WISCONSIN COURT OF APPEALS
DISTRICT 2

REGENCY WEST APARTMENTS LLC,

Plaintiff-Appellant,

v. Appeal No. 2014AP002947

CITY OF RACINE,

Defendant-Respondent.

Appeal from Circuit Court of Racine County
The Honorable Gerald P. Ptacek, Presiding
Circuit Court Nos. 13-CV-1546 and 13-CV-1848

APPELLANT'S REPLY BRIEF AND SUPPLEMENTAL APPENDIX

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I. *DE NOVO* REVIEW APPLIES.

The City does not dispute plaintiff's authorities establishing that the propriety of an assessor's methodology and compliance with statutory requirements are legal issues subject to *de novo* review. (App. Br., p. 24.) It merely suggests in passing that findings regarding "witness credibility" are entitled to deference. (Resp. Br., p. 17.)

This appeal is not about witness credibility; it is about the legal standards governing assessments of § 42 properties. Accordingly, *de novo* review applies.

II. AS A MATTER OF LAW, § 8 AND MARKET RATE APARTMENTS ARE NOT "REASONABLY COMPARABLE" TO A § 42 PROPERTY.

The Woodside Village/Albert House and McMynn Tower comparisons the assessors used in their 2013 comparable sales analysis consist exclusively of § 8 rent subsidized units, and the Lake Oakes comparison consists predominantly of market rate apartment units. (App. Br., pp. 16-18.) The City does not dispute these facts.

The City also does not dispute the substantial differences between § 42 and § 8 properties that place the two in completely different markets. (Id., pp. 8-13.) Nor does it dispute that market rate apartment buildings may not be considered as comparables for subsidized housing (id., pp. 26, 28), which necessarily disqualifies the Lake Oakes comparison.

Plaintiff's opening brief explains that Wis. Stat. § 70.32, Wisconsin case law, the Wisconsin Property Assessment Manual (WPAM), and other authorities limit reliance for the comparable sales approach to recent sales of "reasonably comparable" properties that the assessor verifies, by reviewing the applicable restriction agreements, have similar restrictions as the property being assessed. (Id., pp. 22-23, 24-27.) The City makes two arguments in response, neither of which has any merit.

First, the City points out the WPAM covers all types of subsidized housing in the same section. (Resp. Br., pp. 10, 11-12.) That does not mean all types of subsidized housing are interchangeable for comparable sales purposes. The WPAM distinguishes among 10 different types of subsidized housing programs; instructs assessors to determine the terms and conditions of the "particular program" by obtaining the regulatory agreement; and requires that to be considered comparable, "the recent arm's-length sales should have ***restrictions that are similar to the subject property***." (Ex. 45, pp. 9-38 to 9-42, 9-45; emphasis added.) The fact the WPAM does not literally state § 8 properties may not be used as comparisons in assessing a § 42 property does not imply such comparisons are permitted. The WPAM sets forth assessment principles; it does not purport to list every application of those principles. It is undisputed that § 42 restrictions are not similar to § 8 restrictions; it is undisputed that the

WPAM requires similar restrictions; and it therefore follows that the WPAM prohibits consideration of § 8 properties in valuing a § 42 property.

Second, the City argues the "rents for the [comparison] properties were essentially the same." (Resp. Br., p. 15.) The evidence proves otherwise. (R.37, p. 186; R.38, p. 8.)[1] Moreover, what the WPAM requires is similar ***restrictions***, not similar rents. (Ex. 34, p. 9-45.) Rent similarity only affects revenues and does not account for the greater operational and investment risks with § 42 projects that materially increase expenses and decrease market values. (App. Br., pp. 8-12.)

