FEATURES

Preventing Fraud and Deception

by Vernon Martin

ABSTRACT

Mortgage fraud is at an all-time high, yet the appraisal profession often finds itself unprepared to assist in detecting and preventing the frauds bringing down the financial system. This article focuses on common methods of deception used in fraudulent schemes involving commercial properties and land, including deceptive purchase agreements; deceptive financial statements; misrepresentation of occupancy or tenancy; misrepresentation of property characteristics; undisclosed conditions negatively affecting value; and unrealistic projections of sales, income, and expenses.

The appraisal profession in the United States originally emerged in response to the financial abuses leading to the bank failures and Great Depression of the 1930s. It is implicitly understood that appraisers play a role in protecting the public, and the Uniform Standards of Professional Appraisal Practice (USPAP) was created to codify this purpose.[1] Nevertheless, many appraisers today are unprepared to detect the mortgage frauds that are bringing down financial systems, while others opine that fraud prevention is outside the scope of work expected from appraisers, believing that careless lenders get what they deserve. The ongoing world financial meltdown has indeed punished careless lenders, but unfortunately has also left the general public and taxpayers suffering the consequences. The public deserves better than this. Now is the time to make fraud prevention part of appraiser education and professionalism.

Fraudulent Information Compromises the Appraisal Process

Appraisal textbooks do not teach new appraisers a fundamental truth about human nature–that people often lie, especially to get money. An appraiser needs to be aware of this human frailty whenever the appraiser relies on information from other parties.

The information technology industry has a saying, "Garbage in, garbage out," meaning that even the best systems of analyzing information produce flawed results when data input is flawed. Fraud and deception compromise the data input into the appraisal process. Consequently, what better way is there to start the appraisal process than with a search for the truth?

Appraisal Standards

USPAP's focus is on promoting public trust in appraisal, and "the appraiser's responsibility is to protect the overall public trust."[2] USPAP does not mandate a property inspection, as a property inspection is not critical in all assignments.

1. See Appraisal Standards Board, *Uniform Standards of Professional Appraisal Practice*, 2008–2009 ed. (Wasington, DC: The Appraisal Foundation, 2008).
2. Ibid., Preamble.

However, it does mandate that the appraiser determine the appropriate scope of work[3] for an assignment, and for some assignments a property inspection is a must.

Many appraisers take pride in being incorruptible guardians of truth and objectivity, earnestly and endlessly debating ethics at various meetings and in online forums. It seems incongruous, then, that so many appraisal reports contain an exculpatory "Assumptions and Limiting Conditions" statement that, "No responsibility is assumed for accuracy of information furnished by the client."

Such a statement begs the question, who will protect the client against fraud and deception? If there is fraud and deception, then down the line there may be federal criminal investigators, district attorneys, and bank examiners, but they emerge long after the fraud has been perpetrated and the money lost. Appraisers play a crucial role in protecting clients against fraud and deception before a bad loan is funded. This is particularly important in this day and age of remote lending by national lenders that do not typically see the property that they are lending on. Therefore, they and the public depend on the appraiser to identify any misrepresentations.

Appraisers Responsibility and Legal Precedents

Mortgage fraud is at an all-time high, so it behooves appraisers to be more alert than ever to misrepresentations. Some appraisers feel that following the minimum USPAP standards is the extent of their obligation to clients; others care enough about clients to take extra steps. Appraisers should be aware of the sobering statistic that failure to verify factual information is one of the six most common reasons that appraisers are sued.[4] This is the Achilles' heel of the appraisal profession–reliance on inaccurate information from biased parties. Even if assumptions and limiting conditions legally exculpate the appraiser, that appraiser will still need to employ an attorney for his or her defense if sued, and professional liability insurers are becoming increasingly reluctant to defend negligence so gross as to be considered fraudulent, such as failure to analyze previous sales of the subject property per USPAP Standard Rule 1-5(b).

There is legal precedent for finding appraisers liable for losses caused by failure to verify information. In *FSLIC. v Texas Real Estate Counselors, Inc.,*[5] a Texas federal district court found the appraiser liable for (1) failing to verify the alleged completion of improvements on the property, and (2) failing to disclose reliance on unverified data, when presenting estimates of value and effective age for the subject property.

Similarly, in *Fusco v. Brennan*, the Superior Court of Queens County, New York, held that an appraiser's failure to independently verify the data supplied to him was so negligent that it warranted an inference of fraud, maintaining that the defendant had a duty to all possible investors to inform them of the type and source of data used and the extent of information omitted.[6]

Fraudulent Intent

The face of mortgage fraud, as depicted in the media, is that of organized rings of flippers, who buy low and sell high using straw buyers who default soon after loan origination. This media depiction, whether it is in the newspapers or on *The Sopranos* television drama, distracts the public from more common types of fraud that trick lenders into lending more money than can adequately be secured by the appraised property and its cash flow, but where there is still an intent by the borrower to repay the loan if everything goes well.

