The role of buyer knowledge

in real estate valuation

BY **MICHAEL TACHOVSKY**, PHD. AND **KRISTOPHER WILLIAMS**

Michael Tachovsky, PhD

Kristopher Williams

Many, if not most, valuation assignments involve the application of the cost, income, and sales comparison approaches to value. However, complex issues can frequently arise that involve either beneficial or detrimental conditions which can influence the value of real estate. Beneficial conditions, such as the discovery of minerals or oil on grazing land, can result in an increase in value. Detrimental conditions, such as natural disasters or environmental contamination, could result in a diminution in value. In summary, the field of 'complex valuation' involves real estate characteristics that are 'atypical.' (*Federal Regulations Part 34.42*.).

When complex valuation issues arise, developing an opinion of value may present challenges and transactional data may be limited. However, it is not an impossible challenge. Appraisers have a variety of tools that can be used to solve such a problem. Indeed, many of the techniques available to real estate valuation professionals are expansive in practice, as the professional standards do not limit an appraiser's data to specific geographical bounds or periods of time.[1] However, when potential data is identified, an analysis of buyer awareness may be necessary to determine whether market participants are knowledgeable of the condition being measured.

> "When potential data is identified, an analysis of buyer awareness may be necessary to determine whether market participants are knowledgeable of the condition being measured."

Making assumptions about buyer or market-wide knowledge can result in an invalid and misleading opinion of value.[2] For example, a seller may not know that their property is 'contaminated,' and disclosure of the contamination may not occur. Although the market participants are not aware of the contamination issues, an appraiser may later be provided with scientific evidence and must account for the buyer's and sellers' lack of knowledge.

Knowledge in the valuation process

Knowledge is a critical element in economics, including real estate markets. In both the stock and real estate markets, there are mottos such as "knowledge is power" and "information is king." These and other markets are impacted by the level of knowledge held by the individual buyers and sellers.

A fundamental aspect of appraisal is the definition of Market Value, which is premised on a knowledgeable buyer and seller, and is defined 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. (Appraisal Institute: *The Appraisal of Real Estate 15th Edition*. **Emphasis added.**)"

By definition, Market Value mandates that both buyers and sellers are acting knowledgeably about the risks and uncertainties associated with a property. If the market or individual buyers are uninformed, partially informed, or misinformed, then that impaired knowledge can affect market transactions and the appraisal process. There are some well-known illustrations of these principles. For example, if properties are sold where the buyers and sellers lack knowledge that the site holds significant mineral rights and oil reserves, then the sales price may not reflect its Market Value. The property could be worth significantly more if the buyers and sellers had knowledge of these factors.

Similarly, if a buyer is uninformed, then the sales price of the property at issue may not reflect the Market Value. For example, if the property is sold where the buyer is uninformed, partially informed, or misinformed about a material latent defect, such as it being within a flood zone, then the sales price may not reconcile with the price paid when a buyer is informed of potential flood risks. On the other hand, when the buyer is well-informed of the benefits, risks, and uncertainties of owning and occupying the property, then the effects, if any, of either a beneficial or detrimental condition would typically be reflected in the transactional market data.

As such, if a market lacks awareness of a condition, that does not automatically mean that the condition has no impact on Market Value. Robinson and Lucas set forth that an "appraiser cannot use the transaction as an impaired sale to measure the condition's effect on value" if a buyer lacks awareness of the detrimental condition.[3] However, the Appraisal Institute later published that "those sales actually do reveal the effect of that condition on prices and therefore values in that particular market"[4] and furthermore, that "the knowledge standard against which that is determined is actual knowledge of typical buyers and sellers in the marketplace."[5] The anecdote of 'actual knowledge' is dangerous, as it can be a false premise when an appraiser is provided with conflicting evidence regarding a detrimental condition.

Contrary to the anecdote of 'actual knowledge,' there are thousands of lawsuits filed every year claiming real estate damages for the non-disclosure of detrimental conditions. In these lawsuits, property owners often state, "I would not have paid the same price had I **known** about the detrimental condition," or even, "I would not have purchased the property had I **known** about the detrimental condition."

Simply stating that 'actual knowledge' reflects the knowledge standards of a marketplace is merely an appeal to ignorance, as it does not address the contrary evidence of a detrimental condition that exists. Rather than appealing to ignorance, a real estate valuation professional should study buyer awareness

> "If the market or individual buyers are uninformed, partially informed, or misinformed, then that impaired knowledge can affect market transactions and the appraisal process."

