WHO NEEDS USPAP WHEN YOU HAVE THE TEXAS SUPREME COURT?

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This paper addresses the sharp differences in Texas between fair market value appraising, the process and reporting standards for which are squarely set out in the Uniform Standards of Appraisal Practice ("USPAP"), and condemnation appraising, particularly in partial taking acquisitions, the increasingly obtuse rules for which have been defined and redefined in recent years by the Texas Supreme Court. The paper's thesis is that the safeguards USPAP attempts to establish so that appraisers in Texas (and elsewhere) will fully, fairly, and uniformly consider all appropriate appraisal techniques, methodologies, and relevant data in developing fair market value appraisals that realistically reflect the market value of the property being appraised are frustrated to a significant extent by certain, mostly recent, Supreme Court rulings that prevent a full and straightforward application of the fair market value standard.

This analysis begins with an explanation of the purpose and origins of the Uniform Standards of Professional Appraisal Practice. ("USPAP") Next, we take a brief look at the history and evolution of the market value standard in the appraisal realm, culminating in the adoption and implementation of the USPAP standard.

Subsequently, we will examine some key cases from the condemnation world. This paper does not purport to be an exhaustive analysis or critique of Texas case law regarding the definition of fair market value or applicability of certain appraisal methodologies. The analysis does, however, identify the earlier principal Supreme Court precedents concerning fair market value and highest and best use, which largely mirrored the "consider everything" approach of the appraisal community, as well as more recent precedents from the last ten years or so that in the authors' opinion require condemnation appraisers to deviate significantly from the USPAP standard.

Finally, this analysis inspects some specific, key tenets of USPAP, which, but for USPAP's "jurisdictional exception" provision, are rendered essentially meaningless in a Texas condemnation appraisal in light of certain Supreme Court rulings.

USPAP AND THE REAL WORLD DEFINITION OF FAIR MARKET VALUE

What is USPAP? The American Institute of Real Estate Appraisers was founded in 1932 as part of the National Association of Real Estate Boards. The new organization was formed to further the appraisal profession and its primary purpose was for "the advancement of the science of appraising, the selection and identification of competent individuals, and the control of its members through disciplinary powers."[1]

[1] *Appraisal Thought: A 50-Year Beginning: A Message From the President of the Institute.* American Institute of Real Estate Appraisers, 1932.

The Society of Residential Appraisers, subsequently named the Society of Real Estate Appraisers, was also founded in the early 1930's with a similar purpose. These two organizations ultimately merged about 1990 to form the Appraisal Institute.

The real estate depression and savings and loan crisis of the mid-1980's resulted in a call for improvement in appraisal practices and standards throughout the United States. In 1986, most of the leading professional appraisal organizations formed an *ad hoc* committee to set uniform standards for professional appraisers. Agreeing upon generally accepted appraisal methodologies and standards, the members of this committee adopted the Uniform Standards of Professional Appraisal Practice ("USPAP") and formed The Appraisal Foundation. The Appraisal Foundation subsequently included the Appraisal Qualifications Board and the Appraisal Standards Board. Through the ensuing years, other appraisal organizations were formed, some substantive, and others that existed more or less as "certificate makers."

What's USPAP for? USPAP was incorporated and adopted by the United States Congress with the passage of the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") of 1989. FIRREA requires that real estate appraisals used in conjunction with federally related transactions be performed in accordance with USPAP. According to the Appraisal Foundation:

> More than 80,000 state certified and licensed appraisers are currently required to adhere to USPAP. *USPAP contains the recognized standards of practice for real estate, personal property and business appraisal*. [Emphasis added.][2]

USPAP thus represents the national standard of what constitutes proper appraisal development, consideration, and reporting techniques. It gives appraisers who are compelled to perform compliant appraisals guidance as to the techniques, methodologies, considerations, and reporting standards to be utilized in all conventional appraisal assignments.

FIRREA is not the only governmental mandate concerning the appraisal standards of USPAP. The Office of Management and Budget ("OMB") has also required that federal land acquisition, as well as direct lending agencies only use appraisals that conform to USPAP.[3]

One of FIRREA's many mandates was the requirement that all 50 states license or certify real estate appraisers, and further that those appraisers meet minimum education, experience and examination requirements promulgated by the Appraiser Qualifications Board of the Appraisal Foundation. In Texas, state licensing and certification was accomplished by establishing the Texas Appraiser Licensing and Certification Board, which subsequently adopted USPAP as the standard for the practice of real estate appraising in Texas.[4] USPAP is then not only the professional but also the legal standard for all appraisals done in Texas.

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[2] www.appraisalfoundation.org/html/aboutus.asp

[3] Id.

[4] TEX. ADMIN. CODE, Title 22, Part 8, Chapter 155, Rule 155.1.