The borrower usually commits fraud in order to control real estate with little or no cash down. By minimizing cash equity in the property, the owner earns a high return on investment if the value goes up and the loan is paid back. But if the value goes down, the owner has nothing to lose by abandoning the property and defaulting on the loan because he or she does not have any equity in the property. This is a borrowing strategy commonly taught in the thousands of no-money-down seminars held across the United States every year, but this is tantamount to gambling with other people's money, as the lack of adequate equity cushion and debt service coverage significantly increases default risk.

3. Although the Scope of Work Rule first appeared in the 2006 version of USPAP, the term and concept of scope of work have been in USPAP since 1999.
4. Liability Insurance Administrators, Santa Barbara, CA, http://www.liability.com.
5. *FSLIC v. Texas Real Estate Counselors, Inc*., 955 F.2d 261 (5th Cir. 1992).
6. *New York Law Journal* 13 (January 1982).

In a recent example of this type of arrangement, Florida attorney John Yanchek and developer Michael Tringali pleaded guilty to an $82.7 million fraud against federally insured banks BankAtlantic, Mercantile Bank, and Orion Bank regarding loans on land in the Sarasota area.[7] As the closing attorney, Yanchek concealed that the buyers were not contributing equity to the land purchases and were actually receiving cash back from loans in excess of 100% of the value of the properties. When the Florida land market turned downward, the loans defaulted. Yanchek pleaded guilty to conspiracy, money laundering, and making false statements to a federally insured bank in connection with a commercial loan. The latter of the three charges relates to Section 1014 of Title 18 of the United States Code, which declares mortgage fraud to be a federal crime, encompassing anyone who "knowingly makes any false statement or report, or willfully overvalues any land, property or security, for the purpose of influencing in any way the action of [a financial institution]" upon a loan application, purchase agreement, or other related documents.[8] A violation of this federal fraud statute is punishable by up to thirty years imprisonment and a $1 million fine.

Inherent Conflicts of Interest in the Mortgage Lending System

Complicating the ethical environment today is the practice of compensating loan originators based on loan volume rather than loan soundness, and the recently increased reliance on third-party originators (loan brokers and conduit lenders). Even staff loan officers can and will commit fraud against their own employers if their compensation program rewards them for such behavior.

Common Areas of Deception and Recommended Countermeasures

There are a number of areas in which appraisers are likely to encounter deceptive or fraudulent information; the most common areas include the following:

1. Deceptive purchase agreements
2. Deceptive financial statements
3. Misrepresentation of occupancy or tenancy
4. Misrepresentation of property characteristics
5. Undisclosed conditions negatively affecting value
6. Unrealistic projections of sales, income, and expenses

The following discussion provides examples of these practices from actual situations. Some of the situations are not associated with public or legal documents, as a potential fraud or deception was averted. Rules of confidentiality preclude greater specificity in these instances.

Deceptive Purchase Agreements

One type of fraud in real estate transactions is the deceptive purchase agreement. The first and foremost question that should be asked is, "Is this purchase real?" Various studies have consistently reported that appraisers estimate values identical to purchase prices in 96%–97% of instances, a habit that is quite well known to fraudsters as well as real estate investors and real estate sales agents.

An appraiser should also consider the possibility that the purchase itself is not an arm's-length transaction, but a pocket-to-pocket transaction with the buyer purchasing a property that he already owns. A doctor in the Atlanta area, for instance, fooled a lender into lending too much money on an apartment property with the use of a double escrow–an escrow process in which two purchases are accomplished at one time. Using a limited liability company (LLC) that he controlled, he bought the property from the seller for $1.8 million, and then sold the property to himself for a price of $2.7 million. This latter contract is the one he submitted with his purchase loan application. He was able to buy the property for no money down and then practice *skimming*, which occurs when the owner collects as much income as possible from the property by cutting expenses and services before unhappy tenants move out, net cash flow becomes negative, and the owner defaults on the loan. In the case of the Atlanta property, the owner tricked the lender into lending 100% of the loan-to-value ratio, lost no money, and gained all the income skimmed.