The Furdek/Weissenfluh appraisal suffers from the same flaws as the assessors' comparable sales analysis. They similarly erred in relying upon § 8 (Bradley) and predominantly market rate (Lake Oaks and City Hall Square) properties in their comparable sales analyses. (R.45, pp. 173-74, 177-78; Ex. 69; Ex. 70.)[2] They did not review the restrictions applicable to either the subject property or their comparison properties, as the WPAM requires. (R.45, p. 153.) Their appraisal therefore violates Wisconsin law and may not be considered.

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[1] Lerner did not concede § 42 and § 8 rents are the same (Resp. Br., p. 15), but rather testified § 42 properties rent for $100-$250/mo below market rates, whereas § 8 properties rent at or above market rates. (R.37, p. 186-87; R.38, p. 8.)

[2] Far from "hitting a bull's eye" (Resp. Br., p. 15), the Furdek/Weissenfluh attempt to extrapolate the value of the § 42 units from the City Hall Square sales price totally missed the mark because they assumed all the apartment units were § 42 restricted, when in fact most were market rate apartments. Their analysis at best removed the value of the commercial use and not the value of the market rate apartments. (R.40, p. 66.)

As a matter of law, the comparison properties the assessors used in their 2013 comparable sales approach are not "reasonably comparable" because they do not have similar restrictions. Accordingly, the trial court erred in sustaining the assessments based on the comparable sales approach.

III. THE ASSESSORS' APPLICATION OF THE INCOME APPROACH VIOLATED THE WPAM.

The trial court relied upon the assessors' comparable sales approach to uphold both the 2012 and 2013 assessments, even though the assessors relied exclusively upon the income approach for 2012. (Decision, R.3, p. 8; R.37, p. 16.) The comparable sales approach violated Wisconsin law, as discussed above. The validity of both the 2012 and 2013 assessments therefore depends on the propriety of the assessors' application of the income approach.

A. Reliance on Market Expense Ratio Rather than Plaintiff's Actual Expenses

The law is clear that in assessing subsidized housing, the assessor must use the subject property's actual income and expenses, not market rates. Metro. Holding Co. v. Bd. of Review of Milwaukee, 173 Wis. 2d 626, 634, 495 N.W.2d 314, 318 (1993); WPAM, Ex. 34, p. 9-43. It is undisputed that for both the 2012 and 2013 assessments, the assessors used a market expense ratio of 40% rather than relying upon plaintiff's actual expenses. (R.11; R.37, pp. 25, 27-28, 30; R.39, p. 5.) The assessors thus

grossly understated plaintiff's expenses, resulting in inflated assessments. (Ex. 40, p. 1, ¶ 7; R.38, pp. 140-41, 160.)

The City defends reliance upon a market expense ratio on the basis the subject property did not have actual operating history as of the time of the 2012 assessment. (Resp. Br., p. 19.) The proxy for actual expenses as of January 1, 2012 were plaintiff's 2012 projections available as of the valuation date, not a market expense ratio. Moreover, plaintiff's December 31, 2012 audited financials were available to the assessors for the 2013 assessment, yet they continued to rely on their 40% market expense ratio. (R.37, pp. 45-46, 52-54.)

The City seeks to divert attention from this fatal flaw with the assessors' income approach by arguing Furdek and Weissenfluh correctly applied the income approach by using "actual income and expense information available at the time of trial," i.e. they purportedly used plaintiff's December 31, 2012 financials for their January 1, 2012 appraisal and used plaintiff's December 31, 2013 financials for their January 1, 2013 appraisal. (Resp. Br., p. 19.) This argument reveals the City's misunderstanding of a "retrospective" appraisal. (Resp. Br., p. 19.)

A retrospective appraisal does not allow an appraiser to consider post-valuation date events and apply 20:20 hindsight to determine the value as of the valuation date, as Furdek testified. (R.40, p. 22.) Rather, a retrospective appraisal means the appraiser determines the value as of a

certain date in the past. (USPAP Stmt-3, p. U-85; Supp. App. 3.) USPAP allows consideration of post-valuation date sales "as a confirmation of trends that would reasonably be considered by a buyer or seller" as of the valuation date. However, "[i]n the absence of evidence in the market that data subsequent to the effective date were consistent with and confirmed market expectations as of the effective date, the effective date should be used as the cut-off date for data considered by the appraiser." (Id.; see also FAQs 141 and 144, Supp. App. 5-7.)