Evolution of market value definitions. The underlying basis for virtually all real estate appraisals is the concept of what price a property will bring as between a willing seller and a willing buyer. Real estate appraisers define this concept as fair market value. Even the earliest textbooks on the appraisal of real estate defined market value in terms of the willing buyer, willing seller concept. In 1938, an early appraisal textbook set out the then-current definition of market value, as expressed by the California Supreme Court:

> Market Value is the highest price estimated in terms of money which the land will bring if exposed for sale in the open market with a reasonable time allowed to find a purchaser buying with knowledge of all the uses and purposes to which it is best adapted and for which it is capable of being used.[5]

The Appraisal Institute's definition of market value has remained consistent with this early definition. In 1964, for instance, the Institute's basic appraisal manual defined fair market value thus:

> ….the highest price estimated in terms of money which a property will bring if exposed for sale in the open market allowing a reasonable time to find a purchaser who buys with knowledge of all the uses to which it is adapted and for which it is capable of being used."[6]

Moving forward to the present, we see that the Institute's primary definition of "market value," as expressed in its newly published appraisal dictionary, has remained constant:

> 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.[7]

USPAP itself define "value" more broadly since USPAP's standards must be flexible enough to control the production and reporting of *all* types of appraisals:

> A type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of ownership or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.[8]

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[5] Condemnation Appraisal Hand Book. George L. Schmutz. 1938. p. 142.
[6] The Appraisal of Real Estate, Fourth Edition. American Institute of Real Estate Appraisers. 1964.
[7] The Dictionary of Real Estate Appraisal, Fourth Edition. Appraisal Institute. 2002. p. 177, def. 1.
[8] *Uniform Standard of Professional Appraisal Practice.* The Appraisal Foundation , 2002 edition. ("USPAP"). Definitions section.

This definition means that USPAP's standards stretch to appraisers performing business value appraisals, ongoing concern appraisals, liquidation value appraisals, and any other type of value assessment as well as fair market value appraising. Since the "definition of the term identified by the appraiser as applicable" in a condemnation appraisal must be "fair market value," then, a USPAP-compliant condemnation appraisal would define such as mandated by the Appraisal Institute, and other appraisal organizations, or by the established precedent of a given jurisdiction.

The definition of "fair market value" in the professional appraisal arena has remained generally consistent from the earliest texts to the present: consider all approaches, methodologies, and data that may impact the sell/purchase decision undertaken by market participants in the real world.

FAIR MARKET VALUE IN TEXAS CASE LAW

Evolution of the market value standard in Texas. The most famous definition of market value in Texas comes of course from *State v. Carpenter*.[9] The *Carpenter* court noted that the essential Texas rule concerning whether and how Texas condemnees are compensated for the fair market value of both the property interests condemned from them and "any damage occasioned to the remainder of the property" was established as far back as 1863 and subsequently incorporated without change into the Texas constitutions of 1866, 1868, and 1876.[10] Tellingly, in formulating the definitive market value charge for Texas juries the *Carpenter* court made no mention of any market factors comprising a necessary part of real estate valuation which were to be somehow artificially excluded in the valuation of the remainder property after a partial taking:

> You are instructed that the term "market value" is the price which the property would bring when it is offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it.[11]

Prior to formulating this historic pronouncement of the Texas condemnation market value standard, the *Carpenter* court ruminated upon its components:

> Generally, it may be said that it is proper as touching the matter of the value and depreciation in value to admit evidence upon all such matters as suitability and adaptability, surroundings, conditions before and after, and all circumstances, which tend to increase or diminish the present market value. Evidence should be excluded relating to remove, speculative, and conjectural uses, as well as injuries, which are not reflected in the present market value of the property.[12] [Citations omitted.]

[9] *State v. Carpenter*, 89 S.W.2d 194 (Tex. Comm. App.—1936).
[10] Id. at 197.
[11] Id. at 202.
[12] Id. at 200.

The *Carpenter* court's market value formulation, devoid as it was of reference to any extraneous non-market factors, was effectively the standard for fair market valuation well before the *Carpenter* opinion, and continues to be quoted today.

***Cannizzo* and the concept of highest and best use.** In 1954, the Supreme Court again essentially confirmed the *Carpenter* definition of market value. The Court went on, however, to authorize an extension of the market value definition in cases where the subject property was not immediately developable to its highest and best use, but a reasonable probability existed that the property being appraised could soon be so adapted:

> …'market value' is the price which the property would bring when it is offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it, taking into consideration all of the uses to which it is reasonably adaptable and for which it either is or in all reasonable probability will become available within the reasonable future. This definition will permit the jury to give weight to the probability of the lifting of restrictions as it thinks a prospective purchaser would give.[13]

As support for its decision, the Court observed earlier in the opinion that in the willing seller-willing buyer test of market value it is frequently said that *all* factors should be considered which would reasonably be given weight in negotiations between a seller and a buyer.[14] In explaining its decision, the Court noted that this "consider everything" approach automatically excludes consideration of purely speculative uses to which the property might be adaptable but wholly unavailable, while permitting consideration of all uses to which a property is reasonably adaptable and is, or in reasonable probability will soon become available.[15]

Although there are obviously a number of other Texas cases from this era that discuss the meaning of market value and relative adaptability to a given highest and best use, *Carpenter* and *Cannizzo* stand out as the precedents that most closely track the meanings of those concepts as embraced by the professional appraisal community.