In a recently published case, a Connecticut man, Edward Safdie, created two LLCs to accomplish a similar fraud. Operating as 318 Main LLC, he purchased the Inn at Cheshire for $2.350 million

7. "Florida Attorney Guilty in $82M Mortgage Fraud," *North County Gazette*, February 12, 2009.
8. 18 U.S.C. § 1014, "Loan and credit applications generally; renewals and discounts; crop insurance."

and then transferred the property to Quantum 318 LLC (an entity Safdie wholly controlled) at a much higher price, securing $3.5 million in loan proceeds, and then another $1 million in loan proceeds.[9] The defrauded bank, Beal Bank, ultimately foreclosed on the Inn and sold it for $2.45 million, incurring a loss of over $2 million. Safdie currently awaits sentencing, with a maximum possible prison term of 50 years.[10]

Although it may not be possible for an appraiser to prove that a particular purchase transaction is deceptive or fraudulent, an appraiser needs to be suspicious of instances in which the purchase price is not supported by comparable sales. Too many appraisers treat a contract purchase price as prima facie evidence of market value, and end up using flawed reasoning to adjust the comparable data to fit the purchase price.

Figure 1 shows an excerpt from an escrow instruction document,[11] and it illustrates what sometimes happens behind the scenes. In this particular purchase transaction, a Kansas City apartment building was being purchased at a price per unit seemingly 50% above comparable sales, in a particular zip code that often leads the nation in apartment building foreclosures. Using a fake cash down payment, the purchase price was inflated from $3,732,500 to $4,475,000, although the net cash deliverable to the seller remained the same.

In another case, several hundred acres of land in New Mexico were being purchased at a price seemingly three times as high as similarly zoned comparable sales. It was observed that the seller had made a transfer of ownership to an LLC several months before at an undisclosed price. The buyers had an Internet Web site advertising services as "transaction facilitators," in which they could form a joint partnership with the seller before officially purchasing the property. This could have explained the nature of the previous transfer of ownership, making the current purchase transaction a sham.

Even genuine purchase contracts can be misleading, however, with use of seller concessions, either stated or hidden, such as allowances for repair, guaranteed rental income (in excess of actual rental income), seller-paid closing costs (beyond what is

Figure 1 Escrow Instruction Document Excerpt

The Buyer submitting the offer today wants to buy your property and use one of our products called a Private Contribution. Our program has the potential to turn almost any non-buyer into a buyer. Before responding to the Buyer it is imperative that *you call us* for an explanation of what our agreement with you would be and the required procedures involved.

In most cases, the Seller simply includes our fee in the Sales Price just as they would realtor fees, mortgage payoffs, closing costs, etc. This is illustrated in the scenario below and demonstrates how you can disburse funds to us and still secure the net amount you desire from this property sale.

	With our Program	Without our Program
		(Buyer has down payment)
Purchase Price	$4,475,000	$3,732,500
Closing Costs	-$86,000	-$86,000
PayoutOne (down payment)	-$675,000	0
PayoutOne Fee	-$67,500	0
Seller Net before Realtor Fees	**$3,646,500**	**$3,646,500**

Source: Author's files

9. "CT Man Pleads Guilty in Commercial Mortgage Fraud," *The Mortgage Fraud Reporter,* January 16, 2009.
10. Safdie is 70 years old so it is unlikely he will serve the maximum term.
11. Actual escrow document mistakenly provided to the appraiser by a mortgage broker's assistant.

customary), and favorable seller financing. The competent appraiser will recognize these concessions for what they are, but sometimes the concessions are hidden. Some common techniques to hide seller concessions include the following:

- Seller financing that is forgiven in a side agreement. It is interesting to see letters written to Internet legal forums asking for legal advice on how to accomplish such deception without accidentally causing the buyer liability for repayment.
- The hiding of written concessions in an addendum to the purchase agreement, an addendum that is then excluded from the purchase contract submitted to the lender and appraiser.
- Any form of monetary consideration other than cash at closing. For instance, equity in another property might be offered as consideration. This raises the question, how is the equity measured, and is it measured by an objective, competent source?
- The claim of cash or equity, other than a small earnest money deposit, that has supposedly been contributed to the purchase transaction before closing.

It would be safer for the appraiser to focus on the cash deliverable to the seller at closing, adjusted by the earnest money deposit (as long as it is reasonable). It would be even safer yet if the appraiser ignores the purchase price until after the preliminary valuation analysis has been completed. If the initial conclusion of value is different than the purchase price, this should be the point where the appraiser asks if some important value item that is real and tangible has been missed.

Deceptive Financial Statements

Financial statements are another area where appraisers may encounter fraudulent information. An income-property appraiser needs to be familiar with standard property accounting practices in order to detect unreliable income and expense statements. Whenever possible, the appraiser should request financial statements prepared by independent accountants, preferably operating statements for year-to-date and the two previous years. The following discusses some tricks that appraisers should watch for.