Unlike the comparable sales approach, where the goal is to ascertain market trends as of the valuation date, the goal of the income approach is to determine "the way investors think when they buy and sell income property," i.e. "generate[] a value based on the ***income generating potential*** of a property." (WPAM, Ex. 33, p. 9-12; emphasis added.) Consistent with USPAP, the appraiser may only consider information that was available to the buyer and seller as of the valuation date. Plaintiff's December 31, 2012 financials were not available as of the January 1, 2012 valuation date, so the parties necessarily would have relied upon the 2012 projections. Similarly, plaintiff's December 31, 2013 financials were not available as of the January 1, 2013 valuation date, so the parties would have relied upon the December 31, 2012 financials. (R.40, pp. 172, 243-45.) That is the information to which the assessors and appraisers are similarly limited.

The City cites Rosen v. City of Milwaukee, 72 Wis. 2d 653, 242 N.W.2d 681 (1976) as permitting reliance upon post-valuation date financials for actual income and expenses. (Resp. Br., p. 19.) Rosen did not involve the income approach. The question in Rosen was whether a post-valuation date sale could be considered in a comparable sales approach. The court concluded that so long as the sale was close in time to the valuation date and the market had not changed in the interim, it could be considered in determining the value as of the valuation date. Id. at 666, 242 N.W.2d at 686. Unlike sales, subsequent year income and expense information is not evidence of a "market trend." Neither USPAP nor Rosen permits consideration of post-valuation date financial performance in the income approach.

The City also defends the assessors' reliance upon a market expense ratio as "stabilizing" income and expenses, citing ABKA Ltd. P'ship v. Bd. of Review of Fontana-On-Geneva-Lake, 224 Wis. 2d 551, 591 N.W.2d 879 (Ct. App. 1999) as support. (Resp. Br., p. 6.) ABKA has nothing to do with subsidized housing, so the requirement of using the subject's actual income and expenses did not apply. Moreover, unlike Furdek and Weissenfluh, in ABKA the assessor relied upon the subject's ***pre-valuation***, not post-valuation, income and expenses in constructing a stabilized operating statement. 224 Wis. 2d at 564, 591 N.W.2d at 885. ABKA therefore does not support the assessments here.

The assessors' failure to comply with the legal requirement of using plaintiff's actual income and expenses is a violation of WPAM that alone invalidates the 2012 and 2013 assessments.

B. Reliance on the Wrong Cap Rate "Market"

The WPAM requires cap rates to be derived from "recent market sales of ***similar properties***." (App. Br., p. 33.) The City persists in misreading this requirement as mandating use of a cap rate derived from sales of market rate properties, citing Bloomer Hous. Ltd. P'ship v. City of Bloomer, 2002 WI App 252, 257 Wis. 2d 883, 653 N.W.2d 309 and Mineral Point Valley Ltd. P'ship v. City of Mineral Point Bd. of Review, 2004 WI App 158, 275 Wis. 2d 784, 686 N.W.2d 697. (Resp. Br., pp. 19-20.) Plaintiff distinguished Bloomer and Mineral Point in its opening brief. Those cases require use of a market ***mortgage interest rate*** when utilizing the band of investment method to determine the cap rate for a § 515 subsidized mortgage rate property. Mortgage interest rates are not relevant in determining a cap rate under the "market derived" method the assessors purported to use in assessing the subject property in this case. (App. Br., pp. 33-36.) The City fails to address this distinction.