> "Rather than appealing to ignorance, a real estate valuation professional should study buyer awareness to determine if a market is well-informed of the nature and extent of the detrimental condition(s) being studied."

to determine if a market is well-informed of the nature and extent of the detrimental condition(s) being studied, as the 15th Edition also sets forth that "appraisers verify information with a party to the transaction to ensure its accuracy and to gain insight into the motivation behind each transaction."[6]

Disclosure laws, requirements, and the media

Although there can be legislated disclosure requirements, one must be aware of a condition in order to disclose it. Even if someone is aware, they may not fully understand the risks and uncertainties to properly disclose. An analysis of transfer disclosure statements (TDSs) or verifications with transaction participants are both ways to study buyer awareness.

Some detrimental conditions are self-evident. For example, a recent wildfire will likely have burn zones (for a period of time) that act as visual cues to market participants. Nonetheless, some environmental issues may be less evident for market participants, as general detrimental cues may be absent. For instance, contaminants themselves may be colorless, odorless, and tasteless. Even if some detrimental cues exist, market awareness of the detrimental condition may still be lacking, as detrimental cues might not be recognized by all market participants.

Real estate valuation professionals should be cautious when generalized terms such as "public awareness" and "community awareness" are used to describe property-specific awareness. These generalized terms can be misleading. For example, one can be aware as a general member of the public or a community that there was a wildfire in Malibu, California; nevertheless, this is not enough information to inform them if a specific property has burnt in a fire.

Furthermore, media coverage of a property condition does not necessarily create an informed market because: a limited percentage of the population may read or watch local news, media coverage on an issue may be time-sensitive and only covered for a short period of time, buyers from outside the area are less likely to have witnessed local news stories on the issue, and media may not disclose the specific property or properties condition.

As such, a real estate valuation professional should be careful not to assume that the mere existence of media attention indicates widespread public knowledge.[7] Simply looking at media is not enough because media coverage does not inform whether the actual market participants had that knowledge. Moreover, if detrimental cues are lacking, and market awareness of the detrimental condition is lacking in a study area, real estate valuation professionals may consider techniques such as case studies, surveys, and literature reviews to measure risk effects, if any, on property values.[8]

Challenges in identifying knowledgeable buyers

The challenge to identify knowledgeable market participants has been discussed in various complex valuation scenarios, including partial takings for pipelines. For example, *Applications in Litigation Valuation: A Pragmatist's Guide* states:

> "It is always a challenge to find knowledgeable market participants to give those interviews greater meaning in our evaluations. An equal or greater challenge is finding market sales comparables to use in quantifying our after-taking adjustment for having a pipeline easement on the appraised property."

In the *Appraisal Journal*, Winter 2006 Letters to the Editor, a buyer of a condominium that had been in a lawsuit expressed caution about merely assuming buyer knowledge because of the existence of disclosure laws and Realtors© *Code of Ethics and Standards of Practice* requirements. Prior to purchasing the condo, there were issues in a lawsuit that were remedied by the HOA, such as failure to include firewalls and a failed roofing system; however, the buyer noted that the issues driving the lawsuit were not observable upon typical inspection. The buyer noted that they conducted as much investigation as possible prior to making an offer, including reading property tax complaints filed in the assessor's office, interviewing potential future neighbors, and contracting the manager of the HOA with questions. Nobody in the complex had complained for property tax purposes on loss of value attributable to failed

> "Real estate valuation professionals should be cautious when generalized terms such as "public awareness" and "community awareness" are used to describe property-specific awareness."

> "If detrimental cues are lacking, and market awareness of the detrimental condition is lacking in a study area, real estate valuation professionals may consider techniques such as case studies, surveys, and literature reviews to measure risk effects, if any, on property values."[8]

construction systems; neither the potential neighbors, real estate agents, nor the HOA manager disclosed the failed construction systems or the lawsuit. Moreover, on the seller disclosure sheet, which was required by law, the seller had answered all questions "unknown." The buyer did not learn about the problems until after purchasing the property when a bill from the HOA arrived for attorney's fees for the lawsuit and after attending an HOA meeting.

When studying transactional data to measure the impact of a beneficial or detrimental condition, the buyer's level of knowledge at the time of sale can be a critical factor. A buyer with knowledge of the condition being measured allows for an informed pricing decision. Alternately, if a buyer is misinformed or ignorant, they cannot account for it in their pricing decision.