The Numbers Are Too Round. Professional property management reports are typically exact to two decimal points, as are utility bills and property taxes. Round numbers for every line item of income and expenses tell the appraiser that actual numbers were not used. For example, rent-controlled apartments are experiencing high foreclosure rates in some parts of Los Angeles. Controlled rents are typically uneven and based on application of legally set limits. This means, for instance, that a $500-per-month apartment that is allowed a 3% increase per year will be $515 the next year, $530.45 the following year, and $546.36 the year after. A rent roll for a rent-controlled apartment, therefore, should show uneven amounts for tenants who have been in place for two years or more and round numbers will be an indicator that something is wrong with the financial statement

The Numbers Are Too Consistent. Business circumstances are seldom consistent from year to year, so consistent numbers in financial statements are another indicator that the statements are deceptive. The following shows part of an operating statement submitted by a struggling hotelier in Orlando. The hotelier had lost his Choice Hotels franchise at the end of 2005. What clues can we find that the 2006 figures are fictitious?

Revenue	2005	2006
Rooms	$3,934,040	$5,637,479
Food	722,640	1,035,543
Beverage	181,778	260,488
Telecommunications	49,640	71,134
Rental & other income	181,063	259,463
Total Revenue	$5,069,161	$7,264,107

These are some of the clues:

- Every 2006 line item is the same multiple of the 2005 line item (1.433). This is a statistical impossibility.
- Management's report of a 43.3% increase in room revenues offends common reason. The loss of the Choice Hotels group franchise would have been a severe blow to revenues, cutting off the hotel from Choice's extensive reservation system. (Choice Hotel operates Comfort Suites, Clarion, Quality Inn, Sleep Inn, and Econo Lodge hotels.)
- It is very unlikely that telecommunication revenues would have increased 43.3%, as telecommunications revenues have been universally

declining among all hotels as more and more guests choose to use personal cell phones in lieu of hotel phones.

The Operating Statement Includes Non-Property-Related Revenues. Operating statements may be deceptive because they include revenues from other properties, activities, or businesses not being appraised; owners may even pay themselves management fees and include these as revenues.

One example of the inappropriate inclusion of revenue occurred when the owner of a strip center in Texas supplied deceptive operating statements that included capital infusions as actual income and included common area maintenance (CAM) reimbursements in base rents and as a separate line item of income, therefore double counting CAM. Also, an unusually high percentage of revenues came from late fees, which may have been uncollected. As a result of this deception, reported net operating income for the property was inflated from $67,000 to $178,500.

Operating statements also may include revenues that cannot be expected to be consistent. Apartment owners, for instance, may inappropriately include late-fee income as revenue. For instance, an apartment building owner in Tulsa, Oklahoma, reported so much late-fee income that it was apparent he had a big collection problem. Further, these late fees were being accrued, but not collected.

Appraisers should also watch for one-time sources of income, such as a legal award or the sale of a part of the property. This type of situation occurred when an apartment building owner in Utah applied for refinancing after an unsuccessful condominium conversion and disguised sales of condominium units as rental income.

A property owner may be operating a business out of the appraised property, and the appraiser must be able to distinguish between property-related revenues and business revenues. The following are examples of business-related revenues that would not be likely to continue, as they require a high amount of labor, and business or marketing expertise:

- Cover charges and liquor sales from a night club
- Product sales
- Food and beverage sales
- Services such as valet parking, spa services, or car washing

The Financial Statement Includes Pocket-to-Pocket Rental Income. Some financial statements may be deceptive because they include pocket-to-pocket rental income where the landlord is also a tenant paying rent. As an example, two developers of a speculative new office building in Phoenix were having trouble leasing out enough space to satisfy the occupancy requirements of most takeout lenders, so they wrote leases to themselves creating company names from their initials; for instance, as John Does, they would write a lease to JD Development, Inc.

The Income Is Not Offset by Necessary Expenses. Financial statement should show necessary expenses as well as revenue. Skimping on maintenance increases the amount of future expenses an investor can expect to incur, and this needs to be considered in the income approach.

An example of this occurred where the owner of a 30-year-old Houston-area apartment property reported expenses 28% below the market average, a fact that the owner considered evidence of his superior management ability. However, the property inspection indicated significant deferred maintenance, with over 200 original condensing units needing replacement; extensive termite and water damage to structural wood; and potholes in the parking lot.

Although it is common practice for some lenders to request tax return schedules relating to the appraised property, many have been burnt by counterfeit tax returns. Consequently, some U.S. lenders now require borrowers to sign and submit an Internal Revenue Service (IRS) Form 4506-T, "Request for Transcript of Tax Return," which permits the lender to contact the IRS directly to receive a copy of the borrower's actual tax returns. For any appraiser who has doubts about the reliability of income and expense data provided by the property owner, it is good policy to contact the lender-client to obtain the appropriate tax schedules. Many lenders will thank the appraiser for taking this extra step.