The issue in this case as relates to the cap rate is which "market" to consider in deriving the rate. As the City admits, the assessors used a cap rate derived from sales of market rate apartment buildings (Resp. Br., p. 20), as did Furdek and Weissenfluh. (App. Br., p. 33 & n.11.) The WPAM

specifies that market rate projects are not similar to subsidized housing. (Ex. 33, p. 9-24; Ex. 34, p. 9-45.) The 2012 and 2013 assessments, as well as the Furdek/Weissenfluh appraisal, thus clearly violated WPAM with respect to the cap rate.

IV. THE CITY'S CRITICISMS OF MCLAUGHLIN ARE UNFOUNDED.

In addition to establishing that the 2012 and 2013 assessments violated the WPAM, thereby overcoming the presumption of correctness, plaintiff also demonstrated the correct assessment amounts through the report and testimony of its expert, Scott McLaughlin. Unlike the assessors, McLaughlin used plaintiff's projected income and expenses for his January 1, 2012 appraisal and its audited December 31, 2012 financials for his January 1, 2013 appraisal, thus complying with the WPAM and Metropolitan Holding. (App. Br., pp. 20-21.) Unlike the assessors, McLaughlin derived his cap rate from sales of similar properties, i.e. other § 42 properties, not from sales of market rate apartment buildings, thereby complying with the WPAM. (App. Br., pp. 21-22, 42-44.) His valuations establish that the correct assessments are $2,700,000 for 2012 and $2,730,000 for 2013. (Ex. 40.)

The City's efforts to discredit McLaughlin's report and testimony are specious. McLaughlin is a well-respected appraiser who, unlike Furdek and Weissenfluh, has appraised literally hundreds of subsidized housing

projects over the past 25 years. (App. Br., p. 29.) His sole reliance on the income approach is supported by the WPAM and other authorities discussed in plaintiff's opening brief. (Id., pp. 36-40.) Those authorities are not, as the City argues, limited to cases where the parties both agree to rely upon the income approach (Resp. Br., p. 27). Rather, they unequivocally support reliance on a single valuation method where, as here, there is only one reliable method.

The fact McLaughlin assembled information on sale prices of § 42 properties for purposes of deriving cap rates does not, as the City "presumes" (Resp. Br., pp. 8), mean those sales support a comparable sales valuation. McLaughlin did not have information on the restrictions applicable to those properties, as the WPAM requires. (R.38, pp. 106, 169.)

The City's suggestion McLaughlin used "inconsistent" expense figures (Resp. Br., p. 9) is a reference to his reliance on pre-valuation rather than post-valuation financial data, which was entirely appropriate for his retrospective appraisals. His familiarity with the cap rate for sales of market rate apartment buildings in Racine (id., p. 10) is irrelevant since the WPAM requires consideration of cap rates for sales of "similar" properties, and market rate apartments are not similar to § 42 properties.

In suggesting McLaughlin used lower cap rates in his appraisals of other subsidized housing (id., pp. 9-10), the City ignores that those

appraisals were not prepared for property tax purposes, so the cap rates were not loaded with the property tax rate. (R.38, p. 168.) Adding the 2.5% tax rate, the loaded cap rates for the other properties would have been 11.7% and 12.4%, even higher than the cap rates McLaughlin used for his appraisals of the subject property.

The City's suggestions that the Furdek/Weissenfluh cost approach supports the assessments, and that McLaughlin erred in not relying on that approach (Resp. Br., pp. 8, 21-22, 27), ignore that the WPAM identifies the cost approach as the least reliable. (Ex. 34, p. 9-45.)[3] Even the assessors recognized the cost approach as unreliable and did not use it for the assessments. (R.37, pp. 48-51.) The Furdek/Weissenfluh cost approach inflated the assessable value of the subject property by failing to make any adjustments for economic obsolescence to take into account the restrictions, as the WPAM recognizes would be required but virtually impossible to determine reliably. (Ex. 34, p. 9-45; R.45, pp. 91, 160-61.)