Swerving from the straight and narrow? This rather pure concept of market value, however, has been seriously eroded by a number of recent Supreme Court decisions. While by no means an exhaustive survey, three such decisions are briefed below. The authors chose this representative three because direct application of their respective doctrines makes complete compliance with USPAP impossible.

***Schmidt:* don't consider everything after all**. Fifty-seven years after *Carpenter* came *State v. Schmidt*, 867 S.W.2d 769 (Tex. 1993), arguably the second most significant case in modern Texas condemnation jurisprudence. In *Schmidt,* the Court considered the admissibility of certain market factors on the remainder value of condemned properties: diversion of traffic, circuity of travel, impaired visibility, and construction inconvenience

[13] *City of Austin v. Cannizzo*, 267 S.W.2d 808, 815 (Tex. 1954).
[14] Id. at 814.
[15] Id.

brought about by the public improvement project. The Court concluded that all were generally non-compensable in Texas condemnation cases.[16]

Much ink has been spilled debating the wisdom and rationale of the Court's conclusions in this case. Essentially, the Court reasoned that in cases like Schmidt involving a small, sliver-like taking for a major roadway widening, that (a) the value-reducing factors complained of had been traditionally disallowed as bases for recovery in *inverse* condemnation cases;[17] (b) the factors complained of were not specifically damaging to the landowner but were rather community in nature;[18] and (c) the damages claimed resulted from public improvements constructed not on the part taken but elsewhere.[19] Confoundingly, perhaps, in assessing the landowners' argument the Court readily acknowledged that these factors undeniably impacted market value:

> It cannot be denied that traffic patterns, convenience of access, visibility, and the disruption of construction activities over an extended period of time can affect the market value of property.[20]

The Court further acknowledged that the artificial exclusion of certain factors was likely to result in difficulty for real estate professionals attempting to produce credible, admissible valuation opinions in future condemnation matters:

> [The landowners] argue that the difficult process of determining the value of property is made more hypothetical and uncertain whenever relevant factors are excluded from consideration. As hard as it is to determine the value of property as it exists, it is harder still to determine its value as it might be. For this reason, they argue, the elements of injury asserted in these cases, which unquestionably affect the value of their property, should be considered in determining damages. *While we do not disagree with their assessment of the task of determining value,* we cannot allow a recovery of damages not required by the Constitution and section 21.042.[21] [Emphasis added.]

Obviously, any judicial decision which so plainly first acknowledges the market importance of certain valuation factors and then – under whatever rationale – discards them poses a problem for a USPAP appraiser beginning with the traditional "consider everything" approach to fair market evaluation.

***Sharboneau* and the erosion of "reasonable adaptability."** The Texas Supreme Court has recently considered and essentially rejected the admissibility of an unquestionably established appraisal technique known as the "subdivision development method" in *City of Harlingen v. Sharboneau.*[22]

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[16] *State v. Schmidt*, 867 S.W.2d 769 (Tex. 1993).
[17] Id. at 777.
[18] Id. at 781.
[19] Id. at 778-779.
[20] Id. at 773.
[21] Id. at 781.
[22] *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3rd 177 (Tex. 2001).

Sharboneau involved at its base the admissibility of testimony by the landowner's expert appraisal witness about the subdivision development approach to valuing vacant land. The Appraisal Institute defines this appraisal methodology as follows:

> [A] method of estimating land value when subdivision and development are the highest and best use of the parcel of land being appraised. When all direct and indirect costs and entrepreneurial incentive are deducted from an estimate of the anticipated gross sales price of the finished lots, the resultant net sales proceeds are then discounted to present value at a market-derived rate over the development and absorption period to indicate the value of raw land.[23]

The approach and its applicability was published in at least one appraisal text defining the basic methodology by 1964: "The process, applicable chiefly to undeveloped land, calls for estimating total value as if the land were subdivided and sold, and subtracting the development costs."[24] The subdivision development method was further explained in another appraisal textbook devoted solely to subdivision analyses in 1993: "The subdivision method is essentially an income approach which measures the financial rewards, risks, and costs associated with a real estate investment."[25]

The federal government, too, has noted the general acceptability of this appraisal approach in its Uniform Appraisal Standards for Federal Land Acquisitions[26]. Indeed, the Appraisal Institute's current treatise on real estate valuation in litigation notes that this approach may sometimes by the *sole* method of valuation in certain instances:

> The development approach is the primary, and sometimes the only, method of valuation in a condemnation case when:
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> 1. The appraiser concludes through proper market analysis that the property in question does, in fact, have a highest and best use for subdivision purposes;
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> 2. Comparable before and/or after sales are lacking, and
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> 3. Sufficient market and technical data are available to estimate the value of the property being appraised reliably using the development approach.[27]

In the July 2000 issue of the Institute's primary appraisal periodical, two commentators confirmed that the development approach provides a useful valuation alternative in

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[23] The Dictionary of Real Estate Appraisal, Fourth Edition. Appraisal Institute. 2002. p. 279.
[24] Appraisal of Real Estate, Fourth Edition. American Institute of Real Estate Appraisers. 1964.
[25] Subdivision Analysis. Lovell, Douglas D., MAI, and Martin, Robert S., MAI, SRA. Appraisal Institute. 1993. p. 4.
[26] *Uniform Appraisal Standards for Federal Land Acquisitions.* Interagency Land Acquisition Conference. (Appraisal Institute, 2000). Sec. A-15.
[27] Real Estate Valuation in Litigation, Second Edition. Eaton, J.D., MAI, SRA. (Appraisal Institute, 1995). p. 246.

eminent domain cases that may more accurately reflect the true market value of an undeveloped tract of land. By utilizing the same approach that developers themselves do of analyzing the larger parcel and determining the present value of the projected net income stream from subdivision of the tract, the approach can show the value of potential uses of the property that a conventional comparable sales approach may well overlook.[28]

Plainly, the appraisal literature reflects that the subdivision development method is not only well accepted within the professional appraisal community but also occasionally the preferred method for establishing the value of vacant, undeveloped property, in the proper circumstances.

In *Sharboneau*, however, the Supreme Court considered and rejected as irrelevant a subdivision development approach appraisal performed in a condemnation case.[29] The opinion outlines the steps taken by the landowner's appraiser (Patterson) as follows:

(a) Patterson initially concluded that he highest and best use of the land was for subdivision development. In fact, the parties *stipulated* that the highest and best use of the condemned property was as a residential subdivision;

(b) Patterson then determined how many lots could be carved out of the land based on lot sizes in surrounding neighborhoods;

(c) The appraisal then estimated the gross sales of these lots over a selling period three years, including an inflation factor of 5% for years two and three;

(d) Patterson itemized and subtracted the expenses of development including sales expenses, real estate taxes, closing costs, attorney's fees, and entrepreneurial profit to arrive at the net sales proceeds for the subdivision development;

(e) Patterson applied a discount rate to the annual net sales proceeds to arrive at a present value; and

(f) Finally, Patterson deducted the costs of preparing the land for subdivision use (construction of streets, utilities, etc.) to arrive at his estimate of value for the land, "as is."[30]

Comparing these steps to the broad outline of the subdivision development approach quoted in the Appraisal Institute's definition above, it is apparent that Patterson followed accepted appraisal methodology. The Court itself even observed that the subdivision development approach as expressly outlined by the Appraisal Institute in an *amicus* brief was "broadly similar" to Patterson's work.[31]

The Court nonetheless disallowed Patterson's appraisal despite its obvious adherence to appraisal standards. The Court opined that Patterson's analysis was not a true accounting of market value because, it somehow did not account for all market forces:

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[28] *The Development Approach to Valuation in Eminent Domain Litigation: Capitalizing on Potential Use.* Duvall, Richard O., J.D., and Black, David S., J.D. The Appraisal Journal. July 2000.
[29] *Sharboneau*, 48 S.W.3rd at 186.
[30] Id. at 180—181.
[31] Id. at 181.

> …Patterson's subdivision development analysis determined only what a developer could hypothetically afford to pay to profitably subdivide the property, not what a developer would pay in the competitive, risk-filled marketplace of the real world. Because the appraisal did not account for these forces, it was not relevant to establishing the market value of Mrs. Sharboneau's property.[32]

Of course, an appraisal professional would respond that an appraiser's assessment of the discount rate, absorption period, and relative lot prices accounted for each of the Court's expressed concerns that the appraisal did not reflect the marketplace. Nonetheless, although the Court noted that "in some cases" a subdivision approach might be admissible, by disallowing an essentially textbook application of the method the Court has now presented a serious roadblock to use of this appraisal approach to value in Texas condemnation cases.

In the authors' view, this case represents another significant departure from the pure market value approach set out in *Carpenter*, and in particular a sharp departure from the *Cannizzo* concept of allowing appraisers to consider uses for which a property is reasonably adaptable. Undoubtedly, the decision presents a major issue to any appraiser attempting to both (a) evaluate raw land amenable to subdivision and (b) also comply with USPAP.