Other methods appraisers can use to determine actual expenses include requesting bank statements and cancelled checks. They can also compare reported expenses with expense comparables or expense data from the Institute of Real Estate Management (IREM), the Building Owners and Managers Association (BOMA), and the International Council

of Shopping Centers (ICSC).[12] These three organizations report operating data many ways, such as by region, by property size, by building age, or by property type.

Misrepresentation of Occupancy or Tenancy

A third area of fraudulent information is the misrepresentation of occupancy or tenancy. It is fundamentally important for appraisers to verify that scheduled tenants are actually occupying their assigned spaces and paying their scheduled rents. Such verification involves personal observation and communication with any tenants who are present. A diligent inspection may alert an appraiser to the following problems:

- A tenant has vacated the premises prematurely.
- A tenant has not moved in and might not actually intend to.
- A tenant is paying an amount different than scheduled or is in arrears. This can sometimes be ascertained by simply asking the tenant what he or she pays. (A tenant is more likely than the landlord to mention any special arrangements.)

Just as important, the appraiser should request and receive complete lease documents, including any amendments, and should not rely only on a rent roll. As tedious as this might be, this approach is a useful fraud prevention procedure.

The appraiser should be skeptical of vacancies described as not being vacancies. If the tenant has left, it may be claimed that he is still making rent payments. This should be documented, such as by bank statements.

Likewise, the landlord can claim that a lease has just been signed for a vacant space, but one should be skeptical of situations where tenants have not yet moved in. For instance, a large, older medical office building in South Phoenix was described as being fully leased, but the appraiser found that it was half vacant, with every vacant suite having a sign announcing a new tenant. Half-vacant, older, multitenant buildings do not typically go from 50% to 100% occupancy overnight. As another example, in a recent appraisal of a multitenant industrial building in Connecticut the inspection indicated that the tenant paying the highest rent, a nightclub, had not moved in after supposedly paying fifteen months of rent.

An appraiser should always investigate the operating history of the property and try to explain any unusual changes in occupancy. This prevents situations such as one that occurred in the early 1990s, where a half-vacant apartment building in Riverside, California, was quickly filled when the owner offered free rent, no-money-down specials to homeless individuals shortly before he sold the building to an unsuspecting investor. As the buyer quickly discovered, many of the new residents had no intention of paying rent, and the loan went into default immediately.

In some cases, a concern arises when the tenant appears to be paying rent above the market average. There may be legitimate reasons for this; the lease may have been written at a time when market rents were higher or the tenant may have required specialized improvements that have been amortized into the scheduled rent. However, a scheduled rent above market rent could also be a sign of a pocket-to-pocket lease and should be investigated.

Fraudulent Rent Rolls. To guard against reliance on a fraudulent rent roll, appraisers should ask tenants onsite how much rent they pay. Even if some tenants speak a foreign language, it pays to learn numbers and simple questions in other languages. For example, in the U.S. Southwest and major American cities where apartment tenants may speak Spanish, asking "Cúanto paga de renta cada mes?" (How much do you pay for rent each month?) and learning numbers in Spanish can be helpful. Sometimes a pad of paper and a pencil can bridge the language barrier–written numbers are a universal language.

Verification of Future Tenants. When improvements are only proposed, verifying tenants is trickier. Developers often stretch the truth, representing letters to prospective tenants as lease commitments. Nothing substitutes for signed leases with real tenants. Letters of intent can sometimes be relied upon, but to have any credibility the letters should come from recognized credit tenants on company letterhead.

Despite these intuitively obvious precautions, fraud can sometimes occur. For example, a vacant former Costco warehouse was purchased for $1.62 million in 2001 and appraised one year later for $21.5 million–resulting in a $14 million funded

12. This information is available through the organizations' Web sites: http://www.irem.org: http://www.boma.org; http://www.icsc.org.

loan–based on the assumption that Federal Express, Walgreens, AutoZone, and El Pollo Loco would be leasing it, although there was no documentation of any interest from any of these tenants. In fact, none of these businesses ever moved in.

As the examples show, an appraiser should value a property based on market rents, vacancy rates, and absorption rates until bona fide leases can be produced to indicate anything to the contrary.

Misrepresentation of Property Characteristics

A fourth area of deceptive information is the misrepresentation of property characteristics. There are a host of unfavorable property conditions that can be misrepresented by property owners as to the legality of use, availability of utilities, property size, and property condition.

