

Do You Want Liquidation Value in Your Appraisal?

THE SIGNIFICANT INCREASE in loan workouts has created an abundance of orders for real estate appraisals. For some markets, appraisals have been needed every six months to keep up with falling property values.

As loans' risk ratings deteriorate, financial institutions are considering their options. Should they take the property back, or should they work out the situation with the borrower? A helpful piece of information could be liquidation value of the underlying collateral. Federal regulations do not require financial institutions to obtain liquidation value, so it is solely at their discretion to request this information from an appraiser.

So what is liquidation value and how does it differ from market value? Market value assumes neither the seller nor the buyer is under duress, and the property is actively marketed for a reasonable time. According to *The Dictionary of Real Estate Appraisal*, liquidation value differs in the following assumptions:

- Consummation of a sale will occur within a severely limited future marketing period specified by the client.
- The seller is under extreme compulsion to sell.
- A limited marketing effort and time will be allowed for the completion of the sale.

As noted above, the financial institution specifies the "severely limited future marketing period." I have seen 60 or 90 days used most often. If you request liquidation value from the appraiser, remember to set the marketing period so that both parties know what will be provided.

How does the appraiser arrive at liquidation value? I am familiar with three techniques, albeit there may be others I haven't seen. Surveying real estate brokers is one technique I would recommend as a requirement whenever you ask for liquidation value.

The appraiser surveys local brokers and will usually get useful information on how the subject property type is being perceived by the market. They also will ask how much of a discount from market value is needed to sell the property in the specified 60 or 90 days. I like this technique because this information can be very useful to the workout department in determining a strategy for the loan and the underlying collateral.

The second technique is to find properties that have sold at auction. Then, through verification, the appraiser can find out how the auction price differed from market value. This information would best reflect market action, but it's very difficult to obtain. Workout departments could help



their fee appraisers by providing more information about the properties they sell at auction.

Recently, I heard about a technique that involves discounting the market value over the period between 60 or 90 days and the marketing time estimated in the appraisal. For example, if marketing time is estimated at 15 months and liquidation value is set at three months, the market value conclusion would be discounted at a specified rate for 12



months. My only concern with this method is that I have not seen any market evidence concerning which discount rate to use. Also, how would this method account for the obvious difference in how raw land is treated currently versus a well-located vacant retail building?

All of that aside, one important question remains: Do I want liquidation value in my appraisal? Although the information this value provides may be useful in making a

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workout decision, there are some downsides to obtaining it. Some of my clients have said it has worked against them in court proceedings. Also, some have had their examiners make them mark their loans down to liquidation value instead of market value. Without passing judgment or examining case law, I believe these concerns are real and should be considered before ordering liquidation value in an appraisal report.

There are a few solutions to the problems discussed here. One is to have the appraiser provide the liquidation value analysis in a report separate from the market value report. Another is to have the reports ordered by and addressed to outside counsel. This supposedly avoids the appraisal report being available for discovery by the opposing parties in a lawsuit. I am not an attorney and do not know if these solutions will be viable for your financial institution. Check with your internal counsel before using either one.

In summary, my advice is to obtain liquidation value if foreclosure is an option to be considered. If foreclosure is not currently on the table and the preference is to work the loan out with the borrower, then just get market value. Before asking for liquidation value, consider the issues raised in this article and select a plan that will benefit your company the most. ❖

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