Finally, the fact McLaughlin's report is only four pages long and does not meet all the technical USPAP requirements is immaterial. (Resp. Br., pp. 30-32.) This is a classic case of the pot calling the kettle black. USPAP requirements apply not only to appraisers such as McLaughlin, but also to assessors. (Ex. 29, pp. 1-1, 1-3 to 1-4.) The assessors' 2012

[3] McLaughlin did not "concede" the propriety of the cost approach (Resp. Br., p. 21), but rather testified it is never appropriate to use the cost approach in assessing § 42 properties because the value of the tax credits must be excluded. (R.38, pp. 107, 222-23.)

valuation consists of one page comparable in format to the one-page valuations included in McLaughlin's report. (Compare Ex. 11 with Ex. 40.) Their 2013 report is longer only because it includes the impermissible comparable sales analysis. (Ex. 12.) Neither of the assessors' reports includes the boilerplate sections the City criticizes McLaughlin for omitting. In any event, USPAP compliance is not a condition for admitting or relying upon an expert's report. 260 North 12th St., LLC v. State Dep't of Transp., 2011 WI 103, ¶¶ 54-55, 338 Wis. 2d 34, 808 N.W.2d 372.

CONCLUSION

Plaintiff's emphasis on the assessors' lack of subsidized housing expertise does not mean municipalities must hire outside specialists to assess such properties. (Resp. Br., p. 18.) Assessors can assess subsidized housing properly by following the WPAM. The problem in this case is that the City's assessors substituted their uninformed judgments for controlling WPAM requirements, using comparison sales that do not have "similar restrictions" as the subject for their comparable sales analysis; applying market expense ratios rather than plaintiff's actual expenses for their income approach; and deriving their cap rate from sales of market rate apartments rather than sales of "similar," i.e. other § 42, properties. As a result of these clear WPAM violations, the 2012 and 2013 assessments are not entitled to a presumption of correctness and may not be sustained.

In contrast, the report and testimony of plaintiff's highly qualified subsidized housing expert, Scott McLaughlin, fully comply with Wisconsin law and establish the correct values of the subject property were $2,700,000 for 2012 and $2,730,000 for 2013. (Ex. 40.)

If the City's assessors are not required to conform their methodology to WPAM requirements, the economic viability of plaintiff's low income housing development is doomed. (R.37, pp. 62, 257-63.)

For all of the foregoing reasons, plaintiff respectfully requests that the Court reverse the trial court's judgment; reduce the 2012 and 2013 assessments to $2,700,000 and $2,730,000, respectively; and direct the entry of judgment in plaintiff's favor for refunds totaling $90,976.52, plus statutory interest and costs. (Ex. 1; Supp. App. 1.)

Dated this 20th day of March, 2015.

Respectfully submitted,

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FORM AND LENGTH CERTIFICATION

I certify that this brief conforms to the rules contained in § 809.19(8)(b) for a brief produced using proportional serif font. The length of this brief is 2,994 words.

Dated this 20th day of March, 2015.

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APPENDIX CERTIFICATION

I hereby certify that filed with this Reply Brief, either as a separate document or as a part of this brief, is an appendix that complies with sec. 809.19(2)(a), as applicable.

I further certify that if the record is required by law to be confidential, the portions of the record included in the appendix are reproduced using first names and last initials instead of full names of persons, specifically including juveniles and parents of juveniles, with a notation that the portions of the record have been so reproduced to preserve confidentiality and with appropriate references to the record.

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E-FILING CERTIFICATION

Pursuant to Wis. Stat. § 809.19(12)(f), I hereby certify that the text of the electronic copies of Appellant's Reply Brief and Supplemental Appendix are identical to the text of the paper copies.

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CERTIFICATE OF MAILING

I certify that Appellant's Reply Brief and Supplemental Appendix was sent via Federal Express on March 20, 2015 for delivery to the Clerk of the Court of Appeals. I further certify that the Reply Brief was correctly addressed and postage was pre-paid.

Dated this 20th day of March, 2015.

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