Legality of Use. An illegal use that is contrary to zoning laws, or building and safety codes, may be discovered later by local authorities who will force the landlord to remove the improvement and/or pay for conversion of the space back to legal use. This can lead to loan losses for lenders, particularly where multifamily properties are involved.

The drive to perform appraisals faster has caused some appraisers to skip the task of verifying that the existing improvements are permitted by the appropriate city or governing authority. However, this information can easily be verified online, by a certificate of occupancy, or a phone call to the appropriate department.

Some argue that lax code enforcement has encouraged buyers to pay full price for illegal improvements. In such cases, a market value estimate may be inappropriate for a lender client, as unexpected future enforcement of city codes could jeopardize continuation of the illegal uses. All it takes is one major fire or disaster to change the political climate for code enforcement, as recently happened in Chicago as the result of a disastrous fire.

Be alert to clues of illegal improvements. For instance, a studio apartment without a thermostat, in a building with central heating and cooling, could be a walled-off master bedroom from a two-bedroom apartment. Some landlords do this because they can get more rent from a one-bedroom apartment and a studio apartment than from a two-bedroom apartment alone.

As verifiable as it is, even a property's zoning can be misrepresented. A landowner in South Florida who wished to build a community shopping center claimed commercial zoning, but a check with county officials showed that the parcel actually had agricultural zoning with a designated future land use of commercial–but the only commercial use the county government intended to approve for the subject site was warehouse use.

Availability of Utilities. Some landowners without access to fresh water or sewers might misrepresent this, knowing that their land would otherwise be appraised lower. The potential for loan losses in such instances can be huge. An appraiser should try to verify the availability of services with the relevant municipality or private utility company. A property owner's claim that the property will soon be receiving water or sewer services also needs to be verified.

Property Size. Owners may misrepresent the size of a property. Property size should be confirmed by measuring the property or consulting an objective source for property size instead of relying on rent rolls or landlord claims of property size.

Property Condition. Although the condition of the property will be somewhat obvious at the time of inspection, the severity of the deferred maintenance may be understated. Nonfunctioning equipment–particularly elevators–may be permanently rather than temporarily disabled.

Some owners may contend that major renovations have occurred since they acquired the property; however, the renovations may not be evident during the property inspection. This was the case with the Oklahoma apartment property described earlier, in which a $350,000 renovation allowance was deducted from the purchase price at closing, but no evidence showed that the allowance had been spent. All units of this property still had original appliances and carpets from the early 1970s. The $350,000 was just a cash reduction of the purchase price.

Undisclosed Conditions Negatively Affecting Value

A fifth common area of deception is related to undisclosed conditions that negatively affect value but are concealed by the property owner. Hidden encum-

brances and environmental damages are two types of conditions that may affect value.

Hidden Encumbrances. Owners may conceal encumbrances, such as special assessments, because of their negative effect on value. USPAP Standards Rule 1-2(e) states that an appraiser must

> identify the characteristics of the property that are relevant to the type and definition of value and intended use of the appraisal, including…any known easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, or other items of a similar nature….

This information is typically found in the preliminary title report, but obtaining such a report is easier said than done in a hurried or sloppy lending climate where many lender clients fail to provide reports in a timely manner. Without this information the lender can be deceived. For example, one bank took a $2 million loss on an incomplete subdivision in Utah when it did not know about significant special assessments from the city for providing necessary infrastructure. Therefore, an appraiser should be emphatic about receiving a title report from the client for the client's own protection.

Environmental Damage. Owners of property also may fail to disclose information about environmental damage that negatively affects the property value. This is more likely with property in industrial or rural areas, and property near airports or gasoline service stations. For example, the owner of a trailer park in Michigan failed to disclose that the park was an unremediated Superfund site, as its groundwater had become contaminated. The park owner's solution was to connect to the local city-water supply, but an appraiser should also consider the stigma of the park as an unremediated Superfund site.

There are databases that appraisers can use to check for known environmental hazards, such as leaking underground storage tanks or Superfund sites. The U.S. Environmental Protection Agency's Web site, www.epa.gov, is a helpful source of information. (However, its list of contaminated properties should not be considered as all inclusive.)

Unrealistic Projections of Sales, Income, and Expenses

A sixth common area of deception is the projection of sales, income, and expenses. Appraisers may encounter unrealistic figures in the absorption and price projections for residential developments and in cash flow projections for commercial developments.

Absorption and Price Projections in Residential Developments. Residential developers often submit fanciful projections of sale prices and rates of sales to influence the appraiser. Therefore, an appraiser needs to quantify the rate of sales occurring in the market from objective and comprehensive data sources.