Zwahr: **separate economic unit or project influence?** The third recent Supreme Court case creating a USPAP conflict for condemnation appraisers is *Exxon Pipeline v. Zwahr.*[33] In this pipeline easement case, the landowner's appraiser concluded that the 1.01 acre parcel desired by Exxon constituted a separate economic unit itself, and the landowner desired to establish that fact along with its concomitant value as authorized by earlier Supreme Court precedent.[34] In such a case, of course, the market value of the severed land may be determined without reference to the remaining property.[35]

In *Zwahr*, the landowner's appraiser (Kangieser) determined that the highest and best use of the taken property was for a pipeline easement, and he valued the part taken pursuant to other sales of easement rights-of-way in the vicinity.[36] In arriving at his conclusion, Kangieser relied upon the fact that the Zwahr property already had one pipeline easement along the same alignment as the proposed Exxon easement. This approach is commonly referred to as "corridor valuation," an appraisal approach that is recognized both in regular appraisal literature and in prior Texas case law. (See *Bauer v. Lavaca-Navidad River Authority*, 704 S.W. 2nd 107 (Tex. App.—Corpus Christi 1985, writ ref'd. n.r.e.)).

The *Zwahr* Court's disapproval of Kangieser's opinions, however, was based not upon his use of the corridor valuation method but rather his conclusion of highest and best use. According to the opinion,

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[32] Id. at 186.
[33] *Exxon Pipeline Company v. Zwahr*, 88 S.W.3rd 623 (Tex. 2002).
[34] *State v. Windham*, 837 S.W.2nd 73, 76 (Tex. 1992).
[35] Id.
[36] *Zwahr*, 88 S.W.3rd at 628.

> Because Kangieser relied on Exxon's condemnation in establishing a separate economic unit and in assigning a value to that unit, his final opinion reflected enhancement in the land's value that occurred only because of the Exxon project itself. . . .[V]alue that exists because of the condemnation project is not, under the project-enhancement rule, value for which a landowner may recover.[37]

Without offering any critique as to the intellectual correctness of the decision, it is plain that the opinion frowns on further utilization of the corridor valuation technique in Texas condemnation cases: how may an appraiser *ever* conclude that the part taken is a separate economic unit in such an instance without offending *Zwahr's* interpretation of the project influence rule in an easement case adjacent to an existing easement? To the extent that an appraiser legitimately decides that the use of a strip of land adjacent to a group of easements has a highest and best use of another easement, *Zwahr* appears to discourage him from analyzing and reporting that conclusion. As with the decisions in *Schmidt* and *Sharboneau, Zwahr* presents real problems to a Texas appraiser performing a condemnation assignment pursuant to USPAP's requirements as explained below.

SPECIFIC USPAP PROVISIONS

In this section we identify the more obvious USPAP Standards that are impossible to comply with under current Texas case law without invoking USPAP's jurisdictional exception. A proper understanding of the differences between USPAP's departure provision and its jurisdictional exception rule is key to understanding these issues.

Departure rule. The Departure Rule is codified in USPAP's introduction.[38] It essentially provides that an appraiser is allowed to depart from certain non-binding requirements of USPAP when the appraiser determines that such departures will not result in an opinion or report with opinions that are not credible. It is the appraiser's burden to determine whether or not a given departure will render a non-credible result, and also to advise the client of all such departures.

For example, many residential loan appraisal forms do not require an income approach, and although an appraiser might ordinarily consider the income approach in a fully developed USPAP appraisal, he may omit the income approach if he determines that it can be done without affecting the opinion's credibility, and if he so advises the client and report-reader with the appropriate disclosure, given the report's intended use. The departure rule, however, may only be invoked for USPAP's *non-binding* provisions; that is, those requirements that are *specific* requirements of USPAP that may not be applicable to a given assignment:

> Of those specific requirements that are applicable to a given assignment, some may be necessary in order to result in opinions or conclusions that are credible. When a specific requirement is necessary to a given assignment, departure is not permitted.

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[37] Id. at 630.
[38] *Uniform Standards of Professional Appraisal Practice 2002 Edition.* Appraisal Foundation, p. 11.

> Departure is permitted from those specific requirements that are applicable to a given assignment but not necessary in order to result in opinions or conclusions that are credible.[39]

In other words, there are a number of USPAP standards from which the Appraisal Foundation does *not* normally permit departure. Presumably these provisions are those that the Foundation deems absolutely critical to the production and disclosure of credible opinions and reports. As explained by the Appraisal Foundation itself, while the necessity of applying specific requirements depends upon the characteristics of a given appraisal assignment, binding requirements are absolute:

> Binding requirements must always be complied with in performing an assignment. These requirements are labeled as binding because they are necessary to develop credible results or to communicate those results in a manner that is not misleading.[40]

To deviate from a binding requirement, then, all an appraiser may legally do under USPAP is to invoke the exception that swallows the rule: the jurisdictional exception.