Transfer disclosure statements

Market Value does not establish that a market participant must have 'perfect' knowledge of a detrimental condition, but participants should be well-informed of a detrimental condition for a transaction to be consistent with the definition of Market Value, as is requisite of an arms-length transaction.[9] When the participants of a real estate market are knowledgeable of environmental influences (or other conditions), the price of properties in the study area will either react or not react based on the perception of risk and the potential impact of the conditions.[10]

Robinson and Lucas suggest using a questionnaire to determine market awareness of a detrimental condition, noting that their proposal of a questionnaire is distinct from a formal survey.[11] Additionally, buyer awareness of a detrimental condition can also be studied by analyzing real estate transaction documents and marketing material, such as Transfer Disclosure Statements and MLS listings, when available. If transactions are identified that disclose the nature and extent of the detrimental condition, those transactions can be studied to measure the impacts, if any, of the condition.

Transfer disclosure statements provide evidence of the buyer's level of knowledge regarding various property conditions at the time of sale. For a buyer to consider a certain property condition when making a pricing decision, the buyer must be aware of the condition. If a buyer is unaware or ignorant of a certain property condition, they cannot take it into account. Likewise, if an appraiser wants to measure the impact of a condition on the value of a property, then sales where buyers were knowledgeable of a similar condition should be analyzed.

During the gathering and analysis of disclosures, the data may reveal different levels of knowledge among buyers regarding certain conditions. For example, a disclosure on PFAS contamination may state that "PFAS was tested in well water, household water was hooked up to a municipal source." However, the seller was unaware that the municipal water also contains PFAS. Another disclosure may state that "PFAS was tested in well water, household water was hooked up to municipal which also contains PFAS at a level above the regulatory MCL."

Although both disclosures mention PFAS, there is a different level of knowledge being passed on to the buyer. In these instances, a real estate professional can consider using a ranking analysis to categorize the data. One such example would be to group the disclosures into three categories: ***Type 1: No Known Significant Disclosure, Type 2: Positive, Neutral, or Ambiguous Disclosure, and Type 3: Detrimental Disclosure.*** Ideally, Type 3 transactions will give the best indication regarding the Market Value effects of a given condition.

Conclusion

Issues around buyer knowledge can be a central theme in complex valuation. Determining the potential impact of a plume of contaminants on property values may not be achieved by simply comparing sales inside the plume to those outside of the plume. Further research may be necessary to determine whether buyers were knowledgeable of the condition of the property that they purchased. One way to study buyer knowledge is through an analysis of transfer disclosure statements in the transactions being studied. If a lack of knowledge exists, a real estate valuation professional can consider utilizing techniques such as literature reviews, surveys, or case studies to measure impacts on Market Value.

End notes

1. Appraisal Institute, *The Appraisal of Real Estate, 15th Edition* (Chicago, IL: 2020), 356.
2. Robinson and Lucas, "Seller Disclosure and Buyer Knowledge: How they Affect Market Value," *The Appraisal Journal* (Spring 2007): 139.

[3] Robinson and Lucas, "Seller Disclosure and Buyer Knowledge: How they Affect Market Value," *The Appraisal Journal* (Spring 2007): 136.

[4] Richard Roddewig (Editor), *Valuing Contaminated Properties: An Appraisal Institute Anthology Volume II* (Appraisal Institute, 2014), 196.

[5] Richard Roddewig (Editor), *Valuing Contaminated Properties: An Appraisal Institute Anthology Volume II* (Appraisal Institute, 2014), 196.

[6] The Appraisal Institute, *The Appraisal of Real Estate, 15th Edition* (Appraisal Institute, 2020), 358.

[7] Robinson and Lucas, "Seller Disclosure and Buyer Knowledge: How they Affect Market Value," *The Appraisal Journal* (Spring 2007): 135.

[8] Michael Tachovsky, "Environmental Dead Zones: The Evaluation of Contaminated Properties," *The Appraisal Journal* (Spring 2021): 104-117.

[9] Robinson and Lucas, "Seller Disclosure and Buyer Knowledge: How they Affect Market Value," *The Appraisal Journal* (Spring 2007): 137.

[10] Thomas O. Jackson, "Surveys, Market Interviews, and Environmental Stigma," *The Appraisal Journal* (Fall 2004): 303.

[11] Robinson and Lucas, "Seller Disclosure and Buyer Knowledge: How they Affect Market Value," *The Appraisal Journal* (Spring 2007): 135.

About the authors

Specializing in complex valuation and real estate damage economics, **Dr. Tachovsky** is a testifying expert who has published numerous articles and developed courses on various complex real estate matters. *michaelt@landmarkresearch.com.*

Kristopher Williams is a certified general real estate appraiser who has conducted research in various complex valuations and diminution in value assignments. His research includes environmental, geotechnical, construction defects, natural disasters, expropriation, crime scenes, and other conditions involving a wide variety of property types. *kris@landmarkresearch.com.*