A proposed condo project at a ski resort is one recent example of inflated projections. In this instance, the developer projected condo prices of up to $4 million at a sales rate of twelve per month. Public records, however, indicated only two condo sales per month in the whole town, and new detached luxury homes next door were listed for sale at prices of $3 million and less.

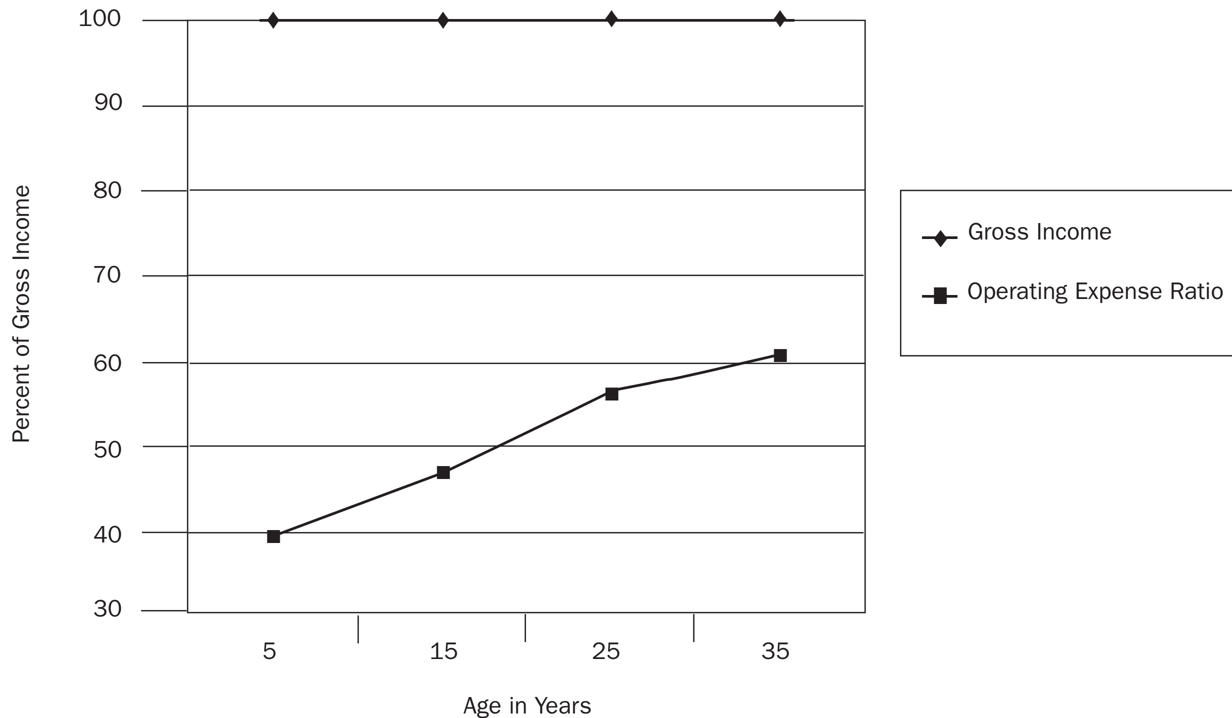
Pro Forma Cash Flow Projections of Commercial Projects. One of the most common errors seen in commercial property owners' projections is the underestimation of expense increases and the overestimation of increases in income. In examining the long-term operating history of income properties, expenses always increase faster than revenues over the life of the building. This is why expense ratios are higher for older buildings, as is graphically demonstrated in Figure 2. Notice how the line representing the operating expense ratio for each age subcategory increases in slope relative to gross income. This is evidence of expenses increasing faster than income for income properties.

There is a logical reason for the relationship between expense and revenue increases. As a building ages, it becomes less competitive in its market and the rate of rental increase slows, while the aging of the property requires increasing maintenance and capital improvements expenditures. This is the reality of physical and functional obsolescence, and appraisers should be alert to projections that show otherwise.

Conclusion

Appraisers should be prepared for dishonesty and always consider the possibility of bias or inaccuracy in information submitted by interested parties. This article has presented some common deceptions appraisers may encounter as well as some possible remedies. Appraisers can do more to help protect

Figure 2 Increasing Expense Ratios as Buildings Age



Source: Based on data from the Building Owners and Managers Association

their clients against fraud, but the extent of this obligation is not yet agreed upon within the profession. Regardless of what is agreed upon as proper due diligence, aggrieved clients, rightly or wrongly perceiving negligence on the part of the appraiser, may ultimately set new standards for appraiser verification and due diligence through litigation, legislation, or the reshaping of regulation (such as the Home Valuation Code of Conduct). The appraisal profession owes its existence to the public's need for protection, and those appraisers who truly care about their clients will look beyond USPAP's minimum professional standards and practice the sometimes-neglected art of verification and due diligence. The Appendix provides a fraud identification checklist for those readers who wish to implement a fraud prevention action plan.