Jurisdictional exception rule. This rule is located immediately following the departure provision in USPAP, and provides as follows:

> If any part of these standards is contrary to the law or public policy of any jurisdiction, only that part shall be void and of no force or effect in that jurisdiction.[41]

The comments to the rule further note that the rule's purpose is strictly limited to providing a saving or severability clause intended to preserve the balance of USPAP if one or more of its parts are determined to be contrary to the law or public policy of a particular jurisdiction.[42] Moreover, according to USPAP, it would actually be misleading for an appraiser to disregard any part of USPAP relying on this provision without specifically disclosing the part or parts disregarded, and also citing the legal authority relied upon by the appraiser for disregarding parts of the USPAP standard.[43]

Let us now consider a few specific examples, and how the current state of Texas case law impacts the USPAP standard for appraising.

Standard I: REAL PROPERTY APPRAISAL DEVELOPMENT. Broadly speaking, the first two USPAP Standards address (a) identification of the appraisal problem and development of the appraisal process (Standard I), and (b)

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[39] Uniform Standards of Professional Appraisal Practice 2002, p. 11.
[40] *USPAP Frequently Asked Questions.* Appraisal Foundation (2002). p. 2.
[41] Uniform Standards of Professional Appraisal Practice 2002, p. 13.
[42] Id.
[43] Id.

actual disclosure and reporting of the appraiser's value opinion (Standard II).[44] As such, Standard II's requirements largely mirror those of Standard I but are keyed to the *reporting* of an appraisal opinion rather than the identification of the appraisal problem and development of the appraisal process. Since a detailed analysis of those provisions of both Standard I and Standard II that require a jurisdictional exception as a result of Texas case law would be somewhat redundant, the scope of this paper only includes Standard I.

Standards Rule 1-1. The first USPAP standard with which an appraiser may not fully comply under current Texas case law is USPAP Standards Rule 1-1. Importantly, this standard is one from which USPAP does *not* permit departure.[45] The relevant provision follows:

> In developing a real property appraisal, an appraiser must:
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> (a) be aware of, understand, *and correctly employ* those recognized methods and techniques that are necessary to produce a credible appraisal . . .[46] [Emphasis added.]

Given the plain language of this standard, consider the example of an appraiser asked to assess the market value impact of a partial taking on a tract of land, not already subdivided, that is obviously readily amenable to subdivision, development, and marketing. As we have seen, the subdivision development approach was first seriously analyzed in appraisal literature before 1964 and has subsequently evolved into an accepted methodology that cannot be ignored when doing a real-world appraisal of property immediately susceptible to subdivision. Indeed, it is unlikely that any lending institution would even briefly consider advancing funds against a subdivision project without having first seen an thorough analysis of land costs, developments costs, market absorption rates, and the other common variables of a subdivision development approach.

Unfortunately from a USPAP compliance standpoint, despite *Sharboneau's* hint that in some instances involving undeveloped land the subdivision development method could be relevant and admissible, the opinion makes plain that a textbook application of that method as defined by the appraisal industry – or as evidenced by Patterson's opinions in *Sharboneau* itself – as such an instance in which the approach might be admissible.[47] Therefore, at least in these types of cases, it is not possible for an appraiser to comply with the binding USPAP Standard 1-1(a) without acknowledging a jurisdictional exception.

Additionally, since USPAP facially mandates the consideration of *all* factors affecting the value of real estate, and *Schmidt* just as plainly disallows

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[44] Uniform Standards of Professional Appraisal Practice 2002, Standard 1 (p. 15); Standard 2 (p. 21).

[45] *Uniform Standards of Professional Appraisal Practice 2002*, Standard 1 (p. 15).

[46] Id.

[47] *Sharboneau,* 48 S.W.3rd at 186.

consideration of some of those relevant market factors, at least in a partial taking appraisal an appraiser must again rely upon a jurisdictional exception.

Standards Rule 1-2. The next USPAP standard which Texas case law frequently compels appraisers to invoke the jurisdictional exception over is another binding one, Standards Rule 1-2. The specific requirements of 1-2 that appraisers are sometimes not fully able to comply with are set out below:

> In developing a real property appraisal, an appraiser must:
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> . . .
>
> (e) identify the characteristics of the property that are relevant to the purpose and intended use of the appraisal, including:
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> (i) its location and physical, legal, and economic attributes; . . .
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> . . .
>
> (f) identify the scope of work necessary to complete the assignment;…[48]

Many eminent domain assignments involve partial takings for roadway widenings. In instances where the remainder property is going to be situated on a fundamentally different roadway, with different access and visibility characteristics from those enjoyed by the whole property before the taking, *Schmidt* and its progeny prohibit an appraiser from fully identifying and considering all of the remainder's "physical, legal, and economic" attributes. Moreover, the comments to Standards Rule 1-2(f) mandate:

> An appraiser must not allow assignment conditions or other factors to limit the extent of research or analysis to such a degree that the resulting opinions and conclusions developed in an assignment are not credible in the context of the intended use of the appraisal.[49]

These comments to subsection "f" underscore the importance in the overall USPAP scheme, of considering all factors and data which bear on market value, considerations Texas appraisers may not make under *Schmidt* in most partial taking cases where the remainder has different locational attributes as a result of the public project for which the property is taken.

