABILITY IMPLICATIONS FOR APPRAISERS."

- *both parties are well informed or well advised, and acting in what they consider their best interests;*
- *a reasonable time is allowed for exposure in the open market;*
- *payment is made in terms of cash in Canadian dollars or in terms of financial arrangements comparable thereto;*

Therefore, if the appraisal of a distressed property is to provide an estimate of value that is less than 'market value,' what terms and/or conditions have been altered or are omitted from the preceding expanded definition?

Perhaps the following definitions from *The Dictionary of Real Estate Appraisal* (*Fourth Edition*) may provide some answers to this question:

Forced sale

1. *Offering and transferring property for a valuable consideration under conditions of* ***compulsion*** [emphasis added].
2. *A sale at public auction made under a court order.*

Forced price

The price paid in a forced sale or purchase, i.e., a sale in which a ***reasonable time was not allowed*** *[emphasis added] to find a purchaser or the purchaser was forced to buy.*

Distress sale

A sale involving a seller acting under ***duress*** [emphasis added].

Although the preceding definitions were written in the context of the foreclosure process, they still provide some valuable clues as to how the valuation of a distressed property in a power of sale proceeding may differ from an appraisal where the sole purpose is to estimate market value.

Referring again to the definition of market value contained in the 2014 version of *CUSPAP*, we find that some of the conditions that expand the definition may not be met. Due to the fact that the seller may be acting under compulsion or duress, they may not be 'typically motivated' in a power of sale proceeding. Also, a reasonable time may not be allowed for exposure in the open market.

So, what do you do when you receive a call from a lender or their representative asking you to prepare an appraisal of a property in forced sale circumstances? What do you do if the lender or their representative requests you to estimate a value based on a 30- 45-day sale period, when the typical exposure period in the marketplace is 180 days?

The recommended first step would be to refer to the relevant edition of *CUSPAP*. The 2014 edition of *CUSPAP* can be found at: ***http://www.aicanada.ca/canadian-uniform-standards/***

In the current version of *CUSPAP*, you will find a definition of value (Definition 2.63), which contains the following note:

Value expresses an economic concept. As such, it is never a fact, but always an opinion of the worth of a property at a given time in accordance with a specific definition of value. In appraisal practice, value must always be qualified, e.g., market value… liquidation value, investment value, rental value, or other.

"AN APPRAISER IS ADVISED TO USE CAUTION AND CAREFULLY EXPLAIN WHAT VALUE HE OR SHE IS ESTIMATING IN THE APPRAISAL AND HOW THAT VALUE MAY DIFFER FROM MARKET VALUE."

Remember that under *CUSPAP* definitions are compulsory and as such an appraiser must provide a specific definition of the value that is being estimated. Therefore, if you are asked to prepare an appraisal of a property with the purpose of estimating a value other than market value, you must include a relevant definition of the value you are estimating.

CUSPAP defines Forced Sale Value as follows (Definition **2.31) :**

> *Term synonymous with "liquidation value", "distress sale" or "power of sale"* ***implying a reduced selling period and compulsion to sell****. Forced sale value is not a concept separate from market value but* ***is a form of marketing conditions less favourable to the seller*** *than those set out in the definition of market value.*

So, hopefully you now understand how the power of sale process may impact the standard definition of market value and that it is incumbent upon you to provide an alternative definition of value in an appraisal where you are estimating a value other than market value. But what are some best practices to employ when you are asked to provide a 'forced sale value?'

- Ask for terms of reference; if they are not available, craft proposed terms of reference in your letter of engagement. It is important that the client understand what you are (or are not) going to include in your appraisal and any proposed extraordinary assumptions and hypothetical conditions should be clearly stated.
- Clearly identify the proposed marketing time assumed in the appraisal and comment on how this may vary from the typical exposure time. Explain how the proposed marketing efforts are different (if applicable) from a typical situation.
- Provide a definition of the value you are estimating and clearly explain how this value differs from market value. A bold statement to the effect that the reported value is not market value would be advisable.
- Be very diligent in describing the condition of the property, as of the date of inspection, particularly noting any components that show excessive deterioration – take plenty of photographs.
- Make every effort not to mislead a reader of the appraisal report.