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Additional Reading

Farber, William D. "Appraiser's Third-Party Liability for Negligent Appraisal of Real Property." In *American Jurisprudence Proof of Facts*, 2nd database. Eagan, MN: Thomson/West, 2005.

Keiter, Allen C. "Bogus Sales Contracts–How They Are Created and How Appraisers Can Protect Themselves." *Valuation Insights & Perspectives* (July 2003): 34–36, 40.

Martin, Vernon. "Appraisal Fraud, FIRREA, and Current Appraisal Practice." In *Law of Distressed Real Estate*, edited by Baxter Dunaway. Eagan, MN: Thomson/West, 2006.

Martin, Vernon. "Detection and Prevention of Mortgage Fraud." *The RMA Journal* 87, no. 1 (September 2004): 70–79.

The Mortgage Fraud Reporter, http://www.mortgagefraud.org.

Mortgage Fraud Blog, http://www.mortgagefraudblog.com.

Appendix

Fraud Checklist
(Items checked "Yes" increase the probability of fraud.)

Purchase Contract	**Yes**	**No**
• Does it not include all addenda and paragraphs referenced in the document?	❏	❏
• Are there missing signatures?	❏	❏
• Is there seller financing?	❏	❏
• Is the seller financing at a favorable rate or allowed to be forgiven?	❏	❏
• Is there reason to suspect that the buyer and seller are related parties?	❏	❏
• Was the property listed at a lower price than the contract price?	❏	❏
• Was the property not listed for sale? (Ask how the seller found the buyer.)	❏	❏
• Does the contract include allowances that reduce cash to the seller?	❏	❏
• Are there third parties providing cash to the buyer or seller?	❏	❏
• Is there another type of consideration in lieu of cash to the seller at close of escrow?	❏	❏
• Is the buyer trying to mislead you?	❏	❏
• Is the purchase price significantly above the previous, recent purchase price?	❏	❏
Property History		
• Has the property been sold recently?	❏	❏
• Has the property traded more than once in a short time span?	❏	❏
• Has the property been listed for sale for more than a year?	❏	❏
• Are there delinquent taxes or other liens on the property?	❏	❏
• Is the property listed on the CERCLA Superfund Web site?	❏	❏
Property Condition		
• Is there evidence of significant deferred maintenance?	❏	❏
• Are any of the improvements not covered by permits?	❏	❏
• Is the property not the same size as represented by the borrower?	❏	❏
• Have alleged renovations not been completed?	❏	❏
Operating Information		
• Are the financial statements provided not the most current available?	❏	❏
• Are the financial statements inconsistent with the leases or rent control?	❏	❏
• Are the borrower's financial statements not supported by tax returns?	❏	❏
• Does the borrower admit to filing false tax returns?	❏	❏
• Are numbers rounded instead of exact?	❏	❏
• Does gross rental income refer to scheduled income instead of collected income?	❏	❏
• Is property management considered a revenue item?	❏	❏
• Are there revenues not related to the operation of the subject property?	❏	❏
• Is there unexplained "other income"?	❏	❏
• Have certain revenues been double counted?	❏	❏
• Are revenues received for services that are not normally billed?	❏	❏
• Have capital infusions or payments between owners been counted as income?	❏	❏
• Is the difference between scheduled income and collected income inconsistent with vacancy at the subject property?	❏	❏
• Are revenues or expenses inconsistent with similar properties in the area?	❏	❏
• Are individual line items all increasing at the same exact rate?	❏	❏
Construction		
• Did the borrower fail to provide plans or specifications?	❏	❏
• Did the borrower fail to provide signed leases or letters of intent on company letterhead?	❏	❏
• Are the proposed improvements inconsistent with the zoning of the site?	❏	❏
• Are there no permits for the construction?	❏	❏
• Does the construction inspector have a vested interest in the transaction?	❏	❏
• Is there no verifiable proof of entitlements, such as an approved final map?	❏	❏
• Is there no verifiable proof of the availability of utilities?	❏	❏
Occupancy		
• Are the tenants listed on the rent roll not there?	❏	❏
• Is the landlord listed as a tenant on the rent roll?	❏	❏
• Were parts of the property not available for your inspection?	❏	❏
• Does the property have a history of high vacancy?	❏	❏
• Were you unable to verify rents with tenant estoppel agreements or interviews?	❏	❏
• Is the stated occupancy inconsistent with the number of parked cars in the parking lot?	❏	❏