Standards Rule 1-3. This is a non-binding provision from which departure is allowed under proper circumstances. It provides in relevant part:

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[48] *Uniform Standards of Professional Appraisal Practice 2002,* Standards Rule 1-2 (p. 16).
[49] Id., p. 17.

> When the value opinion to be developed is a market value, and given the scope of work identified in accordance with Standards Rule 1-2(f), an appraiser must:
>
> (a) identify and analyze the effect on use and value of existing land use regulations, reasonably probable modifications of such land use regulations, economic supply and demand, the physical adaptability of the real estate, and market area trends; and
>
> (b) develop an opinion of the highest and best use of the real estate.[50]

Consider again the example of the condemnation analysis of a partial taking for a roadway where the remainder will have different locational attributes relative to the new facility. *Schmidt's* prohibitions against considering lost visibility and changed access patterns plainly means that an appraiser may not fully consider neither the physical adaptability of the real estate, nor market trends.

As an example of the danger from a fair-market value perspective of not fully considering market trends, note the subsequent tenants the actual Schmidt property has attracted. As the landowner's experts in this case predicted, this once-vibrant commercial property experienced a decline in the quality of commercial tenants as a result of the project. Prior to the taking, the Schmidt tract was leased to national-credit tenants. Subsequently, the property was tenanted by a host of less desirable users, including a pawnshop.

Without considering all the factors affecting the value of a property, an artificial conclusion of highest and best use can well result. Market value is dependent upon an accurate assessment of highest and best use; therefore, the value conclusion may not be credible as required by USPAP.

Since under these decisions an appraiser may not fully analyze the appraisal problem or employ all relevant data, it follows that he would also be unable to develop an accurate opinion of the highest and best use of the real estate.

Standards Rule 1-4. This non-binding rule is another in which the rote application of *Schmidt, Sharboneau,* and their relatives prevents complete adherence without invocation of a jurisdictional exception. The rule provides in part:

> In developing a real property appraisal, an appraiser must collect, verify, and analyze all information applicable to the appraisal problem, given the scope of work identified in accordance with Standards Rule 1-2(f).
>
> (a) When a sales comparison approach is applicable, an appraiser must analyze such comparable sales data as are available to indicate a value conclusion.
>
> (b) When a cost approach is applicable, an appraiser must:

[50] *Uniform Standards of Professional Appraisal Practice 2002,* Standards Rule 1-3 (p. 18).

(i) develop an opinion of site value by an appropriate appraisal method or technique; . . .
(ii) analyze such comparable data as are available to estimate the difference between the cost new and the present worth of the improvements (accrued depreciation).

(c) When an income approach is applicable, an appraiser must:

(i) analyze such comparable rental data as are available and/or the potential earnings capacity of the property to estimate the gross income potential of the property;
(ii) analyze such comparable operating expense data as are available to estimate the operating expenses of the property;
(iii) analyze such comparable data as are available to estimate rates of capitalization and/or rates of discount; and
(iv) base projections of future rent and/or income potential and expenses on reasonably clear and appropriate evidence.

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(f) An appraiser must analyze the effect on value, if any, of anticipated public or private improvements, located on or off the site, to the extent that market actions reflect such anticipated improvements as of the effective appraisal date.[51]

To begin with, subsection "a" mandates the use of appropriate comparable sales data. Pure application of the *Schmidt* doctrine, however, prohibits utilization of comparable transactions that share the now-noncompensable locational attributes of the remainder being appraised, such as reduced visibility and diminished access. Thus, again, an appraiser would need to call upon the jurisdictional exception to explain ignoring data that would be obviously comparable and utilized in the real world. Similarly, in subsections "b" and "c" dealing with the scope of data to be considered in performing cost and income approaches, sale or lease transactions of land or improved properties that were demonstrably impacted by the forbidden *Schmidt* factors would not be able to be considered regardless of their true comparability.

Subsection "f," dealing in part with analysis of anticipated public improvements, is effectively gutted by *Schmidt* and its offspring. The subsection specifically requires an appraiser to consider the effects on value of coming public improvements, whether they are located on or off the property under appraisement. *Schmidt, Heal,* and a number of post-*Schmidt* Texas opinions make plain that condemned landowners may only consider the value effects of public improvements being made on the land actually condemned. This artificial limitation, imposed for whatever legal reason, results in appraisal opinions that are not only inconsistent with USPAP but also make

[51] *Uniform Standards of Professional Appraisal Practice 2002,* Standards Rule 1-4 (p. 18-19).

the already-difficult process of valuing property even more so, just as anticipated and acknowledged in *Schmidt*.[52]

Standards Rule 1-5. This requirement, like Standards 1-1 and 1-2 is binding and may only be escaped by using a jurisdictional exception. It provides in relevant part:

> In developing a real property appraisal, an appraiser must:
>
> (a) analyze any current Agreement of Sale, option, or listing of the property, if such information is available to the appraiser in the normal course of business;
>
> . . .
>
> (b) reconcile the quality and quantity of data available and analyzed within the approaches used and the applicability or suitability of the approaches used.