This last point leads us back to how appraisals prepared in a power of sale proceeding may have some important liability implications for appraisers. Remember that, in a power of sale situation, the owner of the property is entitled to any extra money from the sale. Therefore, an appraiser is advised to use caution and carefully explain what value he or she is estimating in the appraisal and how that value may differ from market value. Although you may have been engaged by the lender or their representative and have clearly identified them as the only intended user, it may not prevent the owner of the property attempting to sue an appraiser for any 'shortfall' between market value and the amount received as a result of the power of sale proceedings. However, following the suggested best practices, as well as demonstrating competence and due diligence will go a long way in mitigating risk.

For further information, you are encouraged to read a *Professional Excellence Bulletin* entitled 'Appraisal for Foreclosure Purposes,' which can be found in the Members Section of the AIC website under the Professional Liability Insurance tab at *http://www.aicanada.ca/wp-content/uploads/PEB-Foreclosure-EN.pdf*

While the methodology you employ in an assignment where the purpose of the appraisal it is to estimate 'forced sale value' may vary due to the availability of data and other local market conditions, the following course of action provides a suggested roadmap that a reasonable appraiser might follow:

- Start by clearly identifying the client and intended user of the report.
- Explain the purpose and intended use of the report. Provide a definition of the value to be estimated and explain how this definition is different from the definition of market value contained in CUSPAP or some other relevant source.
- Clearly identify any extraordinary assumptions and hypothetical conditions in the report.
- In the valuation section of the report, start with an estimate of market value based on a typical exposure period and include a definition of market value.
- If available, gather and analyze transactions involving forced sale circumstances. Pair these transactions with sales of similar properties wherein typical marketing time and effort occurred. The resultant difference should be indicative of the 'discount' applied to properties sold under power of sale proceedings. However, a careful investigation of the circumstances of any such transaction must be undertaken to ensure that you are comparing 'like with like.'
- If information pertaining to transactions involving forced sale circumstances is not available, the appraiser may be able to develop a discount factor based

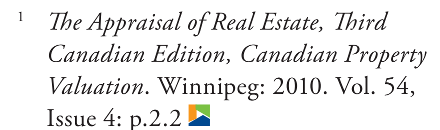
on a review of current market conditions including the extent of competitive properties for sale, the length of market exposure of expired listings, trends in the number of properties listed, etc. If a discount factor is developed in this manner, the appraiser should thoroughly explain to the reader what steps were taken to develop the discount factor. Given a lack of first-tier market data, a discount factor range may be more meaningful.

- Another possible source of information that may support a discount factor for an abbreviated exposure period is an analysis of transactions where the property was sold after say 30 days when the typical exposure period in the overall market was say 180 days. Although the property may not have sold as a result of power of sale proceedings, if the sale price was measurably less than it might otherwise have been with a typical exposure period (market value), the difference may be attributable to an abbreviated exposure period. For example, such a situation could occur if the vendor had already purchased another home and wanted to avoid the cost of carrying two properties, or where a vendor was experiencing financial duress and needed to quickly dispose of their property.

" THERE IS DEMAND FOR THIS TYPE OF WORK IN THE MARKETPLACE AND IT CAN BE REWARDING."

In summary, the appraisal of distressed properties does present appraisal challenges. However, there is demand for this type of work in the marketplace and it can be rewarding. If appraisers follow the suggested best practices and employ relevant methodology, they should be able to complete assignments where the purpose of the appraisal is to estimate value in a forced sale situation with greater confidence and limited risk. In turn, this should minimize the challenges and maximize the rewards.

End note



[1] *The Appraisal of Real Estate, Third Canadian Edition, Canadian Property Valuation*. Winnipeg: 2010. Vol. 54, Issue 4: p.2.2