A condemnation appraiser endeavoring to apply USPAP is faced here with the same dilemma as with the previous Standard: it is not possible to utilize any sale agreement, option, or listing agreements regarding the subject property if they reflect values or value opinions affected by the forbidden *Schmidt* factors. Similarly, it is not possible for an appraiser to fully reconcile the quality and quantity of all data available, if he is artificially prohibited by case law from considering obviously relevant portions.

Finally, in cases involving properties susceptible to subdivision but not actually subdivided, where an appraiser has formulated the opinion that such is the highest and best use of the property being appraised, it is not possible given *Sharboneau* for the appraiser to "fully reconcile the applicability or suitability" of appraisal approaches employed.

CONCLUSION

From its earliest writings, the professional appraisal community embraced the objective "consider everything" approach to fair market valuation; that is, any factor that might reasonably bear upon the purchase/sell decision of two well-informed market participants ought to be factored into the valuation conclusion. USPAP, adopted in the wake of the late-1980's real estate investment meltdown, embraced this standard and formalized it into a set of well-defined rules, the institution of which in condemnation appraising are challenged by recent precedent.

Texas case law, at least through *Cannizzo*, largely tracked conventional appraisal theory. *Carpenter* specified that an appraiser ought to consider everything that bore upon the present market value of the tract, and *Cannizzo* expanded that the highest and best use of condemned property included those uses of property to which it might be reasonably adapted within the foreseeable future, without regard to its current use.

[52] *Schmidt*, 867 S.W.2d at 781.

Schmidt's artificial exclusion of market value reductions due to certain factors represented a marked departure from the pure market value standard. *Sharboneau*, as argued above, effectively eliminated the utilization of the subdivision development approach in condemnation appraisals despite the fact that no real-world developer assesses the value of a potential subdivision in any other way. And *Zwahr*, while not expressly disapproving the corridor valuation approach, estranged it by condemning its threshold conclusion of separate economic unit.

USPAP's dictates are established by both federal and Texas state regulations. Nevertheless, in light of certain Texas opinions, an appraiser's only recourse under USPAP is to invoke its jurisdictional exception to escape application of certain binding provisions, the intent and purpose of which are seriously eroded by select recent case law.

While it is well beyond the scope of this paper to critique every basis for the cited decisions' departure from the market value standard, they do present, perhaps, an interesting question for other areas of litigation jurisprudence: if it is the case that a court may conclude, as in *Sharboneau*, that an appraisal expert has improperly performed a particular technique in spite of a demonstrably textbook adherence to established practice, is it conceivable that such an analysis could be extended to other experts' areas of expertise?

How many lumens of light should a doctor utilize when analyzing an x-ray? How many foot-pounds of pressure should a materials scientist exert upon a specimen before concluding to its breaking point, and is his industry's conclusion of the appropriate amount open to judicial interpretation? Can the relevance of established DNA identification technology now be questioned if a judicial conclusion is somehow reached that some perceived public policy factor outside the realm of medical science mandates that unquestionably relevant conclusions be disregarded?

Whatever the right answer is, recent case law makes plain that the old appraisal standard of considering everything that reasonably bears on market value, of determining enhancement and/or damages from the marketplace, is no longer the norm in condemnation appraising. In the words of the architect of the *Schmidt* opinion:

> These [eminent domain] cases are fundamentally not so much about the words of the constitution or words of a statute or what the science of accounting and appraisal say should be considered in the assessment of value—not so much about those things as it is about fundamental deep-set policy questions of what is the public going to pay for and what is an individual going to be stuck with. And that does not come through the cases of course; rarely are they that blunt about it.
>
> One is more likely to get more attention of the appellate courts or at least the Texas Supreme Court if the compensation argument is couched in terms of "this is something that ought to be compensable" rather than the argument that "what has been impacted is a component of value." Nobody disagrees that visibility [for example] is a component of value

> that people pay for; but the question is whether the public must pay for it.[53]

Arguably, *Carpenter* is not so well settled in our jurisprudence after all.

[53] *Role of the "SeparateEconomic Unit".* Montague, Dixon H. Institute on Planning, Zoning, and Eminent Domain, 2002. Matthew Bender & Company. 2002. p. 13-9, quoting Nathan Hecht, at the CLE Int'l Eminent Domain Conference, Aug. 12-13, 1999, Austin, Texas.